S. HRG. 103-199

ADMINISTRATION'S TAX PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

FOREIGN TAX, POSSESSIONS TAX CREDIT, INVESTMENT TAX CREDIT, BUSINESS MEALS AND ENTERTAINMENT, AND OTHER TAX MATTERS

APRIL 27, 29, AND 30, 1993

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THURSDAY, APRIL 29, 1993

(INVESTMENT TAX CREDIT AND BUSINESS MEALS AND ENTERTAINMENT)

COMMUNICATIONS

ADMINISTRATION'S TAX PROPOSALS (FOREIGN TAX AND THE POSSESSIONS TAX CREDIT—SECTION 936 OF THE INTERNAL REVENUE CODE)

TUESDAY, APRIL 27, 1993

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Baucus, Mitchell, Pryor, Riegle, Breaux, Conrad, Packwood, Grassley, and Hatch.

[The press release announcing the hearing follows:]

[Press Release No. H–14, April 22, 1993]

FINANCE COMMITTEE TO CONTINUE HEARINGS ON ADMINISTRATION'S TAX PROPOSALS

Senator Daniel Patrick Moynihan (D.–NY), Chairman of the Senate Committee on Finance, announced today that the Committee will hold two more hearings on the Administration's tax proposals.

The hearings will begin at *10:00 a.m. on Tuesday, April 27 and at 9:30 a.m. on Thursday, April 29* in room SD–215, Dirksen Senate Office Building.

On April 27, the Committee will hear testimony on the five foreign provisions in the administration's budget, and on the proposals regarding the possession tax credit—Section 936 of the Internal Revenue Code. On April 29, the Committee will consider the investment tax credit proposal, the business meals and entertainment proposal and the moving expense proposal.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. A very good morning to our distinguished guests and our witnesses this morning. This is a regular meeting of the Committee on Finance to continue our hearings on the President's tax proposals that are a part of the budget reconciliation measure which is to be reported by this committee on June 18.

One of the more dramatic departures from the Tax Code of the last 80 or 70 years has been the proposal to sharply cut back the benefits available to corporations located in Puerto Rico under Section 936 of the Tax Code. This is not generally recalled.

It was a provision that was put in place in the first instance to encourage American investment in the Philippines. Over the years it has become the source of a very great deal of economic activity in Puerto Rico and, directly or indirectly, one out of every five jobs in the Commonwealth depends on this provision.

The Congress modified it in the 1980's and required that certain portions of the profits made in the Commonwealth be kept there prior to being brought back to the mainland. But basically it has been intact since its enactment in the 1920's.

Now the President proposes a very large change, not entirely to abolish the tax benefit but to curtail it severely and the consequences will be many.

We are here this morning to learn of those consequences. We are going to have in the first instance a remarkable panel. The Honorable Carlos Romero-Barceló, formerly Governor of the Commonwealth, now its representative in Congress; Hon. Luis Guitierrez, who is the U.S. Representative from the State of Illinois from the Chicago Region; and Hon. Pedro Rosselló, who is the incumbent Governor of Puerto Rico.

They will be introduced in turn by my most eminent and distinguished colleague the irrepressible and always welcome member of the Committee on Ways and Means, Charlie Rangel of Manhattan. We are going to welcome you in just one moment, sir. You will have the opportunity to thank the members, too.

Senator PACKWOOD. Irrepressible, distinguished and what? [Laughter.]

The CHAIRMAN. Leave the last term vague. You never know what term might prove most appropriate. [Laughter.]

Senator PACKWOOD. In any event, I agree with all of the words you have used, Mr. Chairman. I have no opening statement.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. I will wait. No opening remarks.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. I just want to welcome our distinguished visitors and our distinguished Señor Rangel to introduce them. We appreciate that.

Congressman RANGEL. Mucho gusto. [Laughter.]

Senator BREAUX. Thank you.

STATEMENT OF HON. CHARLES B. RANGEL, A U.S. REPRESENTATIVE FROM NEW YORK

Congressman RANGEL. Mr. Chairman, I cannot tell you the great sense of pride that I feel as a New Yorker to see you sitting here on this most important Finance Committee. I wish you well. And as you know, any way that I can be supportive in the other House, we stand ready to work together because a lot of us believe that what is good for New York is good for the nation.

But now that you have this source of responsibility, we have to really be supportive of you and I look forward to working with you.

I want to thank this committee for giving me the extraordinary opportunity to present two people that certainly do not have to be introduced—a former Governor and outstanding public servant in Puerto Rico, who now serves as Congressman, as you indicated; and the new Governor, Rosselló, who comes here.

The basic reason that I am here presenting them really is because I hope they can get a more receptive ear on the Senate Finance Committee than they did in the House.

Over the years, I have been led to believe that the 936 tax incentive is a very, very expensive way to create jobs and that there

ought to be a better way to do it, that many of the corporations that have taken advantage of this tax incentive have indeed abused it. I have been led to believe that many of the pharmaceutical corporations have really obtained obscene profits without considering their consumer. And, again, we encourage them to continue to enjoy the 936 program.

Now I say all these things to make it abundantly clear that I do not come here to support 936. What I am concerned about, however, is how someone can make the decision that the program is not working, claim that we are going to save $7 billion without any hearings in Washington or in Puerto Rico, or without giving some assurances to these citizens who we call on every time there is a war, who we feel sympathy for when we see the height of their unemployment, who we have compassion for when we see the depth of illness and the high mortality rates they have in their hospitals, how we can make this decision not knowing what impact it is going to have on the economy.

One of the things is that they have so many different views as to what would be better than 936, that I really think that the President would have a hard time selecting one of them.

But it seems to me, Mr. Chairman, that if we are going to have any fairness at all with how we treat Americans, that at least we ought to evaluate what we are doing before we do it. And if there is a better way to support our friends and our citizens in Puerto Rico, let us get on with it.

But it frightens me to see how, with the high unemployment they are going through now, that we can take the risk of just dramatically changing and reaching this arbitrary figure of $7 billion without taking into consideration what impact it is going to have.

The elected officials can more eloquently present their argument than I. But I do hope that they do have a better hearing on this side of the Capitol than they were able to get in the House of Representatives.

I thank you for listening to me.

The CHAIRMAN. Well, we thank you, sir, most emphatically. I think your point is that hearings should be held. And for lack of a better setting, and I cannot imagine save for on the Island itself, a better setting than the Committee on Finance. We will hold those hearings in the spirit you request, very properly request, indeed insist upon.

You are right as a ranking figure in the Committee on Ways and Means and a very welcome participant in our discussions at any given time. We thank you, sir.

Senator Packwood?

Senator PACKWOOD. No statement, Mr. Chairman.

The CHAIRMAN. Thank you, Congressman Rangel.

Congressman RANGEL. You have been generous with your time. I thank the committee.

The CHAIRMAN. Now if the gentlemen that Representative Rangel mentioned would come forward—Governor Rosselló, Governor Romero-Barceló. Governor Romeró, I think you will speak first as the sort of senior Representative present.

Representative Gutierrez, we welcome you, sir. We took the occasion to have your colleague, Mr. Rangel, just introduce the three

of you. Consider yourself introduced. You need no introduction to this committee. You and Governor Rosselló are very welcome.

We will go first with you, Governor Romero-Barceló.

STATEMENT OF HON. CARLOS A. ROMERO-BARCELÓ, M.C., PUERTO RICO

Congressman ROMERO-BARCELÓ. Thank you, Mr. Chairman, Senator Packwood, Senator Pryor and Senator Breaux.

Before we start, Mr. Chairman, do we have a time allotment?

The CHAIRMAN. Most do; you do not. You are a member of the other body and you speak as long—now if come noon time and some of us have wandered away— [Laughter.]

Congressman ROMERO-BARCELÓ. I would just like to make sure how much time I had before I begin so I can organize.

I have drafted a statement, which has been submitted.

The CHAIRMAN. It will be placed in the record as if read.

[The prepared statement of Congressman Barceló appears in the appendix.]

Congressman ROMERO-BARCELÓ. I am going to make reference to that statement, but speak on it and not read from it.

In the first place, we are grateful for the opportunity to testify here before you on an issue that is extremely important to Puerto Rico and which has been discussed at length for many, many, many years. Unfortunately, the discussions have not always been held according to the truth or the facts.

The facts have many times been distorted. The facts have been many times exaggerated. There has been a hysteria created in Puerto Rico by those that have a special interest in the 936 tax exempt corporations where the people have been led to believe that any change, any change whatsoever, in Section 936 will create massive unemployment.

In the past electoral campaign the opposition claimed that if I was elected all the 936 plants would close down because I had serious questions about the benefits of the 936 tax credits as they are now legislated. They say that 300,000 jobs would be lost and there would be chaos in Puerto. So everything in the economy depended on the Section 936.

Whereas, we look around and 50 States of the Union do not have Section 936 and none of the other countries in the world have Section 936 and they have their economies going.

So I just wanted to bring that into perspective because I am here today, Mr. Chairman, as a representative of 3.6 million American citizens. I represent approximately six times more than every Congressman in the House and more than half of the Senators in the Senate.

Yet, unfortunately, all of those citizens who I represent are disenfranchised and they have no vote. They have no voting representation here in Congress. I wanted to speak for them, not for the 936 companies.

I am representing the interests of the people and the interest of the nation. The Puerto Rican interests of the nation are not always the same as the interests of the 936. I am sure that the 936 companies would not like to pay any income taxes. They see that as their

best interest. That is not necessarily the best interest of Puerto Rico, nor necessarily the best interest of the nation.

So, since they have no money to pay the lobbyists, since they have no money to pay people to represent them here, I am their elected representative and I want to speak for them and what is important for us in Puerto and for the Nation.

I want to make also a strong statement, that I believe very much in investment and expansion, industrial investment, business investment, creation of new jobs, more jobs, permanent jobs, better paying jobs. And I am not sure that people will recognize this, in Puerto Rico particularly. But I am much more concerned about jobs and creation of jobs than any of these corporations themselves. They are more interested in their own welfare, their own financial welfare.

The 936 tax exempt companies and the banks which benefit from those funds that are a low cost to them, and the brokers, and other individuals and beneficiaries of the 936, claim that the section is indispensable as it is.

The Commonwealth supporters, the one that support the Commonwealth status, claim it is indispensable. But the reason why they claim it is indispensable is because they see it politically as a barrier to equality. They claim, and they have so stated many times, that as long as 936 Section is there, it establishes a difference between Puerto Rico and the States. And they can claim that those benefits are the only ones that will strengthen the economy in Puerto Rico.

Therefore, to become equal, politically and economically, will be harmful to Puerto Rico. They use that argument against 936. That is why you will hear them here today arguing also against any changes in 936 and claiming that it must stay as it is. It is from a political partisan point of view and not taking into consideration and then analyzing the facts as they are.

If we examine corporation by corporation you will find that even as the credits that are proposed by President Clinton—65 percent wage tax credit—many companies will not be paying a single penny in Federal income taxes because the credit is high enough to absorb all the tax liability that they will be subject to.

There are others that will be paying little taxes with 65 percent wages and others that will be paying more. But we must also keep in mind that Puerto Rico's incentives to investment are not only tax exemptions.

We have the following other tax investment incentives, which are first of all, a plentiful, trained work force. And a plentiful supply of workers which are easily trainable.

A productivity that has been recognized here in the nation by the United States Manufacturers' Association and by other institutions that have made the studies as to productivity, as being more productive than the mainland workers. That is another incentive.

The wages are on an average half of the wages that are found in the mainland. Even in the poorest States, when compared to the poorest States, the lowest wages, our wages are about two-thirds of the wages in the poorest States, the States with the lowest wages.

We have an infrastructure that is comparable to the infrastructure of many States, an infrastructure better than some of the States, an infrastructure not as good as other States. But it is comparable on the average. And we have instant audio-visual communication with the rest of the nation which is unavailable in most foreign jurisdictions in this continent, in the Western Hemisphere.

We have an enviable geographic location, right in the center between North America and South America, right to the eastern end of the Caribbean, where the sea leans and the air routes converge and it has easy access for the Nation, particularly to the eastern seaboard and the Southern States.

We have the same dollar, the same money, the same coin. There is no problem with currency exchanges. We have political and economic stability unavailable in most of the other countries in the Western Hemisphere.

And we have now something which is very important. The only place in the United States, and the only place in America, where both English and Spanish are official languages, which is a great incentive for anyone who is dealing with the mainland, and Canada, and South America. So these are incentives that are there beyond the tax incentives.

I sometimes feel resentful when I hear people that there are no other incentives in Puerto Rico, that Puerto Rico needs real, real special treatment. Otherwise, we cannot bring anyone there. It makes us look like we're less. People feel that we are less than what we really are. We have a lot going for us.

But it is true, that as long as we are not part and we are not conceived as a domestic investment area, as long as we are conceived as a foreign investment area, we should have some special benefits.

Let me address myself now to corporations by corporations because some of the corporations have come to see me, to tell me about what a catastrophe is going to be if any changes are enacted on 936—they are threatening that they will leave. They are saying, we will have to make reconsideration of our investment strategies. We might have to close plants. We might not expand. We might end up by moving somewhere else. But they say, we are not saying we are going to do it, but we might.

Most of those companies that are saying that today, Mr. Chairman, were exactly the same companies that back in 1978 when I was Governor of Puerto Rico and imposed the first local income taxes on those companies said, those are exactly the same ones, who did not leave.

As a matter of fact, one of them came to see me—that is Baxter Travenol. Their executive vice president came to see me. I asked him some questions because they started telling me how they were going to leave. I said, what is your net income last year; and they said $247 million.

I said, well, with $247 million, you take 36 percent of that, and you have $89 million that you would be paying in taxes in any one of the 50 States.

And what was your payroll? They said $115 million. Well, you multiply 65 percent by $115 million and you get $75 million. So it means that in Puerto Rico, different from other States where you

would pay $89 million, you would pay $89 million minus $75 million. That would be $14 million.

I said, now, look me straight in the eye and tell me that that is not enough incentive to grow, to expand, to have more companies in Puerto Rico. He looked at me and then he looked at the other fellow that was next to him and asked, are those the right numbers?

Another company came to see me, a pharmaceutical. It has a small investment in Puerto Rico. When I asked him the same questions, it turned out that their tax liability would be $6,250,000 and their wage tax credit would be $8,750,000. In other words, they had $2.5 million more credits than they had tax liability. I said, how come. How does this hurt you?

So I would ask you that as the companies come and move here that you ask them those questions, what their net income was, and what is their payroll, so you can make those simple arithmetic calculations.

The Government Development Bank in Puerto Rico has put together a study, which I submit with my testimony, where it shows that under my proposal that they be given not a 65 percent wage tax credit, but a 100 percent wage tax credit. Eighty percent of the companies in Puerto Rico, or they represent 80 percent of the workers, they would have complete tax credit—they would not pay anything—or at the most their tax liability would be under 25 percent of the total tax liability they were treated as a State.

And that only 20 percent will be subject to, either with my proposal or with the President's proposal, that only 20 percent would be subject to a tax liability between 50 and 75 percent.

Now I ask, 25 percent tax credit, is that enough stimulus or is it not? That's something that only the numbers and specific questions would demonstrate. But I submit that if a 25 percent tax credit were offered to any state of the Union, they would rip the President's arm.

I think it is still a good tax credit, though it might not be sufficient. We do not know exactly. I cannot judge that. But I think I want to bring these facts because what we have to determine here is not what is best for the 936 companies but what is best for Puerto Rico and what is best for the nation and that these facts should be examined; and that we should not accept all the testimonies that come here with exaggerations saying what is going to happen in Puerto Rico.

Because as you will see, all those testimonies start from an assumption that if 936 is changed, there will be a catastrophe in Puerto Rico, that companies will leave. They do not give you the numbers showing why they will leave. There is no analysis why they will leave. And they refuse to come up with those numbers. I think there are a lot of exaggerations.

However, we want to do what is best for Puerto Rico. I have no problems and I want to say it here clearly that I support whatever the Governor of Puerto Rico submits. I have not read it. I have not had the opportunity to see what it is. I have not discussed it with him.

But whatever is best I will support. But I would like to make two caveats, two conditions. First of all is that I think the tax credit

as it is now written in 936 has not been shown to be a good tax credit in terms of providing jobs.

As you will see from my testimony and from the financial report by the Government Development Bank, the 936 companies in Puerto Rico account, in terms of manufacturing jobs, for 16.8 percent of the total number of jobs. Whereas, two decades ago they were 19.3 percent.

In other words, instead of the manufacturing jobs having grown with the existence of Section 936 as a percentage of the total employment, they have decreased approximately by almost 3 percent. So they have not been doing the job they are supposed to do. A wage tax credit goes directly to the jugular. It is directly an incentive for job creation, which is what we have to consider here when we discuss Puerto Rico.

Therefore, I understand that there is going to be an option offered for the companies, an alternative suggested that the companies can also take the wage tax credit or the income tax credit which now exists, reducing it to 90 percent and then to 80 percent.

I have no objection with an alternative if that option is reduced to zero eventually, whether it be in 5 years or 10 years or 7 years or whatever. But that the tax incentives as they are now, that they be eliminated because I think the evidence is sufficient and I think it is overwhelming to demonstrate that the tax credit as it is now legislated is not going to be providing more jobs.

The other caveat, or condition, which is very important, considering that the most important thing that we have now on the legislative agenda before this Congress is health care; whether a new health care plan is approved or not, Puerto Rico now receives only $79 million under Medicaid, and this issue must be addressed.

If we were treated as a State, we would be receiving over $1 billion. This is health care, Mr. Chairman. This is not welfare. It is inconceivable that in this day and age that American citizens in Puerto Rico, in the Virgin Islands, in Guam, and other territories, are not treated as Americans when health care is discussed and when health care is legislated.

When I was a Mayor, and when I was a Governor, I came here seeking equality, equal treatment, parity in Medicaid, and I was told, look, Puerto Rico is getting enough money. You have over $7 billion in total Federal programs. That is what it grew up to. It was not that when I started. Thus, do not even think about it. We might give you a few dollars more, but we are not going to make you whole in Medicaid.

The CHAIRMAN. If I could say my dear friend, you and I have talked about these matters for some time when I was at the United Nations—that would go back 18 years. On health care, though, we have learned in the press this morning that the Director of the Budget says we will not be getting to health care until next year. So perhaps we should stay on taxes today.

Congressman ROMERO-BARCELÓ. Right.

The CHAIRMAN. Your point is properly taken.

Congressman ROMERO-BARCELÓ. Yes. But let me just say that it was also said, you do not pay income tax. This will be the first time that income taxes will be collected from Puerto Rico.

The CHAIRMAN. Right, corporate taxes.

Congressman ROMERO-BARCELÓ. And I think this committee has jurisdiction over both issues. The policy decisions should be made simultaneously.

The CHAIRMAN. And they certainly affect one the other.

Congressman ROMERO-BARCELÓ. Right.

The CHAIRMAN. We thank you very much, sir.

Congressman ROMERO-BARCELÓ. Thank you very much.

The CHAIRMAN. Representative Gutierrez, we look forward to hearing from you, sir.

Congressman GUTIERREZ. Mr. Chairman, thank you very, very much.

The CHAIRMAN. I believe this is your first appearance before the Finance Committee, isn't it?

Congressman GUTIERREZ. Yes, it is, Mr. Chairman. I hope not my last.

The CHAIRMAN. I am sure it will not be. We welcome you.

Congressman GUTIERREZ. Mr. Chairman, I would respectfully request, given the fact that the Resident Commissioner of Puerto Rico has suggested that he is going to be supporting the observations made by the Governor of Puerto Rico here today, and that is indeed the vein in which I come before this committee, that if we could, Mr. Chairman, with all due respect, hear from the Governor of Puerto Rico, Pedro Rosselló, I think it would help me in terms of what I would like to say here.

The CHAIRMAN. Fine. If that is your wish, we would defer to any member of the other body.

Congressman GUTIERREZ. Thank you very much, Mr. Chairman.

The CHAIRMAN. Governor Rosselló, this would be your first appearance and we welcome you, sir, as the Governor of Puerto Rico.

STATEMENT OF HON. PEDRO J. ROSSELLÓ, GOVERNOR OF PUERTO RICO, SAN JUAN, PR

Governor ROSSELLÓ. Thank you very much, Mr. Chairman, distinguished members of the Committee on Finance. My name is Pedro Rosselló. I am the Governor of Puerto Rico.

I welcome this opportunity to testify regarding changes proposed by the administration to Section 936 of the Internal Revenue Code. A letter from President Clinton was read aloud at my inauguration ceremony this past January 2.

The following is a direct quotation from that letter, and I quote, "As President, I will try to ensure that the Federal Government does its part to help Puerto Ricans with the issues that they face. The administration will consider the circumstances and needs of Puerto Rico as it develops and implements policies that would substantially affect the Island."

To date, I am sorry to report, the recommendations of the executive branch with respect to Section 936 have contradicted that promise. They also contradict the intended purpose of President Clinton's policy of providing opportunities for all Americans.

We in Puerto Rico support the President's objectives and are fully prepared to assume our proportionate share of the burden. Indeed, we strongly endorse many of the administration's specific proposals—among them, the rebuilding of our Nation's infrastructure, and reform of the health care system.

In one key area, however, executive branch policy planners seem to have lost sight of President Clinton's bottom line—that, of course, is jobs—jobs for American citizens.

Nowhere is the need for jobs greater than in Puerto Rico, where unemployment now exceeds 18 percent—2½ times the national level, where the per capita income is less than 30 percent of the national average, where the proportion of families subsisting on a poverty-level income approaches 60 percent, while the mainland figure stands at about 10 percent.

Despite this data, the administration is advocating Section 936 amendments that would actually cripple our Island's capacity to attract, and even to retain, job-creating private sector investment.

Currently, more than 105,000 Puerto Rico residents are employed directly by firms operating under Section 936. These companies also create a significant number of indirect additional jobs elsewhere in the economy.

Section 936 employees account for almost 70 percent of manufacturing jobs in Puerto Rico, and approximately 11 percent of the Island's total employment. Accordingly, whenever the Federal Government contemplates changing Section 936, it is of vital importance to Puerto Rico's government that such changes imperil neither the Island's current employment, nor its future economic development. What is in essence a marginal decision for the Federal Government is a vital and central issue of economic survival to Puerto Rico.

However, peril is pervasive in the administration's latest Section 936 modification plan.

We estimate that these proposals would reduce the annual tax benefits of Section 936 companies by more than 60 percent; would increase the effective tax rates of such enterprises to a level that when Puerto Rico tax levies are factored in would leave the Island noncompetitive; would drain the pool of Section 936 funds by 75 percent; and would slash, by amounts ranging from 25 percent up to 75 percent, the tax benefits pertaining to the companies which employ just about two-thirds of all men and women working at Section 936 enterprises.

That is what I mean by pervasive peril.

None of this is intended to imply that the status quo is ideal. Section 936 can be rendered more effective. I am not here to insist that this incentive program be treated as a sacred cow. As I have already said, Puerto Rico is fully prepared to accept its proportionate share of sacrifice in the national interest.

Nevertheless, using whatever parameters you may choose, the sacrifice being proposed by the executive branch is disproportionate and is crippling to our objectives of building a competitive economy.

The inequity to which I refer can easily and dramatically be quantified. The administration's national economic blueprint envisions sacrifice in the form of tax increases that total about $1,200 per person in the average State. Puerto Rico, by contrast, would be expected, solely through changes in Section 936, to generate new Federal revenues at a level equivalent to $2,000 per person.

In the context of relative income differentials, I may add, this is six times more than the contribution per capita being sought of mainland citizens. I believe that by any yardstick that is unfair.

Moreover, we must keep in mind the extraordinary economic challenges that Puerto Rico confronts.

Although the Island's population density is 15 times the national average, Puerto Rico's current territorial political status has left our people without full access to many basic services. Just last week the Census Bureau revealed that Puerto Rico trailed all 50 States in fiscal year 1992 Federal spending per person, receiving barely half the amount spent in an average State. Obviously, that helps to explain why our economy is less robust.

The provisions of the North American Free Trade Agreement would reduce our ability to compete with foreign countries for several types of labor intensive enterprise.

I respectfully submit that in any of your States 18 percent unemployment would constitute a dangerously explosive situation. Yet, it is against this backdrop, on the premise that it can yield $7.3 billion in revenue over the next 5 years, that the executive branch of the Federal Government today advocates the virtual destruction of Puerto Rico's principal economic development tool.

This cannot be decided merely as a numbers game. The President has asked us to "put people first." This is precisely our plea to the Senate, the House of Representatives, and the White House.

President Clinton has stated he wants to create more jobs, better jobs, higher paying jobs for the American people. Where Puerto Rico is concerned, the administration's current proposal would do just the opposite.

All rational analysis shows that the administration's current proposal will result in a weakened, more dependent economy, a significant loss of American jobs, greatly diminished local tax revenues, and higher capital costs.

The price tag on that projected $7.3 billion in new revenue is simply too high. It sadly reminds me of the Vietnam war story about the village that supposedly had to be "destroyed in order to save it." The Federal Government cannot foster renewed economic growth by taking jobs away from a community of 3.6 million American citizens that needs new jobs perhaps more than any other.

As an alternative to the administration's plan, we propose the enactment of an incentive comprised of two options.

Under the first option, a 936 firm would receive a tax credit equal to the sum of the total compensation it pays to its employees; all of the corporation's Puerto Rico income and tollgate taxes; Federal income taxes attributable to the company's qualified possessions source investment income; and 10 percent of its new capital investment in plant, machinery and equipment.

Or under the second option, the 936 corporation would receive an income-based credit that would be phased down to 90 percent of the existing Section 936 credit in 1994, and to 80 percent in subsequent years. This plan would provide new Federal revenues of $2.8 billion.

Today we bring before you this proposal, which would allow Puerto Rico to participate in the sacrifices being asked of all Americans, but which will also permit us to build a more productive, more competitive, and less dependent economy. We seek not handouts, but instruments for productive development.

Our proposal, which I am submitting to you in more detail as an addendum, and which I urge you to accept, offers a realistic approach to revenue enhancement, and thus to proportionate shared sacrifice by Puerto Ricans. Unlike the administration's proposal, this plan has broad-based backing from labor, business, financial and professional organizations on the Island, as well as Latino and Hispanic leadership groups on the mainland.

But most of all, my proposal provides a foundation upon which Puerto Rico can continue to construct a more self-sufficient economy, one that will propel us closer to equality—equality of rights, equality of opportunity, equality of responsibility—the equality with which you and your constituents are blessed.

We ask for this as fellow American citizens. Thank you very much.

The CHAIRMAN. Thank you, Governor Rosselló, for a very carefully crafted statement, with some very important and challenging numbers which we will have occasion to address during questioning.

[The prepared statement of Governor Rosselló appears in the appendix.]

The CHAIRMAN. And now, Representative Gutierrez, we welcome you again, sir.

STATEMENT OF HON. LUIS V. GUTIERREZ, U.S. REPRESENTATIVE FROM THE STATE OF ILLINOIS

Congressman GUTIERREZ. Thank you, Mr. Chairman. Members of the Senate Finance Committee, thank you for the opportunity of allowing me to testify before you today.

I come before you as a Congressman of a heavily Puerto Rican District in Chicago and as a Puerto Rican myself.

Since the beginning of the current hurricane, 936, I have urged all interested parties in Puerto Rico to unite and to speak with a single voice. I have refrained from commenting specifically on any of the different counter proposals that have come from Puerto Rico to President Clinton's proposal to eliminate Section 936.

I have studied, and will continue to study, such proposals as much as possible in consultation with the Governor of Puerto Rico, and with other Puerto Rican leadership. I will, in the end, support that proposal or set of proposals which helps the Puerto Rican economy the most.

I know Governor Rosselló has been working hard to develop such a proposal and we have heard it here this morning. So have other Puerto Rican leadership and I look forward to hearing from them.

I would like, however, to comment on some general principals that in my opinion should be considered seriously during this discussion. Puerto Rico is a United States' possession. Technically, Puerto Rico is an unincorporated United States' territory. In reality, this means Puerto Rico is a colony of the United States.

Since the Congress assumed sovereignty over the Island and its inhabitants, Congress has controlled the economy of Puerto Rico. Every single important aspect of the economy, from minimum wage laws, to foreign trade, to the extension of coast wise shipping laws to Puerto Rico, currency, immigration, they are all under the juris-

diction of the Congress. The application of 936 to Puerto Rico is but another example of this.

It is my view that the Puerto Rican people have the right to self-determination. We, as a people, have yet to exercise this inalienable right. Perhaps the best example of the need of Puerto Rico to have self-determination is the current debate over Section 936.

Lacking from the official discussion of this issue is consideration of the Puerto Rican point of view. What impact will it have on the Island's economy and, more importantly, on the future of Puerto Rico? Did anyone consider the impact something of this magnitude will have on the lives of 6 million Puerto Ricans, both on the Island and in every single Puerto Rican community on the mainland, including my own in Chicago?

The elimination of substantial modification of 936 without an adequate substitute or safeguard will result, no doubt, in an unprecedented economic crisis on the Island, greatly increased unemployment, and heavy migration to our already overburdened cities, and communities on the mainland.

To be sure, Mr. Chairman, much may be said, and much has been said, in criticism of the way the Puerto Rican economy operates under Section 936. It is not perfect. As you may know, Mr. Chairman, I favor independence for Puerto Rico. And while I agree there is much to be improved with Section 936 as it relates to the environment, to labor relations, to the use of 936 bank deposits, to the lack of involvement of 936 companies with the development of the Puerto Rican community on the mainland and other aspects of the Section; and, while not only the demise of the Section, but the way this whole affair has been handled may seem on the surface to be good for the cause of independence, the truth is that it would be totally irresponsible for anyone to advocate a cause, be it independence, commonwealth or statehood at the cost of the livelihood of tens of thousands of Puerto Rican workers and their families.

The way the current debate is unfolding is unfortunate. If there are concerns about the pharmaceutical companies and the prices they charge for medicines, let us deal with that issue as such. If there are problems with the so-called runaway plants, let us deal with that issue as such. If some companies may be abusing Section 936 by transferring and, therefore, sheltering profits from continental operations which should otherwise be federally taxable, then let us work to close such loopholes.

But what I strongly object to, respectfully, Mr. Chairman, is to proceed in such a fashion as to drastically alter the current basis of the Puerto Rican economy without considering the impact this will have, not only on the economy of the Island, and subsequently on Districts like mine, but just as importantly, the impact this would have on the whole status question debate on the Island. And this, Mr. Chairman, would be done, really in the absence of meaningful participation by the people of Puerto Rico in the process.

Mr. Chairman, Puerto Rico is not a state of the union. Puerto Rico does not have voting representation in Congress. The only participation Puerto Ricans had in the Vietnam War situation, for example, which many believe started our great deficit problem, was to have young men die on the battlefield in disproportionate numbers.

Puerto Ricans did not vote to elect the President, nor the Congress, which ran the huge deficits for that war and the subsequent deficits. Puerto Rico always received a fraction of the Federal funds it would receive if it were a State. Our Vietnam veterans, and this is a shame, do not receive in Puerto Rico the same benefits veterans receive on the mainland.

Puerto Rican communities on the mainland, Mr. Chairman—and I know you have studied this in depth—are some of the poorest in our country.

So I respectfully ask, how come Puerto Ricans who benefited the least from the spending bonanza that led to our huge deficit, who were not represented on the decision making bodies that created this deficit, who have a per capita income of about half of that of Mississippi, and a third of our National average, who last year received about half the Federal outlays per person of our National average and who suffer from at least twice the national unemployment rate, however, Mr. Chairman, is the economy of Puerto Rico expected to contribute more than twice to the President's deficit reduction initiative than those of us on the mainland are being asked to do?

If you consider all of the factors cited above, you are asking the fragile Puerto Rican economy to contribute at least 12 times as much per person to the reduction of the deficit than what is being asked of the U.S. economy as a whole.

Mr. Chairman, I wholeheartedly agree with the March 24 Washington Post editorial that there is no "Puerto Rican Policy" behind the proposal to eliminate Section 936. In fact, Mr. Chairman, I am informed there is currently not even a Presidential Advisor on Puerto Rican matters in the White House.

Mr. Chairman, I respectfully submit to you, and to this committee, that to continue down this path will prove to be disastrous both for Puerto Rico and the United States. I again respectfully submit to you that the time has come to review in depth and comprehensively the relationship between the United States and Puerto Rico and to proceed decisively and constructively along a dignified path of self-determination for the people of Puerto Rico.

For only in such a context does it make sense to study any proposal to significantly alter the very basis Congress itself laid out for the current economy of Puerto Rico to grow and develop. I cannot think of a better investment of our taxpayer dollars than to provide for the health economic development of the Island of Puerto Rico, regardless of the final outcome of the status question in Puerto Rico.

In closing, Mr. Chairman, I can assure you not only of my support for the President's overall plan for deficit reduction, but also that of all Puerto Ricans. Let us, however, remain cognizant about the history and reality of Puerto Rico and Puerto Ricans so as not to create a worse problem than we are trying to address here today.

Thank you very much, Mr. Chairman.

The CHAIRMAN. We thank you, sir, for a very powerful and cogent testimony.

[The prepared statement of Congressman Gutierrez appears in the appendix.]

The CHAIRMAN. If you won't mind, and I am sure you won't, I would just like to make one statement before general questioning. In respect to your statement, you say, and correctly, ". . . it is my view that the Puerto Rican people have a right to self-determination."

I mentioned earlier that I was the U.S. Ambassador to the United Nations under President Ford. That is the first occasion on which I had the honor to meet Governor Romero-Barceló. He was then Governor of Puerto Rico.

There was a movement in the United Nations to denounce the United States for its relationship to Puerto Rico as one of being a colonial power to a colony. I made the point, on behalf of President Ford, that every President of the United States since Harry S. Truman has proclaimed to the people of Puerto Rico, to the United States, and to the world, that the people of Puerto Rico are free to chose between Commonwealth status, which is the present status, and which was chosen in 1967, alternately, independence, which you have said you favor, sir, or statehood.

This is a free choice, and I think this question is coming around again as it does regularly. But the right of self-determination has been proclaimed by the United States, and I am sure it will be respected by this Congress, and I cannot doubt it will also be proclaimed by this administration.

So with that, agreeing with you, setting that record clear, I would like to thank you all and we will turn now to questions.

And first of all, of course, to the Senator, sometimes Chairman, once and future Chairman if we do not get this tax bill through. [Laughter.]

The CHAIRMAN. If we get it through. Correction is heard.

Senator PACKWOOD. That is correct. I am praying for the tax bill, Mr. Chairman.

Governor Rosselló, let me ask you just one question about a statistic in your statement. It is on page 3. "The inequity to which I refer can easily and dramatically be quantified. The administration's national economical blueprint envisions sacrifice in the form of tax increases that total about $1,200 per person in the average State. Puerto Rico, by contrast, would be expected solely through changes in Section 936 to generate new Federal revenue at a level equivalent to $2,000 per person."

I am intrigued with your first figure. The President's tax plan, I assume is what you mean by the economic blueprint.

Governor ROSSELLÓ. Yes.

Senator PACKWOOD. Is going to cost about $1,200 per person in the average State, close to $5,000 for a family of four.

Governor ROSSELLÓ. That is correct.

Senator PACKWOOD. What is your source on that? I would love to have that.

The CHAIRMAN. Well, would the Senator yield for questions. Take 272 and you divide it by 256 you get more than 1,000. Multiply it by five and you get close to 5,000 per family.

Senator PACKWOOD. Thank you. I appreciate that.

Governor ROSSELLÓ. Thank you, Mr. Chairman.

Senator PACKWOOD. Now, how solely through the changes in 936 do you come to $2,000 per person in Puerto Rico just on 936?

Governor ROSSELLÓ. When you divide the $7.3 billion by 3.6 million inhabitants, you come up to that figure.

Senator PACKWOOD. On 936 alone?

Governor ROSSELLÓ. On 936 alone.

Senator PACKWOOD. Mr. Chairman, thank you. I have no other questions.

The CHAIRMAN. I thought you might not. [Laughter.]

Senator Pryor, you now have extra time.

Senator PRYOR. I hope I won't abuse that, Mr. Chairman. Thank you.

I have enjoyed very much, Mr. Chairman, the personal discussions with I have had with the Congressman and the Governor from Puerto Rico. I look forward to visiting with our new friend from Illinois on this issue.

I think, Mr. Chairman, my concern basically about Section 936 is that it, simply put, it is out of whack; and it has become skewed to the extent that I think we need to make a, you might say, midterm correction in Section 936. I think we have to change it.

I am not one to say we have to totally abolish 936. I think though that we must look at the facts and figures and numbers. And to say that no longer can we justify Section 936 in its present form, providing the results that we are getting today.

For example, one concern that I have had, and I take this, I might say, to the Chairman and to Senator Packwood, from the 1992 GAO report, a very fine report, on just the drug companies in Puerto Rico during 1987, that the drug companies, some are receiving a $71,000 tax credit per employee. That the average wage for those same employees is on the average $26,000, leaving a $45,000 differential.

The $45,000 differential, that goes into the pockets of the pharmaceutical companies and that is not allocated for the benefit of the people of Puerto Rico.

Mr. Chairman, I would like to say something else. I would like to state, and I have seen studies on this, that the people of Puerto Rico, according to these studies, and according to industry records, are perhaps the most productive people on the face of the earth. I commend the worth ethic of the people.

I think the drug companies in particular are taking advantage of those people. I think they are taking advantage of this great island. And I think that the system as I have said is out of whack, the benefits of this present 936 law that we have in the IRS Code, the real benefits, go to the companies rather than to this Commonwealth and to the people.

If I were a drug company I would go to Puerto Rico, and I would manufacture my drugs in Puerto Rico. That is where I would be set up because the law encourages this abuse.

I think all of these fears that are being cast about, about all the companies that are going to be leaving this island if 936 is changed, if it is modified to any extent, I think is a threat.

I think it is a threat. It is a fear tactic. I think that it is a sad situation when we see the drug companies basically casting this fear on the Island as it is. And I think we can change this proposal. I am not sure that I support President Clinton's 60-percent approach. But I am willing to look at it. I am willing to sit down and

talk about it. But I think we have seen a lot of abuse in the system.

I have advocated changing it, sometimes abolishing it. And if we cannot do any of that, then I want a Section 936 to apply to some of those counties in Arkansas with 27 percent unemployment. I would love to see that, Mr. Chairman. I would love to have a 936 for some of those delta counties that have 25 and 27 and 30 percent unemployment.

Mr. Chairman, I thank you and I hope I did not abuse the time.

The CHAIRMAN. You most assuredly did not, Senator Pryor. We thank you.

Senator Breaux?

Senator BREAUX. Well, I thank our distinguished guests for representing Puerto Rico so well, and their constituents so well, in this presentation.

The argument that the administration makes is that by making the change to the 65-percent credit, it would have a positive effect because it would be more closely tying the tax credit to the employment and the possessions in the Commonwealth and would actually be a positive step in encouraging employment not a negative step.

Can you comment on that?

Governor ROSSELLÓ. Sure. I think and I must say that I agree with Senator Pryor's pointing out that there have been some abuses and we come here not to say that this not be changed. If there has been some abuses, then let's deal with the abuses.

But, Senator Breaux, I think that when you quantify the impact and you notice that over two-thirds of the corporations currently under Section 936 will receive a reduction, which is very significant from 25 to 75 percent of their actual tax benefits, then you must realize that maybe not all, but some significant portion of those corporations will have to make decisions that will be based on not continuing or not expanding their operations in Puerto Rico.

It is a significant piece of reduction in benefits. If those operations are taken away, it obviously results in the loss of jobs.

Senator BREAUX. Where do you think they would go?

Governor ROSSELLÓ. Where? Well, Puerto Rico competes right now for that type of industry with places like Singapore and Northern Ireland. Conceivably not in the short run, but *int he* medium- or long-term, they could go into the expanding market that is developing with Mexico and some of the other Latin American countries.

Senator BREAUX. But the point I would make is, if they go to those places they certainly are not going to get the benefit of any kind of 936 tax assistance.

Governor ROSSELLÓ. No, they would get the benefits through Section 901 where they can get credits for whatever taxes are paid locally.

Senator BREAUX. But that does not equal the benefits that you would get even with the 65-percent limitation on Section 936, would it?

Governor ROSSELLÓ. Well, the thing is, Senator Breaux, it is not in a vacuum that you have to examine this. It is where you start from. You are starting from a point where you are asking Puerto

Rico to essentially in the aggregate produce $7.3 billion that has to come out of the economy. I do not think anybody can say here that that is a minor impact on the economy of Puerto Rico.

As far as the Government of Puerto Rico, it also means that the Government of Puerto Rico will have approximately $500 million less in its income tax base for coming years. I think, and I respectfully disagree with our Resident Commissioner, that it would be a major impact in Puerto Rico from the point of view of taxes and the services that the government offers. Additionally, it would impact Puerto Rico as a good scenario for doing business in the manufacturing sector.

I think all the studies have unanimously shown that. I do not think that is a question of arguing with the data. It is whether we can look for an alternative that addresses the national concerns. Yes, Puerto Rico has to participate in the sacrifices.

We are proposing a plan here that will gather new revenues for Treasury to the tune of $2.8 billion, which we think is fair and it is proportionate. And at the same time not cause the disruption that the administration is proposing unanimously as seen as a major attack on the Puerto Rican economy.

Senator BREAUX. Thank you for excellent testimony.

The CHAIRMAN. Thank you, Senator Breaux. We all agree on that point.

Governor Romero-Barceló?

Congressman ROMERO-BARCELÓ. Mr. Chairman, may I elaborate a little bit on this, the issue that was just discussed?

One of my concerns has always been the fact that Section 936 puts Puerto Rico in the position of being a foreign investment area, as a foreign investment tax area. So that the companies in the mainland, the pharmaceutical and all of them, when they are considering their domestic investments, their domestic strategy for investments and expansion, Puerto Rico is not included. And we are not included until they begin thinking of their foreign investments.

If whatever changes are made and Puerto Rico is brought into the physical system of the corporation, in other words, the companies in Puerto Rico are allowed to consolidate their tax returns, then Puerto Rico will be brought into the domestic investment area of concerns. Then companies will start comparing Puerto Rico with the States instead of comparing Puerto Rico with foreign companies because it would be very difficult for us to compete, wage wise and environmentally wise, with foreign countries.

The CHAIRMAN. That is a very interesting point.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Governor, I wonder if you could briefly outline your proposal. I did not understand it to the degree that you referred to it. You said your proposal was appended to your statement. Could you just very briefly outline the provisions of it?

Governor ROSSELLÓ. Sure. Essentially, we have a two-tiered or two-option proposal. One that goes directly to stimulating the labor-intensive sector of manufacturing in Puerto Rico and another to giving incentives to the high capital, low labor intensive sector.

I do not think that it is the objective of the national policy to create low paying jobs for the nation. On the contrary, create more

jobs, but higher paying jobs. And we participate in that goal for Puerto Rico also.

By doing this we provide stimulus to both sectors. One of them is basically based on a wage credit, although we are calling it a total compensation credit to include the benefits, which I must say in Puerto Rico some of the mandated benefits are higher than the wages in many of the competing countries in Latin America. So it would essentially put us out of business.

Including 100 percent wage compensation credit, a credit for whatever taxes are paid in Puerto Rico, a 10-percent credit on new investment in Puerto Rico, and essentially leaving unchanged the so-called passive investment income through qualified possession source investment income in Puerto Rico, which already is in existence. So we would maintain that.

And as a second option for those high capital types of enterprises, address Senator Pryor's concern about abuses and cut down the maximum allowed now under an income-based credit to a 90 percent and then to an 80 percent maximum.

Essentially, when we are talking about $2.8 billion which would be produced by this plan, it is coming essentially from where Senator Pryor has his main concerns. I think those are valid concerns.

So we are proposing here a plan that has a balance on one side, recognizing Puerto Rico's proportionate participation in addressing the national deficit and at the same time allowing us some instruments that will stimulate labor-intensive sectors of our manufacturing industry; and on the other side, retaining some incentives for the high capital, high-tech enterprises which Puerto Rico does want to retain.

Senator BAUCUS. Now what are the revenue estimates of your proposal compared either with current 936 or with the administration's proposed changes?

Governor ROSSELLÓ. Pardon me, sir?

Senator BAUCUS. What are the revenue losses to the United States?

Governor ROSSELLÓ. Well, the current system essentially provides no revenues. The President's proposal would provide $7.3 billion in new revenues from Section 936 corporations. Our proposal would generate $2.8 billion in the same period. So essentially it is $7.3 billion versus $2.8 billion contribution.

Senator BAUCUS. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Could I say to you, Senator Baucus, as well as to our distinguished witnesses, we do have a General Accounting Office estimate of some of the job-related benefits. I believe it was Senator Pryor who asked for that.

In 1987, and I will simply refer to a firm that is located in New York, the Pfizer Co., an extraordinary company, that is where the penicillin in World War II was made. It was invented, developed in Britain. Penicillin actually was made in Brooklyn.

But GAO estimated that there were $156,400 in tax savings for every employee in Puerto Rico. That is a formidable sum.

Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

Let me welcome the new Governor here today. We have not met before. I want to just say at the outset that I have a particular interest in Puerto Rico. My sister lives there and is married to a native citizen of Puerto Rico. So I have taken the time to understand in some detail how 936 works and study the economy of Puerto Rico generally.

I must say, Mr. Chairman, I think we have already heard, despite the fact that there are some differences of view, that the Clinton proposal goes too far. I think it is going to be disruptive and damaging in a way that I do not think anyone intends.

In a sense, we are going to have to figure out how we offset the costs involved in cutting 936. For example, if your unemployment rate, now at 18 percent, goes higher, payments for unemployment compensation will increase. Also costs for food stamps, which is already a major issue, would have to be considered; and a host of other things along that line.

I am struck, too, by the fact that as economies get into economic difficulty and stress we see crime as a consequence usually goes up. And you are struggling with that in Puerto Rico as we are in many of our cities here across the country.

Governor ROSSELLÓ. Absolutely.

Senator RIEGLE. So I am very much concerned as to how far we stretch social fabric in terms of taking the unemployment higher than it is today. Puerto Rico has a very fragile economy. It would be one thing, as you pointed out, if we could go back to another time in the past and maybe do things differently. But that is not where we are. We are where we are today.

I think we have to be very careful about having disruptive affects that we may not intend. I see a real potential there for that. I think as well when you put NAFTA—the North American Free Trade Agreement—the Mexican Free Trade Agreement into this context, it is one more element that also is a very threatening development on the margin.

In Puerto Rico, for example, in answer to Senator Breaux's question, the minimum wage law is in effect. Am I right about that?

Governor ROSSELLÓ. Yes, that is correct.

Senator RIEGLE. So there is a wage differential between Puerto Rico and let's say in Mexico, which is even closer in terms of the transportation issue than the United States——

Governor ROSSELLÓ. That is right.

Senator RIEGLE. And the workers there are working for 75 cents an hour or $1 an hour, leaving for the moment aside the special tax credit features, there are other tax credit features as well—you mentioned 901, I think, Section as well—but those cost differentials on labor alone are so substantial that I can see a runoff of jobs, not just new location decisions being made to go somewhere else.

But I can see why plants that have been around for a number of years in Puerto Rico might be phased out and those plants be re-established. You mentioned Singapore. It is just as easy to do it in Mexico, especially if the Free Trade Agreement is to be enacted. I hope it will not be in the form it is in. But in any event, that is another high risk here.

I am concerned, Mr. Chairman. I know the great concern you have about Puerto Rico. The people there do have to make this sta-

tus decision for themselves. We have been very clear on that. There are different points of view. We have heard some today.

There are people who feel very strongly that the Commonwealth status ought to continue as is. But leaving that very difficult question aside because that is really a question the Puerto Rican people themselves must answer, I do not think we want to take and create a kind of an economic turmoil and upheaval there that can serve no good end, no good purpose.

I think it is a very fragile economy. So while I think some adjustment is needed, I think what the President has proposed goes further than will yield us positive results in the end. I think if we are left with hurtful results, it will not only hurt Puerto Rico, it will hurt this country; and we want neither of those events.

The CHAIRMAN. Thank you, Senator Riegle. We are going to hear, of course, directly—shortly now—from the administration. But the question you put, and Senators Breaux and Pryor and Baucus have said the same, the question of disruption is the question the administration has to answer; and I am sure they will seek to do so. But it has to be addressed. I cannot doubt that the same views are held by Senator Grassley and Senator Hatch. But we will hear.

Thank you, Senator Riegle.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

What sort of effect would a Section 936 based credit have on the pursuit of statehood, if any?

Governor ROSSELLÓ. Senator, I think that the Puerto Rican people will have the opportunity this year, towards the end of this year, to express their will as far as their political status. That is a commitment that we have and we will act upon it.

But I think no matter which of the three alternatives that we have discussed for many years, many decades, you have to start from the point of a strong economy. I do not think it is in the interest of independence or Commonwealth or statehood to start from a weakened economy.

So in a sense, even though status has been discussed here today, I see that no matter what our particular inclinations might be on that, and I am a supporter of statehood, I think each one of the formulas has to start for its success from a strong economy.

So I think in essence the effect would be a neutral effect in terms of simply providing Puerto Rico the instruments, the mechanisms, to leave a dependency state and become more competitive. That is, I think, the basis of our proposal.

Senator GRASSLEY. Governor, Congressman Romero-Barceló said that the 936 credit has done a poor job on creating jobs. Do you agree with that assessment?

Governor ROSSELLÓ. I do not agree with that totally. I think we see one of the effects and we are not seeing what the effect would be without 936. We are seeing just one side. There is data that suggests it has been very important.

In Puerto Rico if you look at the jobs, the high tech jobs have been replacing losses in labor-intensive jobs and manufacturing. In other words, the high technology corporations that have been stimulated by 936 have been replacing what has been a 20 year steady loss of labor-intensive type of enterprises.

I think we can also see as a worldwide phenomenon that in manufacturing as production goes up the jobs curve is coming down, signifying greater productivity per employee. That is a worldwide phenomenon. It is also happening in Puerto Rico.

In Puerto Rico the participation of manufacturing in our gross domestic product is increasing at the same time the number of jobs in manufacturing is going down. But I submit to you that that is a worldwide international phenomenon.

Senator GRASSLEY. Congressman Gutierrez, you said or indicated, I believe, that in order for this to be successful all the interested parties in Puerto Rico are going to have to get together behind a single proposal. I assume you are close enough to it. Does that look like a real possibility that that can be done?

Congressman GUTIERREZ. Senator, I believe that it can be accomplished; and that, indeed, Governor Rosselló's presence here this morning, and his testimony, and the fact that so many interested groups given the great division that is created in Puerto Rico around the issue of status and as we can argue about so much that goes on in Puerto Rico, and, indeed, what is best for Puerto Rico.

I see a growing consensus around the platform that has been presented before this committee by that of Governor Rosselló to the point, Senator, that someone who from the mainland, a member of Congress, who believes that Puerto Rico should be an independent country, and the Governor who states here today that he is a supporter of statehood, we have both come here today to state what is most important is job development and the creation of those jobs and what is good for the Puerto Rican people, irregardless of our own ideological views.

So I think the fact that I am here at this table supporting Governor Rosselló is indicative of the unity that is coming around his proposal.

Senator GRASSLEY. Congressman, do you feel the same way?

Congressman ROMERO-BARCELÓ. Yes, Senator, providing, as I mentioned, that Puerto Rico is made whole in health care. Let me explain why.

I think the funds should go to Puerto Rico, besides the fact that Puerto Rico should be treated the same, because we are talking about health care and not welfare, we are American citizens and there is no justification whatsoever for the widows and the orphans of men who died for their nation being not be entitled to the same quality health care, and why foreigners in this Nation if they are residents should be entitled to health care and not American citizens of Puerto Rico.

So if that inequality is addressed and Puerto Rico gets the quality health care it yearns for, we will get about a billion dollars that would create a lot of jobs in the health care industry. But, more importantly, parity will also improve the health care of the people of Puerto Rico and would more than make up for whatever inconveniences or losses we might have with the President's or someone else's proposal.

With that proviso, I support the Governor's position. Because what I do not want to see in the future when I come up here to ask for parity in Medicaid that someone says, well, wait a minute, you came here and we gave a lot of benefits to the 936, much more

than the President had proposed, now you cannot come here asking for that money because we do not have it. What I do not want is that to happen.

If that policy decision is made now, and we can guarantee that to the people of Puerto Rico, the ones that cannot have any lobbyists here to represent them and to do lobbying in the Senate and the House, if we can guarantee that to the people of the Puerto Rico, I am sure the economy of Puerto Rico will benefit from it, Puerto Rico will benefit from it, the people of Puerto Rico will benefit greatly from it.

The CHAIRMAN. Thank you, Senator Grassley.

I think at this point a statement must be made in the spirit of openness that we like to share in this committee. It is this: statehood involves absolute equality of treatment with other States. That means full participation in programs such as Medicaid. That means no 936.

I just think that we do not want anyone to have any other illusion. Equality is equality and it is a choice that is yours to make. The implication should be clear.

If there is any member of the committee who thinks otherwise, I would like to hear that. Equality means equality.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Governor Rosselló, your testimony indicates that Section 936 companies are responsible for almost 70 percent of all the manufacturing jobs in Puerto Rico. How important is manufacturing compared to other business sectors, say, tourism, for example?

Governor ROSSELLÓ. Manufacturing accounts for approximately 40 percent, 39 percent, of the gross product in Puerto Rico. Tourism by comparison only affords 5.5 percent of that gross domestic product to Puerto Rico.

So the major sector in terms of production, there is no question that it is manufacturing. When you look at jobs in the different sectors, manufacturing accounts for about 16 or 17 percent of the jobs. And there the predominant sector is a service sector which is the growing, the fastest growing, and probably the dominant sector, in terms of job production.

But what these data imply is that manufacturing is creating higher paying jobs within the sector of the economy of Puerto Rico.

Senator HATCH. Well, you and others have told us that if the Clinton proposal were enacted manufacturing operations, employment and investment on the Island would decrease significantly.

Governor ROSSELLÓ. Yes.

Senator HATCH. What would be the impact on the Island's economy if that were to happen in terms of lost jobs, unemployment, poverty rates and so forth?

Governor ROSSELLÓ. Well, I think the effects would be very clear and very simple in a sense. Job loss, and as somebody suggested here, an added need for social program support in Puerto Rico.

There is an interesting fact that as economic conditions get worse in Puerto Rico there is a start-up of net migration outside Puerto Rico to the States. That would imply a major load also in some of the States where that migration would occur. It would also have

an affect on the 936 funds that are now being invested in the Caribbean section, through the Caribbean Basin Initiative.

I think we have to look not only at the intended consequences, but some of the unintended consequences. We would see, if Puerto Rico has a loss of jobs and a weakened economy, social turmoil such as higher incidents of crime, which is a major concern, and I must say the prime concern of our people at this point.

There are many studies that suggest and even prove that for every percentage increase of unemployment you get a proportionate increase in crime, in mental health.

Senator HATCH. It would be devastating to you is what you are saying.

Governor ROSSELLÓ. It would be devastating in my opinion, yes.

Senator HATCH. Now, we have heard a great deal over the past few years about how certain industries, such as the pharmaceutical industry or the chemical industries, are taking advantage of the Section 936 credit and the critics claim, that these industries are providing commensurately few benefits in the way of jobs to Puerto Ricans or to the Puerto Rican economy.

How important to your economy are these industries—the pharmaceutical industry, the chemical industry?

Governor ROSSELLÓ. Well, the pharmaceutical industry is very important to our economy because it provides the high technology, high-capital investment sector of manufacturing. It is very important to Puerto Rico because we do aspire to having not only more jobs but better paying jobs.

So in that sense it is a very important sector. I do say that some very valid criticism has been leveled at some corporations and some sectors of the pharmaceutical industry. We have to address that. I think that is fair. And in a sense what we are presenting here essentially takes the major contribution from that part of the spectrum where that criticism has been leveled at.

Senator HATCH. Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Well, there we are. Thank you, Senator Hatch, for very thoughtful questions.

Thank you, Governor. Thank you, colleagues from the House. We very much appreciate the thoughtful, factual presentations you have made. We will have to address this matter, and we will continue to be in close consultation with you as we do so.

Again, good morning, sir.

Governor ROSSELLÓ. Thank you very much.

The CHAIRMAN. While we are awaiting our next witness, Hon. Samuel Sessions, could I mention to the committee that we had hoped to have a quorum here at one point this morning that we could report out four administration officials who need to be in place. We held the hearing yesterday.

If those of my colleagues who can stay will do so, and if you see anyone in the corridor, would you tell them to come in.

May I say to Mr. Sessions, if you would like to have Mr. Samuels sit with you at the table, that would be entirely agreeable to us.

The gavel now descends. Well, now there are new persons entering the room and they are welcome, too.

Very well. We now go to the fourth witness today, Hon. Samuel Sessions, who is a Deputy Assistant Secretary of the Treasury, and

he is informally accompanied by his colleague-to-be, Assistant Secretary Designate Samuels. We welcome you both, sir. Gentlemen.

Would you proceed, please?

STATEMENT OF HON. SAMUEL Y. SESSIONS, DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY, WASHINGTON, DC, ACCOMPANIED BY LESLIE SAMUELS, CONSULTANT

Mr. SESSIONS. Thank you, Mr. Chairman. For me, in particular, it is an honor to appear before this committee on behalf of the administration concerning a variety of provisions in the President's budget plan. The provisions are the proposals relating to the possessions tax credit, earning stripping and the provisions relating to international business.

I will cover them in the order in which they are covered in my written testimony. I would like to ask that my written testimony be included in the record.

The CHAIRMAN. It will be included as if read.

[The prepared statement of Mr. Sessions appears on page 455.]

Mr. SESSIONS. It is rather lengthy. What I will attempt to do is summarize the main points. Just to give you an overview, the proposals that are discussed in the testimony are a royalties provision and a provision relating to the allocation of research and experimental expenses, a provision related to the treatment of working capital under the foreign tax credit, a provision relating to current taxation of certain accumulated passive assets held by companies abroad, a transfer pricing rule, a rule relating to contingent interest, a rule relating to conduit arrangements, then rules relating to possessions tax credit and earnings stripping.

My plan is to skip over a couple of these proposals and leave that to the written testimony.

The CHAIRMAN. Why don't you leave out earnings stripping, all right? [Laughter.]

Mr. SESSIONS. I would be delighted. Let me start then with the royalties provision. As I said, it consists of two components. To give you a little bit of background, as the testimony says, under current law U.S. taxpayers are taxed on their worldwide income and are allowed a credit for foreign taxes paid on that income.

The credit is subject to a limitation that is designed to ensure that foreign taxes are not allowed to offset the U.S. tax that would be applied to U.S. income. The way the foreign tax credit limitation is computed is essentially to take the effective rate for the taxpayer's income and multiply that times the taxpayer's foreign source income. That sets the foreign tax credit limitation, which is the maximum amount of foreign taxes that taxpayers can credit against their foreign source income.

For example, if the U.S. tax effective rate is 36 percent, let's say, if the President's proposal relating to the corporate tax rate is enacted, and if a taxpayer has $100 of foreign source income, the maximum amount of foreign taxes that could be credited against that $100 would be $36.

If the taxpayer actually has paid $50, let's say, on that income, the additional $14 cannot be credited currently. It can be carried forward and carried back.

On the other hand, if the taxpayer has paid only $20, for example, of tax on that income, the difference between the $36 and the $20 will be payable to the United States as U.S. tax, in other words, $16 of U.S. tax.

In the case of the first example that I gave where there is $50 in tax and only $36 is creditable, this is called an excess credit position. The taxpayer has excess credits. And it is in the interest of taxpayers to use those excess tax credits, if possible, to offset U.S. tax on other foreign source income.

So there is an incentive for taxpayers to generate low-tax foreign source income that those credits can be applied against, which eliminates the U.S. tax on that income.

I am planning to present an example, a numerical example, at the end of this discussion of royalties—you can go ahead and put it up now—to go through this. I will try to go through the principles first and then use the example to illustrate them. We are going to hand out a copy of this also so that members will be able to view it more easily.

In any event, as I said, there is an interest in having lower taxed foreign source income against which the excess credits can be applied. The foreign tax credit limitation already contains a mechanism that is designed to prevent that in certain cases, particularly passive income.

And there are a couple of instances of active income that are typically low-taxed that have the foreign tax credit limitation applied separately to them, so that you cannot take the excess credits from one type of income against U.S. tax on those other types of income. That is what these separate foreign tax credit categories, or separate baskets as they are sometimes called, are designed to do.

One type of income that is typically low-taxed and, therefore, is a candidate for use in this way by taxpayers to absorb excess tax credits is royalties income. Some royalties income is already included in the passive basket under current law and, therefore, is subject to this separate limitation.

Two categories are not. They are referred to at the top of page 2 of my written testimony. One is royalties derived in the active conduct of a business and received from an unrelated person. The other is royalties received from a related person, which are treated effectively on a look-through basis. Under the look-through rules, you do not look at the character of the royalties income itself. Instead you look at the character of the income of the foreign subsidiary, let's say, of a U.S. company and you assign that income and the subsidiary to the various baskets based on the character of its income.

That is a little bit of background on royalties. As I said, I will do an example once I describe the proposal.

Looking, I hope, briefly at the other side of this proposal, another aspect of the foreign tax credit is allocation of expenses. Taxpayers typically want to allocate expenses to U.S. source income and away from foreign source income.

The reason for that is that it increases the foreign tax credit limitation when you do so. And the allocation of research and experi-

mentation expenses have been the subject of considerable interest over the past decade and a half, roughly, for this reason.

In 1977 the Treasury proposed regulations that dealt with this issue. They have been suspended by legislation on numerous occasions. Most recently they were dealt with again, this time by Treasury notice, in June of 1992. Under this notice, for an 18-month period, a rule that previously applied by statute which allows 64 percent of R&D performed in the United States to be allocated to U.S. income was provided.

Basically, on page 3 of my written testimony——

The CHAIRMAN. And it is 20 minutes of 12:00. [Laughter.]

Mr. SESSIONS. Shall I go to my example and kind of explain it?

The CHAIRMAN. Why don't you? We have omitted earnings stripping as somewhat too sensational. But let's see if we cannot go to your example.

Mr. SESSIONS. All right, I'll use this example.

The CHAIRMAN. Perhaps someone will point it out for you.

Mr. SESSIONS. Right. The example explains the proposal. The first column is designed to illustrate the situation of a taxpayer before a decision for plant location and relating to a new product. This is just a simplified example. There are many variations on this.

Take a U.S. company that has $100 of income in a foreign jurisdiction. It has a 50 percent tax rate. It has paid $50 of foreign tax. As I said, the amount that it could credit against that tax, the amount of tax it can credit against U.S. tax, is limited to $36. That is the fifth line down, I guess.

The $50 of foreign tax completely offsets the $36 of tax that would have applied, meaning that the taxpayer pays no U.S. tax on that income. That is the zero there. Its total tax on its income is $50 and it has $14 of excess credit. That is sort of the example I started out with.

Now if this taxpayer were to develop an intangible, for example, that it could either exploit in the United States or abroad, the next two columns illustrate what would happen under current law if it were to do that.

If it were to locate in the United States, which is the second column, it would have $100 of U.S. income. Effectively very little changes in its foreign tax credit situation. All of the foreign tax credit information basically stays the same. But since it has earned $100 in the United States, it pays $36 of tax on that income. But the total tax is the $50 of foreign income and the $36 in the United States for a total of $86. That is the tax liability it would have if it were to choose to locate in the United States.

Under current law, if it were to choose to operate abroad and earn an additional $100 of income abroad, we are assuming—I think this example has been passed out—that a certain amount is paid back in the form of dividends, 50 percent of the income is paid back in the form of dividends, 50 percent is paid back in the form of royalties. The $50 of royalties income will be deductible in the foreign jurisdiction.

So it has $150 of income taxable in the foreign jurisdiction. That is why you get $75 of foreign tax. That is the third line down. Again, its tax credit limitation, the maximum amount it can credit,

is $72—36 percent of $200. So the $75 of foreign tax, again, completely offsets its U.S. tax. It pays no U.S. tax. It pays $75 of foreign tax and it has $3 of additional excess credits.

The result is, by operating abroad it has lowered its tax liability from $86 to $75, a very significant benefit—$11 worth of tax benefit on $200 of income. What our proposal would do is illustrated in the last column. What it does is say that we are going to put the royalties income, which is the $50 that was paid back from overseas, 50 percent of the $100 of additional income, and place it in a separate category, so that you have now a maximum of $54 of taxes that can be credited against the $150 of dividend income, non-royalties income, that is 36 percent of $150.

There should actually be next to that an $18 figure. It should say $54 plus $18 because we are allowing a maximum of $18 creditable—a maximum I say—against the $50 of royalties income. But since it has paid no tax on the royalties income, it has been exempt from foreign tax, there is no tax credit available against that income. Therefore, it pays $18 of U.S. tax, which you see on the next line down.

Having paid $75 of foreign tax and $18 of U.S. tax, its total tax liability is $93. As a result, it has not gained a tax advantage from operating overseas. That is basically what our proposal does. It says that if you place the royalties separately, take it out and apply the tax credit limitation separately to it, if the foreign tax actually paid on that income is lower than the U.S. tax rate, we collect the difference.

In this case, the foreign tax is zero, so you collect $18 of tax on that income. The other part of this proposal is to allocate 100 percent of R&E expenses for R&E performed in the United States against U.S. source income. That is a very favorable allocation rule for U.S. taxpayers.

That is the description of the royalties proposal.

The CHAIRMAN. Mr. Sessions?

Mr. SESSIONS. Yes.

The CHAIRMAN. Because we are going to have many opportunities to talk to you about some of the more detailed tax measures, why don't you address section 936? The Senators are here waiting to hear from you and we want to question you.

Mr. SESSIONS. This is on page 13. As has been discussed with the committee, and I am sure the committee is familiar with section 936, section 936 essentially provides a tax credit which eliminates the tax on income that is earned in Puerto Rico, or one might say is treated as earned in Puerto Rico under various income allocation rules, by a corporation, a Section 936 corporation, that has a significant business presence in Puerto Rico as defined under the Tax Code.

Now you have to have a certain level of business activity in Puerto Rico to qualify for 936. In addition, as was discussed earlier, there is a benefit available for reinvestment, of passive income earned on reinvestment of 936 earnings in Puerto Rico. Those are the two 936 benefits.

The CHAIRMAN. Could I just for the record note that the Virgin Islands are also——

Mr. SESSIONS. Right. It is for all possessions. The bulk of the operation and the use of the Section 936 credit is from Puerto Rico or is allocated to Puerto Rico.

Section 936 was enacted to promote jobs and investment in Puerto Rico and other possessions. It has certainly achieved some significant successes in this regard. However, it has been criticized by a number of commentators over the years as being a very inefficient means of promoting employment and growth in Puerto Rico and suggestions have been made on numerous occasions about how it could be changed to be made more efficient.

In particular, this is at the top of page 14, some companies received benefits under Section 936 that are quite disproportionate to the employment and other activity that is created in Puerto Rico.

For example, Treasury data indicate that while the average pharmaceutical worker in Puerto Rico earned $30,400 in total compensation in 1989, the tax expenditure for each job is $66,081 or 217 percent of wages. We could have effectively taken that $66,000 and employed more than two employees for the cost of the taxes lost in this case.

In addition, companies accounting for only 12.6 percent of Section 936 employment received 63.5 percent of 936 benefits. That shows that disproportion. The reason for this disparity is that the Section 936 credit is tied to income that a company earns in possession, or that is treated as earned in a possession under income allocation rules, rather than the number of jobs and the amount of tangible investment that is attributable to the operations in Puerto Rico.

The administration's proposal would link the 936 benefit more directly to these two factors—to jobs and to investment in Puerto Rico. In general, the current rules would be retained. However, there would be two limitations applied to the credit that could otherwise be claimed under 936.

First, the credit for active business operations would be limited to 60 percent of wages paid. In addition, wages would continue to be fully deductible. This means that you get a 60-percent credit and a benefit equal to your tax rate times the amount of wages. If you assume a 34-percent effective tax rate, you are giving a total of a 94-percent credit for wages paid in Puerto Rico. This would apply to wages up to the Social Security wage base limit or under current law $57,600 of wages.

Second, the exemption for income from investments, from passive investments, would be limited to income from assets with a value equal to 80 percent of the firm's annual average tangible business investment within the possession.

In other words, if you have $100 of business investment within the possession you would be able to have a tax exemption on income from $80 of passive assets. This would give an incentive, if taxpayers wanted to expand the exemption for passive assets, they would have to expand their investment in tangible assets. This should, we believe, provide an incentive for taxpayers to increase their investment in Puerto Rico.

Again, we are linking the credit to jobs and to investment. As a result, we do not believe that this proposal will cause significant disruption in the Puerto Rico economy. Given the figures that I

mentioned before that only 12 percent of the employment is attributable to companies that receive 63.5 percent of the benefits indicates that one can——

The CHAIRMAN. Twelve percent of the 18 percent? Your 12 percent of the 936 employment?

Mr. SESSIONS. That is correct.

The CHAIRMAN. This a percent of a percentage?

Mr. SESSIONS. Right, 12 percent of the 936 employment is attributable to companies that derive 63.5 percent of the 936 benefits. This certainly suggests that a significant amount of curtailment of the Section 936 benefit can be achieved without significantly reducing employment in Puerto Rico.

That is essentially what I had planned to say on the possessions tax credit. I would be happy to answer questions on anything in the testimony or go back and cover anything I have not covered. But I assume those are the main subjects of interest to the committee.

The CHAIRMAN. We thank you, Mr. Sessions. Just one quick question from me. Would you agree with the characterization of Governor Rosselló that the per capita tax increase in Puerto Rico would be roughly twice that for the mainland, the $1,000 plus against the $2,000?

Mr. SESSIONS. I think it is a matter of how you look at it. The Section 936 benefit goes to the U.S. corporations. It does not directly go to Puerto Ricans as such. And, therefore, I think it is somewhat misleading to say that per capita Puerto Ricans would bear a much larger burden than citizens on the mainland.

In fact, since Puerto Ricans are exempt from U.S. tax on their Puerto Rican income, they bear no burden under the President's plan directly.

Since we are giving what amounts to effectively almost a 100 percent credit for wages, we do not think it is going to decrease employment significantly in Puerto Rico. Therefore, I guess, on balance, I would have to say that I do disagree with that statement because I do not think it is an accurate representation of the revenue raised from the proposal.

The CHAIRMAN. Thank you.

Senator Packwood?

Senator PACKWOOD. Mr. Secretary, there are quite a number of corporations in Oregon with international operations that are interested in deferral. You partially repealed the deferral of foreign income when 25 percent or more of a company's assets are passive assets. How did you get to the 25 percent? What is the basis for that?

Mr. SESSIONS. Well, we looked at data. We think, first of all, that the 25-percent figure is a fairly generous figure. We looked at data for both passive assets for corporations in the United States and passive assets for subsidiaries of U.S. corporations abroad.

Senator PACKWOOD. You say you looked at data.

Mr. SESSIONS. Right.

Senator PACKWOOD. Have you done studies? Whose data is this? What data?

Mr. SESSIONS. This is data that we have generated ourselves.

Senator PACKWOOD. Okay. Can I have access to that?

Mr. SESSIONS. Yes, we can provide that to you.

Senator PACKWOOD. Thank you.

Mr. SESSIONS. The information relating to passive asset percentages in the United States is, we think, somewhat less reliable than the information we have about foreign corporations because we have to look largely at book figures for the United States. We have better data because of existing anti-deferral rules about asset percentages for corporations operating abroad.

What we found is the following. We think it is quite interesting. If you look at passive assets held by subsidiaries of U.S. corporations operating in non-tax haven countries—in other words, countries that have a tax rate similar to the United States, and one would think would therefore be comparable on a tax planning basis to the United States—the percentage for all industries of passive assets as a percentage of total assets is 7 percent, well below the 25-percent figure in our proposal.

For companies located in tax havens, the percentage is 30 percent. We have heard the argument that the assets are there for good business reasons.

If you look at these figures, you have to conclude that one has better business reasons to accumulate assets in a low tax jurisdiction than one does to accumulate assets in a high tax jurisdiction. That does not seem to us to be very plausible.

We think that the reason that the assets are accumulating in the low tax jurisdictions is essentially tax planning and we do not think there is any particular reason, given this disparity between tax haven and non-tax haven countries, to allow the deferral to continue when a company has accumulated assets to that extent.

Senator PACKWOOD. Let me ask you though, your test is an average therefore. You are looking at 7 percent and you say, my gosh, if 7 percent is the average, certainly anybody who is above 25 percent ip so facto must be doing it for tax reasons alone.

Mr. SESSIONS. Well, as I said, when you have an 18 percentage point differential, that gives a lot of cushion in favor of the taxpayer. Most of the industries are well below the 25 percent. Very few of them even come close to the 25 percent. Obviously, in some cases there may be a case where there is 25 percent for good business reasons.

But when you are starting with an average that is so far below 25 percent, we thought an objective test——

Senator PACKWOOD. Well, that is all I am asking, is there may be companies above 25 percent legitimately. But you are averaging and you are saying, well, in that case, that is tough luck for those companies.

Mr. SESSIONS. Well, we are giving them 300 percent of the average. That seems to us fair in view of the need to have an objective rule.

Senator PACKWOOD. Second, if you flunk this 25-percent test, if you are over it, then you go back to 1962. That is the most far-reaching retroactivity I think I have ever seen. I do not know if businesses keep records for 30 years. But how do you justify a 30-year retroactivity?

Mr. SESSIONS. Well, one could look at it the other way. Well, let me start with this. First of all, we have rules that as you well know

allow the deferral of income. If income is accumulated for a very long time, effectively what was there for deferral has turned into an exemption.

Second, the reason for deferral is, or at least the reason that is usually given, is that there are good business reasons for a company to be located in a foreign jurisdiction. There is not any particular reason for passive assets to be accumulating in a foreign jurisdiction. Passive assets do not have any particular nexus to any jurisdiction.

Therefore, we think at some point when the accumulation is so large that it is appropriate to impose a tax on that accumulation.

Senator PACKWOOD. But is the tax on simply the accumulation of the passive assets or is it on all deferred income for 30 years if you fail the——

Mr. SESSIONS. It is on income that is accumulated to the extent that you have passive assets that exceed the 25-percent threshold.

Senator PACKWOOD. And the tax is only on the assets, only on that excess, not on all deferred income?

Mr. SESSIONS. That is right.

Senator PACKWOOD. I have other questions. I will wait.

The CHAIRMAN. Sure.

Senator Pryor?

Senator PRYOR. Thank you, Mr. Chairman.

Mr. Sessions, the new proposal, the administration proposal, on 936 changes. Am I not correct, aren't they still linked to profits limited by wages paid in Puerto Rico; is that correct?

Mr. SESSIONS. That is correct, limited by wages. That is right.

Senator PRYOR. Well, I am wondering why a better proposal is not one that is linked to purely investment and spending directly in Puerto Rico, into the Puerto Rico economy. Would that not work more efficiently?

Mr. SESSIONS. There are others on the committee who would prefer, I think, a more generous proposal, a 936 proposal that would have cut back on the 936 benefit to a lesser extent than the administration's proposal.

In offering the proposal the administration came forward with, there was a recognition that the Puerto Rican economy has been developed to a significant extent in reliance on Section 936.

As it is currently structured, what we are trying to do is develop a measure that sort of strikes a balance between the concern that the Chairman expressed earlier—disruption of the economy, and we think we have done that; we think we have come up with something that does not disrupt the Puerto Rican economy—and at the same time an incentive that is considerably more oriented, a great deal more oriented toward jobs and direct investment in Puerto Rico.

So it is a balancing and that is what we have attempted to do.

Senator PRYOR. The wage credit that I have proposed basically—and I know that you have taken into consideration in this proposal, and I appreciate it—it seems like the wage credit to me is really what we are trying to get at, and trying to deal with, and trying to encourage.

What has happened with the present 936 and it is certainly no secret is that of the 100,000 jobs that are what we call 936 jobs

in Puerto Rico, 18,000 of these are pharmaceutical company jobs—18 percent. But the pharmaceutical are getting over 50 percent of the 936 benefits, putting those benefits in their pocket and not giving back to the economy of Puerto Rico.

This is what I am trying to deal with the wage credit and this is where I think the wage credit might have the intended consequences that we are moving forward on.

Mr. Sessions, one final comment. That is that we have a lot of companies in Puerto Rico. We have talked mainly, Mr. Chairman, about the pharmaceutical companies. The reason we talk about the pharmaceutical companies is because they are getting the greatest benefit. There is no question about it.

But basically they are being rewarded for their profits, rather than for the number of citizens of Puerto Rico that the hire in their plants. For example, we have H.J. Heinz operating there. We have Dow Chemical. We have textile and apparel companies, and the electronic industries, including Hewlett Packard.

None of these companies come out nearly with the same benefits that the pharmaceutical companies do. I think that just for the record I wanted to spread that across the record so that we would have it for future consideration and debate.

Mr. Chairman, I thank you and I yield back the balance.

The CHAIRMAN. Thank you. I believe that Mr. Sessions' data was very compatible with yours. Perhaps you would let us know whether that small percentage getting such a large part of the benefit were, in fact, pharmaceutical.

Mr. SESSIONS. I do not know for sure.

The CHAIRMAN. When you find out.

Mr. SESSIONS. Right.

The CHAIRMAN. When you find out.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Sessions, with respect to the royalties provision, does the administration have evidence or documented instances where U.S. companies, similar to your example, pick up, and go overseas to take advantage of the royalties provision, present royalties provisions, to lower their—is it worldwide or United States; I have forgotten which—taxes? Do you have examples of that actually happening?

Mr. SESSIONS. Well, the Treasury is not sort of general trier of fact about the motivations of taxpayers. We can look at the tax incentives that are available. For example, the ones I have provided in the example I gave.

There is no reason for the Treasury to gather data directly about what motivates taxpayers' decisions. I will mention one fact. After the 1986 Act, which tightened up the foreign tax credit limitation in a number of respects, and lowered the U.S. corporate tax rate. When you lower the corporate tax rate, it increases excess credits.

For example, if we had had a 48-percent rate the excess credits in my first example would be $2, not nearly as significant as $14. So both of these things, the changes of the foreign tax credit rules, and the change to the corporate rate, provide an incentive rate for taxpayers to generate low-taxed income abroad.

We think it is interesting that from 1982 to 1985 royalties paid from abroad increased by 17 percent. From 1986 to 1991 they increased by 300 percent. That disparity suggests to us that at least part of that is attributable to an effort on the part of U.S. companies to locate abroad, at least to generate royalties income abroad, that allows them to engage in this averaging of foreign tax credits.

Again, there is no reason for the Treasury—I do not think taxpayers would be very comfortable if we went around asking them why they do things.

Senator BAUCUS. Yes. I appreciate that. Obviously, we have competing goals here. One is to reduce the budget deficit. Another is to enhance American worldwide competitiveness, to make sure American companies are as competitive as possible. Both to increase our living standards as American citizens and also to compete effectively against companies overseas.

So supporting, therefore, as best we can the degree to which the 300-percent increase in royalties is attributable to changes in tax law or attributable to U.S. companies' desires to avoid taxes and, therefore, set up overseas operations or the degree to which that has arisen because American companies are becoming more competitive and are selling more products overseas through licensing arrangements because that is the way software is sold and packaged.

I think it is important to know, where that line is drawn and what, in fact, are the actual reasons for that increase. Do you have any sense?

Mr. SESSIONS. Well, it is a very large increase. I think it is about a 1,800 percent increase, 1,700 percent increase. It is somewhat difficult to see. I do not think many people would argue that there was a 17-fold increase in the competitiveness of U.S. companies operating abroad from the last half of the 1980's by comparison with the first half of the 1980's.

Senator BAUCUS. Or turn it around. I wonder if you have any sense of the degree to which, as some companies I think claim, that as a consequence of this provision, if it, in fact, is enacted that the companies will not repatriate income but rather keep operations overseas.

Mr. SESSIONS. We do not think there is any reason this would lead companies not to repatriate income. We have rules that ensure that if they do license abroad that they will pay back a fair royalty on the intangible that is licensed. So they in some respects cannot choose not to repatriate a royalty.

The other source of income, the form in which they could repatriate, would be dividends. And as the example shows, if you've already paid a high rate of foreign tax on the dividends—$50 let's say as opposed to $36——

Senator BAUCUS. Right.

Mr. SESSIONS.—you pay no U.S. tax on the repatriation. So there is no disincentive to repatriating the dividend. So in some there is no disincentive to repatriate the dividend and there is not much of an option in repatriating the royalty. So we do not think it will lead companies not to repatriate.

Senator BAUCUS. I agree we can reduce the deficit and change the Tax Code, where appropriate, to prevent inappropriate gaming

of the system and so forth. But, these are questions that arise basically because some companies believe that this is going to adversely affect their competitiveness.

It is up to us to try to determine the degree to which that factor is true.

Mr. SESSIONS. We understand that.

Senator BAUCUS. And the degree to which they are just trying to continue within the system.

Thank you.

The CHAIRMAN. Thank you, Senator Baucus.

Senator Grassley?

Senator GRASSLEY. Regarding transfer pricing. You remember during the campaign the President really made quite a big deal out of going after these foreign companies to get them to pay their fair share of taxes. He was suggesting that we were going to bring in $45 billion and as far as politics are concerned, it really worked.

He was not only going to go after the foreign tax cheats, but he was going to raise a large, enormous sum of money and it was going to solve, in a sense, our financial problems.

Well, as with a whole host of issues after the campaign was over, reality, as well as truth set in. So instead of $45 billion it looks like we are going to get less than a $4 billion proposal.

Now I think most of us felt that the $45 billion figure really was not very realistic. How is it, if you could explain to me, that we ended up going only after 10 percent of what we originally started out to get on this? Because we were all looking forward to this helping us solve a lot of budget balancing issues.

Mr. SESSIONS. Well, we are not going after only 10 percent. The legislative proposal that we have offered is scored as raising, I think it is around $4 billion. And, therefore, that proposal itself is around 10 percent.

Senator GRASSLEY. That is the part I am talking about.

Mr. SESSIONS. Right. But that is the legislative proposal and the legislative proposal can—underscoring rules, you can only score changes in the law as opposed to enforcement of existing law.

The President, I think, was referring in part to better enforcement of existing rules. We are, as part of a broader initiative in this area, going to step up enforcement of the existing rules under current law, quite significantly.

In my testimony on page 10, this initiative is described fairly briefly, almost at the bottom of the page. We are adding 235 full-time employees in this area alone for the 1994 fiscal year at a cost of $30.6 million. So we are going to devote 235 new employees in fiscal year 1994 alone. So we are going to greatly step up our enforcement of existing rules.

We are also going to work very closely with our international trading partners to get their cooperation with this problem. Again, that is an existing law matter. It is not going to be scored.

What we have tried to do is work within the framework of the existing arm's length method. We believe that our approach will work, including both enforcement and the legislative initiative. If it does not work, we will pursue other options.

Senator GRASSLEY. Well, maybe something has changed. But we have scored. For instance, we have appropriated money for more

IRS agents under the idea of bringing in more money and we scored that. So why can't you score this? And even if you cannot score it, how much do you expect to bring in from this extra enforcement?

Mr. SESSIONS. I do not have an estimate of about how much we are going to bring in. And as to why it is not scored, I will have to get back to you on that.

The CHAIRMAN. Well, why don't we try to find out the answer to the Senator's question.

Senator GRASSLEY. Yes. Well, you know, we have scored for hiring more IRS agents.

The CHAIRMAN. May we have an answer in writing when you have a chance?

Mr. SESSIONS. Yes.

Senator GRASSLEY. And maybe part of this is from what the budget resolution is or the budget law is, too, Mr. Chairman.

Now on this royalty proposal, there was a leading Democrat on the House Ways and Means Committee that was quoted as saying, "I do not think the current language, or anything close to it, will pass." Then we have had other newspaper reports that indicated that there was some misapprehension about the President's initiatives going to pass. They use the term that they were jeopardized.

How committed is the administration to the royalty proposal in light of this visible Democrat opposition?

Mr. SESSIONS. Well, the administration is committed to the package that it has proposed. I think the Secretary indicated that there was no intent on the part of the administration to make any further changes in our proposal.

Obviously, the Congress will have its say about these proposals. And as far as what happens on that side, that is I think for this committee and the Ways and Means Committee. But there is no intent to back off of the proposal and we stick with our original proposal.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Conrad, you were here much earlier and have now returned. We welcome you back.

Senator CONRAD. Thank you, Mr. Chairman.

Perhaps I could put up a chart. Mr. Chairman, and members of the Committee, Mr. Sessions, this chart shows, I think, an interesting comparison. It shows that U.S. subsidiaries of foreign corporations are paying less taxes than foreign subsidiaries of U.S. corporations. Not just less taxes, but dramatically less taxes.

On the left you see the amount that foreign subsidiaries of U.S. corporations are paying. They are paying to our foreign competitors almost $24 billion a year on $823 billion in receipts.

But U.S. subsidiaries of foreign corporations are paying us only $5.8 billion in taxes on about the same level of receipts, some $826 billion.

Now I know one can make the argument that different profit levels perhaps differ in different markets, but I think the sheer difference here sends us a signal that something is wrong. I believe what is wrong, Mr. Chairman, members of the committee, is that we have a tax system on these types of transactions that does not work.

As a former Tax Commissioner and as former Chairman of the Multi-State Tax Commission, I have spent a good deal of time on these issues. And just to put in perspective for members of the committee what is involved here, we are trying to recreate arm's length transactions between companies that are commonly held.

We are trying to go back and make believe that these companies are not jointly owned and jointly controlled, but that they are separately owned and separately controlled. We are trying to invent what would happen if these transactions really occurred between arm's length parties.

And, Mr. Chairman, and members of the committee, there is no way to do that. I have spent literally hundreds of hours looking at the tax returns of multi-national corporations. Anybody that thinks you can separate out, through a series of accounting adjustments, what would have occurred if these would have been arm's length transactions is just not attached to reality.

Let me try to make the point this way. The IRS has recently announced an initiative called the Advanced Pricing Agreement so that we could reach agreement on these questions before returns are filed. They acknowledge, in a report published in April of 1992, that they expect the average advanced pricing agreement to consume 1,200 to 1,600 staff hours—1,200 to 1,600 staff hours.

They have only got 600 to 700 staff to handle all international issues. There are 40,000 subsidiaries of foreign-owned multi-nationals doing business in this country. There are approximately 2,000 major U.S.-based multi-nationals.

My question to Mr. Sessions is, how can we seriously suggest there is any way that we can police these transactions using Section 482 with the amount of staff you have, the number of transactions there are, when you acknowledge it takes 1,200 to 1,600 hours to do one analysis, an advanced pricing agreement, when you are dealing with a cooperative company? How is it possible that we are going to do anything serious in this area?

Senator HATCH. Regarding the Senator yield for just a short question on your chart?

Senator CONRAD. Yes.

Senator HATCH. Regarding the $23.9 billion, does that lump all the countries together where foreign taxes are paid?

Senator CONRAD. Right.

Senator HATCH. Versus just the United States.

Senator CONRAD. These are foreign subsidiaries——

Senator HATCH. That is all the——

Senator Conrad—of U.S. corporations that are paying taxes around the world on $823 billion in receipts. In other words, the receipts are about the same. We are paying almost $24 billion. They are paying less than $6 billion.

Mr. SESSIONS. In response to your question, your question, I think, is how we think maintaining the current system has any prospects for success. We do believe that our proposal, which requires for taxpayers who wish to avoid penalties, that they provide documentation in advance of their transfer pricing method, will be a very significant change and will both increase compliance by the companies and make audits of those companies a great deal easier.

We also believe that the advanced pricing agreement approach is very promising. I am not, I must say, familiar with the 1,200 to 1,600 hour figure that you give. I believe though that even if that were true for advance pricing agreements at the outset, it is a new technique. We think that over time as agents become more accustomed to this approach, and as precedents are set within industries, that the time consumed for developing these agreements would decrease dramatically.

I might also comment that even if it were 1,600 hours, though as I said I am not familiar with the figure, our addition of 235 new employees would allow us to do a great number of advanced pricing agreements. We think if we can accomplish, enter into agreements with the largest corporations, the top 200 or 300, that we will get at the great bulk of the problem.

So we do think that this is a promising approach. We have indicated on a number of occasions, however, that we are committed to this. We agree with you that it is a serious problem. And if this is not successful, we will look at other alternatives.

Senator CONRAD. If I could just make a concluding comment.

The CHAIRMAN. Please.

Senator CONRAD. When I was in Louisiana, Mr. Chairman, for Mardi Gras, I heard a comment that if you cannot run with the big dogs, stay on the porch. [Laughter.]

You know, that means something down there. I am not quite sure what it means. [Laughter.]

I think it applies here. I think we are in very serious trouble on this issue and I do not think what is proposed here is going to solve the problem. Frankly, I think we might as well stay on the porch.

The CHAIRMAN. I think the Chair has to rule that we cannot really resolve this until Senator Breaux returns. [Laughter.]

Senator PRYOR. I bet that was advice from Senator Breaux to you.

The CHAIRMAN. Senator Hatch.

Senator HATCH. Well, thank you, Mr. Chairman. Just a few questions of Mr. Sessions.

Has the Treasury performed any analysis that would show the affect of this royalty provision proposal on the competitiveness of U.S. companies to take business abroad?

Mr. SESSIONS. I am not sure that we have done any specific numerical analysis. As I said, part of the rationale behind the proposal is to increase jobs in the United States. We have looked at our tax rates by comparison with other countries, the tax burden in the United States by comparison with other countries, the way that other countries handle this same situation, and we think we are pretty much on a par with the way——

Senator HATCH. Is there any other countries that do it?

Mr. SESSIONS. Other countries do similar things. There are a great variety of approaches that countries take to this situation. But a number of important countries have taken an approach that is somewhat similar to this.

Senator HATCH. In my home State of Utah, for instance, is the headquarters for a number of software development companies. In fact, it is very important to our State and to the nation as a whole

that Novell, WordPerfect, and you can go right down the line, are international businesses.

I have been told that this royalty provision may encourage some of these companies, whether they are in Utah or otherwise, to move their research facilities overseas to ensure that the income derived from that research will be considered active income to avoid the negative consequences that would result from the enactment of this particular provision.

Now would that not be just the opposite of what the administration is trying to do with this proposal?

Mr. SESSIONS. We have thought about this and we do not think that there is any reason to believe that research and development or research and experimentation would move overseas. First let me just comment that we have two proposals in the package that directly encourage research and experimentation in the United States—the permanent extension of the R&D credit and the 100 percent allocation rule that I described in my testimony.

But beyond that, even disregarding those two provisions, there are a number of non-tax and tax reasons why a company would not want to move its research overseas. Non-tax reasons include considerations relating to intellectual property rights, the need to have a sort of a nucleus of R&D personnel and get a cross fertilization of ideas among those personnel, which would lead you not to want to just scatter your R&D around the world.

And in addition, tax considerations do not suggest that there is much of a reason to move R&D overseas either. Most R&D is conducted in high-tax jurisdictions. If you move to a high-tax jurisdiction, the income from the R&D will be taxed by that jurisdiction at the local rate.

It does not make a great deal of sense from a tax planning standpoint to move your R&D to a higher tax jurisdiction and then have the income from that R&D taxed at that rate.

Let me just mention one other statistic. You asked originally about statistics on this. The percentage of R&D performed in the United States and overseas by U.S. companies has remained quite constant over the last 15 years, suggesting that non-tax considerations governed here.

It has been the case for about 15 years that about 90 percent of that R&D has been performed in the United States and about 10 percent overseas. This has been quite constant over the last 15 years. There have been a great number of changes in the U.S. tax laws over that period as well as in the tax laws of other countries.

The fact that those percentages have remained static suggests that taxpayers have responded to business considerations rather than the changes in the tax law.

Senator HATCH. Well, does the administration believe that there are valid business reasons, and not tax avoidance reasons, for a U.S. company to locate its facilities overseas?

Mr. SESSIONS. Yes, we do believe that there are valid business for companies. Not all, but certainly some.

Senator HATCH. And wouldn't this proposal hurt those businesses that are already located overseas for what they consider to be valid business reasons, such as the need to be nearer to the market place?

Mr. SESSIONS. Well, it is a question of what you consider. Any time a company pays higher tax, obviously, one could say that that hurts that company. But looking at it from the other standpoint, at present a company can be earning income that is not taxed. This only affects companies who are getting low taxed income repatriated, in other words, cash-in-hand from a foreign jurisdiction.

The provision only applies if the income has been subject to a lower rate of tax or no tax in the foreign jurisdiction. If you do not make this change, effectively what you are saying is, we think it is appropriate for neither the foreign country nor the United States to tax that income at all, despite the fact that the expenses which led to the creation of the intangible were deductible in the United States and generated lower tax initially.

So you can have a negative tax rate even in that situation and we think it is an appropriate change.

Senator HATCH. Thank you.

The CHAIRMAN. Thank you, Senator Hatch.

Finally, Senator Riegle.

Senator RIEGLE. Thank you.

The CHAIRMAN. May I just say before you, Senator Riegle, that we are very much aware that we are running behind. It does not appear that we will be able to hear the second of the two panels that are still to come. We are sorry about that. We will hear the second panel on Friday and everybody will have plenty of time. These have been important subjects that take the time of important persons.

Senator Riegle?

Senator RIEGLE. Mr. Chairman, thank you. It is taking a long time this morning because it is an important issue and there are many members participating. I thank you for bringing the other panel back on Friday. I know that may change some people's schedules to have to be here, but I hope all can be here because I think it is important that we fill out the record with all the points of view.

Let me also ask unanimous consent to insert in the record, Mr. Chairman, a letter from the Kellogg Co., and other letters along the same line from Dow Chemical, from EDS, Proctor & Gamble, and some others. They all relate to the issue of the administration's proposal to treat active business royalties from a foreign manufacturing subsidiary as passive for purposes of calculating the U.S. foreign tax credit.

There are some anomalies in this proposal that affect certain companies in ways that I think are unintended and hurtful. So if there is no objection, I would like to put those letters in the record.

The CHAIRMAN. Would you put them in the record.

[The letters appear in the appendix.]

The CHAIRMAN. Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

Let me just ask Mr. Sessions, do you have a conversion ratio you use for what the cost of the U.S. Federal Treasury is for every 1 percent increase in unemployment in Puerto Rico?

Mr. SESSIONS. I am not sure whether we have a conversion ratio, no.

Senator RIEGLE. Well, would it not be useful to have one? I mean, if you have policies that may have the effect of raising unemployment and in turn require other U.S. expenditures, wouldn't we want to know what that is?

Mr. SESSIONS. I do not know that we have a formula. We certainly have consulted with other agencies about the cost that might be incurred if unemployment were to be increased. As I indicated, we do not believe that this proposal will result in job loss in Puerto Rico.

I think it might be appropriate to emphasize how generous a proposal——

Senator RIEGLE. Let me just stop you because the time is limited and I have listened to you say that and I do not agree with your analysis, just to be very blunt about it. But I think you ought to be able to tell me directly what a 1-percent increase in unemployment or a 3-percent increase would cost in the way of a revenue impact.

If you are wrong on the job loss issue, then it is going to cost us money out of another pocket and you cannot just sweep that under the rug. So I would like to ask you to get that. I would like to have it and I think the committee ought to have it.

Let me also raise an issue with respect to NAFTA. Have you done a direct analysis as to what over a period of time NAFTA, if it were approved—I know Panetta says it is not going to be approved—but when it is——

The CHAIRMAN. That was noted.

Senator RIEGLE. Yes, a rather large story today. In any event, do you have an analysis that would show over a period of time what the job loss might be to other low-cost, low-wage competitors in this hemisphere where the capital investment attractiveness is being improved and increased as NAFTA clearly would do in Mexico, as to what either the displacement would be of jobs sliding out of Puerto Rico, say, over to Mexico? We have already had a lot of jobs leave Michigan and go to Mexico. Or just the whole issue of whether or not further job increases would be likely to occur in a higher wage situation like Puerto Rico, where they have the same minimum wage we do, versus say in a Mexico situation.

Mr. SESSIONS. Well, there are certainly people within the Treasury who are looking at NAFTA and its impact on various sectors of the U.S. economy, including Puerto Rico.

I am not directly involved. I am not a trade expert and I will again have to ask someone else to get back to you on that, simply because it is not within my area of expertise or the Tax Policy Office's area.

Senator RIEGLE. Well, let me tell you the reason I raise the issue. I think there is a cross-connect. I think these international economic tradeoffs and comparisons are highly relevant. I think what will happen here is that by creating a more favorable investment and job environment in Mexico that everybody is going to be affected.

In other words, it changes the relative balance for everybody. It certainly does in this country. I think we are going to see a much increased job loss and job flow to Mexico. But I think as well Puerto Rico is particularly susceptible to that because they have the ad-

ditional cost of being an island, so they have the transportation issue to have to deal with.

But when you take an immediately adjoining country like Mexico that can truck goods in the United States and the trucking rules are changed very favorably to Mexico, I think you are creating a new element that these things are not separate, independent events. In effect they are on one level, but when you sort of get them going simultaneously, I think there is a cross connecting effect.

I would ask you to take a look at that. Not just in year one but take a look at it over a period of time because that comes back in again on the first question I raised. That is, if we are going to be spending more on unemployment compensation, say, in Puerto Rico and more on food stamps in Puerto Rico as a result of jobs displacement, jobs moving somewhere else, whether it be Mexico or other places in the Caribbean, I think that would be very important for us to know. So I would ask you to take a look at that.

Mr. SESSIONS. If I could just respond briefly.

The CHAIRMAN. Please do.

Mr. SESSIONS. As I said, we understand there is a connection between NAFTA and jobs in Puerto Rico. I would like to comment on what the impact is of this proposal on jobs in Puerto Rico, the tax proposal.

As I said, with a 60-percent wage credit and deductibility, effectively the employer in Puerto Rico is going to pay, assuming a 34 percent rate, only 6 cents on the dollar of wages in Puerto Rico, or assuming a 36-percent tax rate, 4 cents on the dollar.

That means, for example, that although Puerto Rican workers are required to be paid the minimum wage, 6 percent of the $4.25 minimum wage is only about 25.5 cents. So the labor cost for employment in Puerto Rico for 936 companies is going to be very low.

To give you another example, our wage credit goes all the way up to $57,000. If you have an employee who is paid $40,000, assuming the employer is bearing only 6 percent of that cost, a 94 percent, or perhaps a 96-percent benefit, that employer is bearing only $2400 of the $40,000 of wages.

We think that is a very significant incentive to employ workers in Puerto Rico. If you have someone who the market says is worth $40,000 and you only have to pay $2400 of that after tax, we think that is a tremendous incentive.

Senator RIEGLE. Isn't it surprising though that if that is so that the unemployment rate there is 18 percent?

Mr. SESSIONS. Well, the credit at present is not tied to employment. It is tied to income—income of the corporation. So at present at least a very great percentage of the tax expenditure is devoted to the offset of income on intangible assets that are in Puerto Rico and not on funds that are channeled into the hands of Puerto Rican workers.

Senator RIEGLE. I understand that. But it also argues that if you were employing more people down there, you would have more of that tax credit to be able to use.

Mr. SESSIONS. Well, that is true under our proposal. There is no link whatsoever under the current 936 credit to employment in

Puerto Rico. The only thing you have to do is to satisfy the business activities test.

And it is in the interest of 936 corporations—I am not saying they all do this—but from a tax standpoint, it is in the interest to have as little activity in Puerto Rico as possible and get the maximum tax benefit you can through the income allocation rules.

Senator RIEGLE. You will get me the two things I asked for that you do not presently have?

Mr. SESSIONS. Yes.

The CHAIRMAN. And perhaps you will also give us the cost per job and the hourly wage cost when you calculate the tax credit.

[The information requested follows:]

DEPARTMENT OF THE TREASURY,
Washington, DC, May 19, 1993.

Hon. DANIEL PATRICK MOYNIHAN, *Chairman,*
Senate Committee on Finance,
U.S. Senate,
Washington, DC.

Dear Mr. Chairman: This letter responds to your requests for additional information at the April 27, 1993, Senate Finance Committee hearing.

In my testimony, I noted that the 936 companies that received 63.5 percent of the tax benefits accounted for only 12.6 percent of the employment by the 936 companies. You inquired what portion of the 63.5 percent of tax benefits accrued to pharmaceutical companies. Pharmaceutical companies account for 65 percent of the credits and 69 percent of the employment in this group. "Other chemical" companies account for 8 percent of the credits. Companies in food processing, electronics and scientific instruments are also included. Thus, pharmaceutical and related companies account for more than two-thirds of the benefits.

You also requested further clarification of the Administration's argument that the section 936 proposal provides a large incentive for additional employment in Puerto Rico. Companies whose current law credits exceed the 60 percent of wages threshold will receive a 60 percent credit for any additional wages paid. In addition, wages will remain fully deductible from taxable income even though they receive a large credit. Accordingly, if a 936 company above the threshold hires an additional worker and pays $40,000 in annual wages, it will receive an increased 936 credit of $24,000. In addition, the deduction for wages will reduce U.S. tax liabilities by another $13,600 (at a 34 percent tax rate), for a total of $37,600. Viewed differently, a company subject to the wage cap will reduce its tax liability by $3.89 for workers paid the minimum wage of $4.25—resulting in net wages of only $0.36 per hour.

Under the Administration proposal, the labor intensive companies that account for 56 percent of total 936 employment will receive exactly the same tax benefits as they do under current law. The companies above the 60 percent threshold that remain in Puerto Rico will receive a very powerful incentive to hire additional workers.

Please let me know if there is any further information we can provide.

Sincerely,

SAMUEL Y. SESSIONS, *Deputy Assistant Secretary, Tax Policy.*

The CHAIRMAN. Senator Packwood, did you want to pursue this?

Senator PACKWOOD. No, no further questions.

The CHAIRMAN. I think we have to move on to our second panel, which will be our last panel.

Mr. Sessions, we thank you very much for a very lucid, very forthright testimony. Mr. Samuels, we welcome you to your proximate position. We hope to get you before the week is out.

Mr. SESSIONS. Thank you.

The CHAIRMAN. Now we want our next panel to be heard. We look forward to it. People have come a long way.

Our next panel will return, not that we ever departed, to the question of Section 936. We have a very distinguished group of witnesses and we want to hear them all and in the order listed we will simply go forward. It is a great pleasure for the committee to welcome Hon. Victoria Munoz, who is President of the Popular Democratic Party of Puerto Rico.

Ms. Munoz, would you proceed, please?

There are prepared statements. They will be placed in the record as if read. Proceed precisely as you choose.

[The prepared statement of Ms. Munoz appears in the appendix.]

STATEMENT OF HON. VICTORIA MUNOZ, PRESIDENT, POPULAR DEMOCRATIC PARTY OF PUERTO RICO, SAN JUAN, PR

Ms. MUNOZ. Mr. Chairman and distinguished members, I am Victoria Munoz, President of the Popular Democratic Party of Puerto Rico, which in the last election obtained 46 percent of the votes.

Our party, founded in 1940 by my father, the late Governor Luis Munoz-Marin, has always worked closely with the Congressional leadership. Throughout many years, we worked on the creation of Commonwealth and in the implementation of "Operation Bootstrap," an economic development program that transformed Puerto Rico from the "Poorhouse of the Caribbean" into a "showcase" for American democracy.

Fifty years ago, Puerto Rico remained one of the poorest countries in the Western Hemisphere, with a per capita income of $140 per year, life expectancy of 45 years, in one of the most densely populated areas of the world with no natural resources.

Going from poorhouse to showcase in only 20 years was possible because together we found creative solutions to the social, political and economic problems of Puerto Rico. We are very proud of these accomplishments, as you should also be. They speak highly of both Puerto Rico and the United States, of our mutual understanding and collaboration.

It is in the same spirit that I am here today to ask for a fair, equitable treatment for Puerto Rico and defend the economic development that has successfully created thousands of jobs for our people.

Over one-fourth of our total employment is generated directly and indirectly by 936 companies. The proposal for a wage credit to substitute for Section 936 seriously threatens these jobs. In order to grasp the magnitude of the consequences, imagine that a bill under your consideration would threaten 20 million jobs in the United States.

Our party supports the initiative of President Clinton to move America forward. As American citizens, we could and can contribute. But that contribution must be based on fairness, consistent with our economic realities and our need for further economic development. The proposal under your consideration is not fair to Puerto Rico.

By curtailing Section 936, the U.S. Treasury estimates that it will take out $7 billion from the Puerto Rican economy in 5 years. This will be a severe blow that will create an economic contraction with substantial job losses and a major threat to our long-term viability.

A recent study concluded that the number of unemployed would increase by 50 percent by 1995, the equivalent of over 8 million job losses in the United States. Any contribution from Puerto Rico cannot be at the expense of increasing our already unacceptably high unemployment. It must be based on our economic capabilities and proportional to the sacrifice that the United States as a whole is being asked to make.

Equally significant is the need to present Section 936 as an economic development tool. It has allowed Puerto Rico to attract manufacturing investments replacing low wage, unskilled jobs with better jobs and a world-class work force.

In the last 10 years Puerto Rico has lost 11,000 jobs in labor intensive industries and has replaced them with tremendous efforts with high tech manufacturing employment. The proposal under your consideration eliminates the income credit and offers a wage credit for a job market that we have been consistently losing to low-wage areas, even with the present 936 benefits and without NAFTA, which creates an additional threat to our labor intensive industries. The wage base proposal does not offer a better deal to labor intensive industries than Section 936.

How are we going to reduce the present level of 18 percent unemployment if we lose our most effective tool for job creation, Section 936? Our government already employs 30 percent of the labor force. Our only alternative is growth in the private sector by providing attractive local tax incentives complemented by Section 936 to bring investment to Puerto Rico.

I am here today so that the 3.6 million American citizens in Puerto Rico are heard by this Senate so that their future is not one of poverty and dependence. To that end, in my extended testimony submitted for the record, we are proposing that the current arrangement for inter-company allocation of intangible income be reviewed by the U.S. Treasury to raise additional revenues without causing significant damage to our economy.

President Clinton said, "Most people on welfare are yearning for another alternative, aching for the chance to move from dependence to dignity. And we owe it to them to give them that chance." That is precisely the chance that the Puerto Rican people yearn for and Section 936 provides.

Thank you very much.

The CHAIRMAN. Thank you, Ms. Munoz. And we do have your extended testimony, which will be placed in the record at the appropriate level.

[The prepared statement of Ms. Munoz appears in the appendix.]

The CHAIRMAN. We will go right through our panel before questions. Dr. Luis Costas-Elena, who is legal consultant to the Puerto Rican Senate, appears before us on behalf of Puerto Ricans in Civic Action of Santurce. Perhaps you would tell us more about the organization. But welcome, sir, and proceed.

STATEMENT OF DR. LUIS P. COSTAS-ELENA, ON BEHALF OF PUERTO RICANS IN CIVIC ACTION, SANTURCE, PR

Dr. COSTAS-ELENA. Honorable Chairman Moynihan and Senators, I am Luis P. Costas Elena, General Counsel and Vice Presi-

dent of Puerto Ricans in Civic Action, a civic, non-partisan, grassroots movement in Puerto Rico.

We, Puerto Ricans in Civic Action, wholeheartedly support President Clinton's Proposals for Public Investment and Deficit Reduction, especially the reform of IRC Section 936 into a wage credit. We also support Senator Pryor's bill.

I, personally, have been studying 936 and its antecedents, 931 and 262, for almost 20 years for my L.L.M. thesis for Harvard Law School under Professor Stanley Surrey and my S.J.D. thesis also at Harvard.

The CHAIRMAN. Oh, you are a Surreyvian. We welcome you to this body. They hold a very special place in our Section.

Dr. COSTAS-ELENA. Puerto Rico should receive domestic solutions and programs, not tax gimmicks that can only produce resentment in the States because of runaway businesses. The March 1993 CBS segment by Dan Rather on 936 runaway plants, the 1987 Kansas Business Review Study, the Pulitzer Prize and 1992 bestselling book, "America: What Went Wrong?" exemplify the substantial harms caused by 936 against your constituents.

At the very least IRC Section 936 should have a sunset provision and strict requirements for reauthorization. Immediate reform of 936 into a wage credit and sunsetting could provide $3 billion in additional funds for the U.S. budget, above and beyond what President Clinton has proposed, funds that could be used partially to finance the uncapping of Medicaid in Puerto Rico or any future substitute National Health Program that includes the Island, plus the fomenting in Puerto Rico of programs for education, jobs and infrastructure.

Marcus Aurelius in his Meditations has stated, "The Universe is change, life is opinion." And St. Augustine On Free Choice of the Will affirmed, "(Y)ou shall know the truth and the truth will make you free."

Accordingly, we have for many years been pointing out that the facts belie any need for gradualism in the reform of IRC Section 936 and that IRC Section 936 is a scandalous, ever-increasing Federal tax expenditure, which in effect is a wasteful, Federal welfare program basically for pharmaceutical and other Fortune 500 corporations.

You and I should wholly agree with Prof. Stanley Surrey of the Harvard Law School, former Assistant Secretary for Tax Policy of the U.S. Treasury during the Kennedy administration.

"A tax incentive does involve the expenditure of government funds. A dollar is a dollar, both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label. Tax incentives do involve expenditures 'backdoor expenditures.' And a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the backdoor."

The Congressional Budget Office has explained, "A tax expenditure is analogous to an entitlement program on the spending side of the budget. The amount expended is not subject to any legislated limit but is dependent solely upon taxpayer response to the par-

ticular provision. In this respect, tax expenditures closely resemble spending programs that have no ceiling."

Section 936 is extremely perverse, expensive and a tremendous drain on the Federal budget. The annual Federal tax expenditures of Section 936 have increased to $2.8 billion in 1989 from the $80 million of antecedent Section 931 in 1972. The U.S. General Accounting Office has calculated that from 1993 through 1997 the U.S. Treasury will lose $15 billion—billion, as in budget busting—because of IRC Section 936.

According to the Puerto Rico Planning Board the estimated number of employees in the entire chemical and analogous products group in Puerto Rico—936 and non-936 corporations—which includes pharmaceuticals, was at most 22,600 for fiscal year 1991, including temporaries. And such employees are around 2 percent of the total number of employed persons—925,000—by major industrial sectors in Puerto Rico.

Yet, pharmaceutical corporations pocketed 49 percent of the Section 936 tax expenditures in 1989 or $1.385 billion of the $2.82 billion in total Section 936 expenditures in 1989.

In other words, Section 936 is the worst type of welfare, welfare for the extremely rich pharmaceutical corporations—those that least need Federal subsidies and that employ relatively few persons in Puerto Rico—in the misguided and false expectation that some of those Federal subsidies will indirectly to the average Puerto Rican trickle down.

Section 936 is a Section of the Federal, Internal Revenue Code that allows U.S. corporations, principally the Fortune 500, to organize U.S. subsidiary corporations to do business basically in Puerto Rico and then shift income.

I would like to jump over to recent studies by the Puerto Rican Senate, that especially regarding the alleged 936 funds in Puerto Rico they have already concluded that, "At December of 1992, 93.5 percent of the funds were invested for a period of 90 days or less. The deposits at 30 days generated a return of 2.6 percent, while the deposits of 5 or 6 years offered a return of 5 percent. This dramatic data for a date before President Clinton's proposals arose, reflected almost the totality of the 936 funds available at that date were not financing activities of economic development, but were dedicated to liquid instruments for the financing of activities at very short term."

In other words, the 936 corporations looked like their predecessors, 931, cash-rich mutual funds.

Thank you.

The CHAIRMAN. We thank you, and we note your citation of James Tobin further in the statement.

Dr. COSTAS-ELENA. I have additional data that I would like to introduce as part of the record if I may.

The CHAIRMAN. Would you be so good, Dr. Costas-Elena. We will look forward to it and we will need it.

Next we will hear from Luis Nunez, who is President of the National Puerto Rican Coalition, which is based here in Washington, DC.

Mr. NUNEZ. Yes.

The CHAIRMAN. We welcome you, sir, and good morning.

STATEMENT OF LUIS NUNEZ, PRESIDENT, NATIONAL PUERTO RICAN COALITION, INC., WASHINGTON, DC

Mr. NUNEZ. Thank you very much, Mr. Chairman. I have submitted my testimony for the record. But I would like to make a few comments at this late morning session.

The CHAIRMAN. Yes, I should have said good afternoon.

Mr. NUNEZ. Good afternoon.

The CHAIRMAN. We will put this in the record as if read, and you may proceed exactly as you wish, sir.

[The prepared statement of Mr. Nunez appears in the appendix.]

Mr. NUNEZ. The National Puerto Rican Coalition is an Association of over 100 non-profit organizations across the United States. It was founded to promote the economic, social and political well-being of all Puerto Ricans, the over 6 million Puerto Ricans who live in the United States and in Puerto Rico. Currently we estimate there are 3.6 million Puerto Ricans living on the Island and 2.7 million in the States.

In listening to some of the testimony today several words come to mind one that Puerto Rico has a unique relationship to the United States. Second, that it is a very fragile economy. Both of those comments are exactly on target.

Puerto Rico is totally dependent as a private economy on 936. We talk about the specific jobs created through 936 but we pay very little attention to the over 200,000 indirect jobs that have been created.

The CHAIRMAN. The multiplier effect.

Mr. NUNEZ. The multiplier effect. Exactly, Senator.

The CHAIRMAN. Yes.

Mr. NUNEZ. And if you have experienced Puerto Rico like I have, I went to Puerto Rico in 1958 on my honeymoon and over a 35, 40 year period I have seen Puerto Rico advance from a relatively impoverished economic back water of the Caribbean into perhaps the most advanced technological society in the Caribbean and perhaps South America.

This is due to the development of a high-tech industrial base for Puerto Rico, this could not have happened without a tax incentive. Now this also happened at the cost of an exodus of over a million Puerto Ricans leaving the Island of Puerto Rico between 1945 and 1965. We are the products of that exodus. There are Puerto Ricans in every State of the Union, including Alaska and Hawaii. The majority live, as you well know, Senator, in New York State. They also live in New Jersey.

We have identified 43 congressional districts where there are substantial Puerto Rican communities across the United States. I would say that every community of Puerto Ricans here is quite concerned about the future of Puerto Rico.

Listening to Governor Pedro Rosselló this morning, I would state we support his position regarding the changes that should be made in the current 936. I do not think there is any argument at this point in time that 936 needs to have some changes made.

However, the vast majority of Puerto Ricans, the vast majority of the leadership of the island, wants to ensure that these changes will have a minimal impact on the ability of Puerto Rico and its people to advance economically.

There is no question that the impact of President Clinton's proposal will be at the high end of the job ladder. We talk about 10 percent, 20,000 jobs in the pharmaceutical industry. Those are the jobs that are the best paid, the most skilled jobs in Puerto Rico.

I would raise the question of people who criticize the tax incentive, what do we want, what do we want for Puerto Rico, just the low-wage jobs in which Puerto Rico has to compete against other societies where the wage rates are five times less than they are in Puerto Rico or do we want to make Puerto Rico a truly competitive industrial society that can compete with any other economy across the world?

I think the latter is what we want. And I speak today primarily on behalf of the Puerto Rican communities in the United States that want to see a better future for Puerto Rico, who are concerned about an exodus of Puerto Ricans coming to our communities in the States who all have their own sets of problems. We cannot afford to have an enormous exodus of the magnitude that occurred in the 1950's and the 1960's to the mainland.

I think the issue of the economy of Puerto Rico has to be solved in Puerto Rico. It cannot be exported to the United States.

Saying that, I want to make one point crystal clear. Puerto Ricans are American citizens. Puerto Rican jobs are American jobs. So when we talk about runaway plants, we are talking about plants in an American environment. This is a very important consideration that we all have to take into account as we look at the future of Puerto Rico.

The prosperity of Puerto Rico is important to the continental United States. It is important to the whole Caribbean. We note that Puerto Rico has played an important role in fostering an economic development loan fund in the Caribbean area.

At the House Ways and Means hearing several weeks ago the Ambassador from Jamaica applauded that program. I would like to see a similar program to foster economic development in Puerto Rican communities using 936 funds.

The Governor of Puerto Rico has endorsed that concept. Congresswoman Nydia Velazquez has also endorsed that concept. It is spelled out in our testimony. I think I would again counsel this committee that the future of Puerto Rico and the future of the Puerto Rican community in the United States are bound together and we are concerned and we are supportive of the economy of Puerto Rico and the people of Puerto Rico.

Thank you.

The CHAIRMAN. Well, we thank you, Mr. Nunez. That was very carefully and very properly set forward. I think we might get somewhat similar sentiment from Mr. Arturo Carrion, who represents the Puerto Rico 936 Private Sector Coalition in San Juan.

Good afternoon, sir, and welcome.

STATEMENT OF ARTURO L. CARRION, ON BEHALF OF PUERTO RICO 936 PRIVATE SECTOR COALITION, SAN JUAN, PR

Mr. CARRION. Good afternoon, Mr. Chairman, and members of this distinguished committee. My name is Arturo Carrion. I am here today as the spokesman for the Puerto Rico Private Section

936 Coalition, 29 organizations that have joined to preserve our blueprint for economic development.

The organizations in this Coalition represent approximately 30,000 businesses of all sizes and from all sectors of Puerto Rico's economy, which account for more than 50 percent of total private employment in Puerto Rico.

For the record, I am submitting a full written statement, including a list of the organizations in the Coalition and a summary of the impact which the issue at hand will have on each economic sector represented.

The CHAIRMAN. We will enter that in the record, of course.

[The prepared statement of Mr. Carrion appears in the appendix.]

Mr. CARRION. We are conscious of President Clinton's call for sacrifice by all Americans to strengthen the U.S. economy. However, this sacrifice must be shared equitably among all Americans. This is not the case with the administration's proposals as they pertain to Puerto Rico.

Puerto Rico is being asked to carry a disproportionate share of the tax burden in the President's program. We are the only jurisdiction being asked to put at risk the very foundation of our economy.

The revenue-raising proposals in the administration's program, total $246 billion, which represents slightly less than $1,000 for each American citizen on the mainland. In contrast, the $7.5 billion being asked from Puerto Rico's economy represents more than $2,000 for each of Puerto Rico's 3.6 million American citizens.

If we factor into the calculation the fact that Puerto Rico's income per capita is one-third of the income per capita on the mainland, we find that the proportionate share of the tax-raising burden placed on Puerto Rico is six times higher than the corresponding burden on the mainland.

The administration has two clear-cut objectives—to raise revenues and to create jobs. Both are simple and clear. Neither of them requires or justifies the sweeping changes in Puerto Rico's economic structure that I have been proposed.

Since the late 1940's we have increased our per capita GNP 18 fold, from $348 in 1950 to $6,450 today. Employment has increased more than 50 percent in that period. Section 936 and its predecessors have been instrumental in these achievements.

Even with its achievements, Puerto Rico must still compete without natural resources, one of the world's highest population densities, and a per capita income about half that of the poorest State. In contrast to many countries that compete with us for investment capital, we are bound by some of the toughest environmental standards in the world—by U.S. minimum wage laws, by the cost of maritime transportation in U.S. ships, and by higher energy costs than in the mainland.

Creating jobs is ultimately the main thrust of the President's economic program. Section 936 is essential if Puerto Rico is to continue doing just that—creating jobs. Besides generating 115,000 direct jobs in manufacturing, the activities of 936 corporations support over 200,000 additional jobs and services, trade, retailing and many other activities characterized by medium and small sized

companies, led by Puerto Rican entrepreneurs. These are the people represented by this Coalition.

In the financial sector, 936 companies supply more than 40 percent of all financial resources available for lending and investment in productive employment generating activities. As part of the administration's program, Treasury has proposed a wage based limitation to the 936 credit, which is not by itself an efficient incentive to maintain the mix of high technology and labor intensive industries that we have today.

An income based credit is needed to maintain this balance. The Government of Puerto Rico has recognized the need to keep both elements in effect.

In view of the need to protect the economic system based on Section 936, any modifications considered necessary to the 936 system must conform to several parameters to ensure Puerto Rico's ongoing economic development in harmony with objectives and needs of the U.S. economy.

These parameters are the following: Puerto Rico must answer President Clinton's call to sacrifice in proportion to its capabilities as the lowest income and highest unemployment economy within the United States. Puerto Rico's economic model must be capable of fostering a favorable environment for creating jobs, generating income, enhancing the linkages between all the sectors of the Puerto Rican economy and supplying funds for low-cost financing of public infrastructure and private productive activities.

Modifications to improve the 936 system must provide for the continuous stability of Puerto Rico's investment climate and its attractiveness for future investment and job creation.

Finally, modifications to the current 936 system must be implemented on a gradual basis to give the economy time to readjust its basic underpinnings.

Thank you very much, sir.

The CHAIRMAN. Thank you, sir. May I just say—this is altogether an aside—I see that you represent the Association of Businesses in Old San Juan and also the Association of Automobile Distributors.

Now, if you could persuade someone to keep those automobiles out of Old San Juan, you might find you have a vote on this committee that surprises you. [Laughter.]

Mr. CARRION. We have been trying to do that for quite some time, sir.

The CHAIRMAN. The last member of our panel, a very welcome member, Richard Leonard, is director of Special Projects of the Oil, Chemical, and Atomic Workers International Union, AFL–CIO. Mr. Leonard, we welcome you, sir.

STATEMENT OF RICHARD W. LEONARD, DIRECTOR, SPECIAL PROJECTS, OIL, CHEMICAL, AND ATOMIC WORKERS INTERNATIONAL UNION, AFL–CIO, LAKEWOOD, CO

Mr. LEONARD. Thank you very much, Mr. Chairman. Again, my name is Richard Leonard and I am a Director of the OCAW, which represents approximately 100,000 workers, 10,000 of which are in the pharmaceutical industry. We very much appreciate your kindness in allowing us to testify here today.

I would like to begin by saying that our organization, along with the entire AFL–CIO, is in complete support of the President's program to put a 60 percent wage credit cap on the possessions tax credit. We find that this is essentially a very modest proposal that intends to recapture, I believe, about 40 percent of that which would otherwise be lost to the Treasury over the next 5 years.

And we find that it is very specific, highly specific, in that it directly targets a fairly narrow and small group of companies that have captured an enormous portion of the possessions tax credit while providing a comparatively less amount of benefit to the economy of Puerto Rico.

In fact, we have identified about 34 companies that seem to have captured the vast majority of this benefit. Among them are companies like Merck, for example, that employ 1,200 and earn a tax credit of something like $151,000 on each of those employees.

In fact, Merck has been able to restructure itself so that something like 40 percent of its net income producing capacity worldwide is now sheltered in Puerto Rico and accomplished by 3 percent of its worldwide work force.

The CHAIRMAN. Would you say that once again, sir?

Mr. LEONARD. Merck has structured itself in such a way that 40 percent of its net income producing capacity on a worldwide basis is now relocated in Puerto Rico and accomplished by 3 percent of its worldwide work force.

I might add that the same is true of American Home Products, that has about 1,400 employees in Guayama. It is rewarded with a tax credit equivalent to $75,000 per year for each of these jobs. And it has put 42 percent of its worldwide income-producing capacity within this shelter which is accomplished again by 3 percent of its worldwide work force.

Pepsico and Coke are two companies in Cidra that produce their highly proprietary formulas. In the case of Coke, for example, they employ 371 people and derive a $371,000 per year credit for each of those employees. This is of the equivalent of 1,100 percent of the average wage paid to those employees.

These are just some examples and they are not atypical of what we have been talking about here this morning. Together we are looking at a group of companies that have created, taken together, 3,100 jobs. But this is not even accurate because 1,000 of these jobs were created as a result of the destruction of 1,000 jobs on the mainland when American Home closed plants in Indiana and Pennsylvania and moved that work to Puerto Rico to take advantage of tax sheltered manufacturing.

This process of the tax financed export of jobs that we have seen here is part of a much larger process. We have identified some 24 situations where companies have abandoned mainland locations, engaged in mass layoffs or closures in order to come to Puerto Rico to take advantage of the tax breaks that are offered there.

In the study that we did, which is by no means comprehensive, we identified 10,000 mainland workers who were displaced as a result of this process, most of them in recent years. This underscores a very cruel irony. That is that the very group of middle Americans who are financing this scheme are unwittingly buying into a lottery where the winning entries are pink slips.

This is true for the Acme Boot Co., which is at this very moment letting go of 480 employees to move its equipment and its plant and its management to Toa Alta, Puerto Rico. It is true in the case of the Syntex Corp. in Palo Alto, CA that is moving its operation to Humacao and destroying jobs for 281. It is true of the Sunstrand Corp., that at this moment is discharging 200 employees in Brea, CA to take up residence in Puerto Rico.

The Clinton program does not end Section 936. It basically ends the feeding frenzy which has been taking place here for a number of years at the expense of taxpayers, at the expense of workers, and at the expense of communities on the mainland.

Section 936, I think, in its original form was a great instrument, having great promise for the development of Puerto Rico. But I submit that this has been squandered, that billions have been squandered and that communities, and workers, and taxpayers have been damaged in this process.

I mean the pharmaceutical guys have got a lot of courage. It takes a lot of guts for a pharmaceutical company to look the American public square in the eye and suggest that they finance 100 percent or 200 percent of their wage bill in some region.

I also credit the President with a lot of courage, considering the political might of the pharmaceutical industry, for taking a stand, a gutsy stand, in his proposal. We think it is the right thing to do.

I would add that the President's program is not only modest, it is really quite generous. It is so generous, in fact, that the vast majority of 936 companies will not be impacted by the program at all. These are the companies that are supplying most of the jobs in the Commonwealth.

We are concerned that under the present circumstances we could be seeing additional job exports, more Clarksville, TN, for example. And, clearly, this is not an outcome intended by this administration.

For these reasons, we have supported legislation to stop the export, the tax-financed export of jobs. Three such examples now exist in the House of Representatives in the form of House Bills 1207, 1210 and 1630.

I would conclude by saying that the members of this Committee have the opportunity to perform a great service to workers and taxpayers and mainland communities by holding firm on the President's 60 percent wage credit proposal and advocating the passage of legislation to stop the tax financed export of jobs.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Leonard.

[The prepared statement of Mr. Leonard appears in the appendix.]

The CHAIRMAN. Senator Pryor, you have, of course, been a leader in this whole area. You have been very patiently awaiting your opportunity to speak, and here it is, sir.

Senator PRYOR. Mr. Chairman, I know it is very, very late. I will take just a moment.

April 19, just 10 days ago, the Fortune Magazine came out and showed once again that the pharmaceutical industry's profitability in 1992, was five times the return on sales of the Fortune 500 median company or part of the economy; three times the return on eq-

uity, the pharmaceutical industry had over the median Fortune 500 entities in our economy.

Mr. Chairman, I want to complement you and the staff because this morning's hearing has gone now, what, 3 hours or more. It has been I think the most fair, equal representation of both sides of this issue. I think it is superb. I want to complement you and your staff for doing this. I have heard some interesting and some education things today.

I just have one final question. Maybe, Mr. Nunez, I could ask you. If the average tax credit for a pharmaceutical company is $71,000; and the average salary is $26,000. That leaves $45,000 to put in the pharmaceutical company's pocket. Do you feel that they are sharing their wealth with you and with the Commonwealth and with the people there in Puerto Rico?

Mr. NUNEZ. Well, as has been alluded, Senator Pryor, the direct jobs created have a multiplier effect on these jobs. I read that article in Fortune Magazine myself and it was a very fine article, Senator.

The point is also that pharmaceutical companies are averaging about a 20-percent return, roughly, which is very high. But in totality it is not as high as a lot of people think it is. The reality of American industry is that return on investment has been very low over the last few years.

Do we want to penalize them because they make more money than the average industry in America? One point. The second point is, the quality of the jobs that are created.

One of our companies that I am fairly close to is Johnson & Johnson. Johnson & Johnson brought eight of their managers from Puerto Rico to Washington a couple of years ago and I had dinner with them. They were all Puerto Ricans. They were all plant managers of plants valued at over $100 million.

These people were the most highly trained engineers, pharmacists, chemical engineers; plant managers of some of the most high tech companies in this country or in the world. They were all Puerto Ricans. Those are jobs that would not have been created in Puerto Rico without tax incentives provided by 936.

By adopting the wage credit we will subsidize the low-wage industry putting Puerto Rico in competition with all low-wage areas of the Caribbean. I think ultimately Puerto Rico will lose that battle. The future of Puerto Rico has to be in the development of the high tech, high salary jobs as it has to be for the United States as a whole.

We are no longer competitive at the low-wage rate. Puerto Rico continues to lose jobs at the low end of the spectrum. There have been major job losses in the tuna canning industry which was a mass employer. Half of those jobs have disappeared in Puerto Rico in the last 5 or 10 years. We just cannot compete.

The CHAIRMAN. Did you say tanning?

Mr. NUNEZ. Tuna canning.

That was a big industry in Puerto Rico. That is practically disappearing because it is really very much based on the differential in wages.

Now I think Governor Rosselló's proposal seeks to address some of this imbalance through the option of reducing the current tax credit by 20 percent. I think that begins to address that issue.

Senator PRYOR. I thank you very much. I appreciate that.

Thank you, Mr. Chairman.

Mr. NUNEZ. Thank you.

The CHAIRMAN. Senator Pryor has to leave. He is a leader of the membership of our Democratic caucus, which began meeting 45 minutes ago. I am here. I am not a member of anything. [Laughter.]

Senator PRYOR. He is just the Chairman of the Committee. That is all. Thank you, Mr. Chairman.

The CHAIRMAN. Surely. Thank you, sir.

Ms. Munoz?

Ms. MUNOZ. Yes. I want to add that the multiplying effect is also seen in small businesses. If you have only the wage credit as proposed by the President, what companies will do is contract jobs through the small businesses in Puerto Rico, they will incorporate it into their personal expenditures.

Also, it is very important for us to have this balanced economy. We have a study and we will let you have it. We will send it to you. That the multiplier for the average 936 company is 2.17 jobs. And the average manufacturing job under 936 is almost two for each job created, but for most industries almost four.

These are jobs that have an average of $26,000 to $30,000 salary, average salary. You have a big multiplier in local supplies, in the local economy and in the small business in commercial in the sectors I derived from the primary money-making or economy for the using sectors.

So we are talking about real jobs. I want to address also the fact that in the 1970's everybody was saying that we had a very big petro chemical industry and everybody was saying that they were threatening to go from Puerto Rico, the price of oil was raised, and it was not true, and we should never believe that they had a lot of money invested in Puerto Rico and they would never leave.

Well, the price of oil went up and they left Puerto Rico and we lost many jobs there. So we cannot take lightly these threats to leave Puerto Rico.

Already they are leaving for Santa Domingo, the pharmaceutical are phasing out a 1,000 worker plant in Puerto Rico and relocate in Santa Domingo in the Dominican Republic. So we are talking about dealing Puerto Rico a very bold economy and making us very much poorer and more dependent on welfare programs which is not what we want. We want good jobs at good wages.

Mr. CARRION. Senator, may I get a dissent in here?

The CHAIRMAN. Yes, Mr. Carrion, and then Mr. Leonard. Was that you, Dr. Costas?

Mr. COSTAS. Yes.

The CHAIRMAN. You first. I am sorry.

Dr. COSTAS-ELENA. I would like to point out to the distinguished Chairman that anyone that resorts to multipliers to defend 936 is implicitly recognizing that the direct data do not support or justify the continued existence of 936.

If the direct data were enough to justify, you would not need to resort to multipliers, which are basically estimates or guess work.

Number two. Lester Thurow of MIT came down to Puerto Rico in the 1970's and he precisely pointed out the lack of linkages to justify these alleged multipliers perennially used by the defenders of the 936 and 931 tax exemption program of Puerto Rico.

Most recently Thomas Hexner and Glen Jenkins—Glen Jenkins is the director of the Harvard Tax Program of International Studies—and he has pointed out the ridiculousness of these multipliers and that they are basically just inventions of the defenders. And he points out that if you actually use those multipliers you will wind up with more people employed in Puerto Rico than there are actually people in the entire labor force of Puerto Rico.

The CHAIRMAN. That is a complex thought. [Laughter.]

Mr. Leonard?

Mr. LEONARD. Thank you, Mr. Chairman. To the extent that these multipliers, in fact, exist, I would like to point out that this works in reverse as well. I mean, to the extent that we can show that something like 10,000 mainland jobs have been destroyed in this process, and you look at the multiplier numbers that are presented by some of the defenders of 936, you could make the argument that 20,000 to 30,000 jobs have, in fact, disappeared in the mainland as a result of this migration to tax havens in the possessions.

So I would just like to raise that point. That this situation can be looked at from both ends.

The CHAIRMAN. Well that is entirely——

Mr. LEONARD. If, in fact, the multipliers exist.

The CHAIRMAN. This is one society and one economy where there is this one sector of the economy has this special arrangement.

Mr. Carrion, the last word is yours.

Mr. CARRION. Thank you very much.

I would like to respond briefly to Senator Pryor's comments. I believe that he was referring in that article to a study by the General Accounting Office. I think it is appropriate to mention that that study was done on a limited number of selected companies. I guess it is just about 20 companies that really earn the larger portion of the profits earned.

But on the other hand, they represent the largest number of indirect jobs created. I would like to respond to Mr. Costas-Elena, that definitely the indirect job production is a fact. There is no way you can escape from that fact. If you create a direct job, you have to create some others around it.

And particularly in the case of the high-tech industries, they have the highest multiplier effect because of the very nature of their operation.

I would like to share with you also what we call Puerto Rico at a glance. First of all, regarding the payment of taxes, I think that, you know, much has been said that 936 companies do not pay any taxes. Just for the record, first of all, under the profit split method, 936 companies do pay Federal income taxes on the 50 percent of the income attributable to the U.S. sources.

Secondly, they pay substantial amounts of income and withholding taxes to Puerto Rico. Let me give you some facts. The total in-

come tax revenues of the government of Puerto Rico for 1992 was $2.3 billion, of which the corporate income tax amounted to $1 billion, of which 936 corporate taxes amounted to $513 million.

The CHAIRMAN. A third of the corporate tax.

Mr. CARRION. Please note that 50 percent of the corporate income taxes are paid by 936 companies.

On the other hand, about the so-called 936 funds, the funds have been invested very, very well in Puerto Rico. We do have a very strong regulatory process which governs how these funds are invested. The amount of 936 funds invested in commercial finance, is $6.7 billion; in housing financing, $4.8 billion; in public sector finance, $4.1 billion; in CBI countries finance, $1.1 billion; and in other general investments, $2 billion.

Most of this money is coming from the high tech companies that do provide indirect jobs, that do provide 936 funds, and that do provide a very high quality of employment in Puerto Rico, not only on a direct, but also on an indirect basis.

And I submit to you that in the same way that the distinguished panel has just mentioned, that the loss of jobs in the States that he proclaims, would create a very difficult indirect job loss in the States, the same thing would happen in Puerto Rico, sir.

The CHAIRMAN. Well, I think we can all agree that there is nothing really contradictory in what anyone has said here. The issue is before us. We are very much in your debt for the testimony we have. We are aware of how important this issue is. We are aware that more than a few things depend on the outcome of our decision.

If I may say to Mr. Nunez, my first visit to Puerto Rico was a half a century ago when I served in the U.S. Navy in 1946. I loved it then and have loved it ever since.

We will have to deal with this in the general setting of our tax measures. I will make it my business to speak directly to the President about this, give him a sense that this involves larger issues than simply revenue here, and we hope to settle them responsibly.

And if we do, it will be because we have had the advice and very helpful counsel of each of you. So I want to thank you. And at 1:30 in the afternoon I declare our morning session adjourned.

[Whereupon, at 1:26 p.m., the hearing was adjourned.]

[The prepared statement of Senator Hatch appears in the appendix.]

ADMINISTRATION'S TAX PROPOSALS (INVESTMENT TAX CREDIT AND BUSINESS MEALS AND ENTERTAINMENT)

THURSDAY, APRIL 29, 1993

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:33 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Bradley, Breaux, Conrad, Packwood, Chafee, Durenberger, Grassley, and Hatch.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good morning to our distinguished witnesses and our most welcome guests. This is to continue the series of hearings that Senator Packwood and I have put together on the President's tax proposals as they are incorporated in the budget resolution.

We are most honored to have a panel of persons of unexampled experience and authority, at least with this committee who will give us their views, with respect to the investment tax credit and some other business proposals.

Dr. Fred Bergsten, is Chairman of the Competitiveness Policy Council and is well known to our committee; Mortimer Caplin, a public official of great distinction and attorney in Washington right now; Dr. James Gravelle, who is with the Congressional Research Service in the cconomic policy area; Harry Sullivan, who is co-chairman of the Tax Reform Action Coalition; and Peter McNeish, who is secretary and member of the board of directors of the Small Business Legislative Council.

As is our practice, we will go down the list as the witnesses appear in our witness list.

Senator Packwood?

Senator PACKWOOD. No opening statement, Mr. Chairman.

The CHAIRMAN. We wish to hear our witnesses. Dr. Bergsten, good morning, sir. We begin with you.

STATEMENT OF C. FRED BERGSTEN, PH.D., CHAIRMAN, COMPETITIVENESS POLICY COUNCIL, WASHINGTON, DC

Dr. BERGSTEN. Good morning, Mr. Chairman and Senator Packwood. Thank you very much for the opportunity to testify.

I am this morning, as you said, representing the Competitiveness Policy Council, which, as you know, is a 12-member national commission created by the Congress several years ago, totally bipartisan, 12 members appointed by the President, the Senate and the House, comprised equally of business executives, labor union leaders, government officials, and representatives of the public interest.

A month ago we presented our second report to the President and the Congress, laying out a detailed blueprint for a comprehensive, competitiveness strategy for the United States, attempting to respond to the mandate that the Congress gave us in creating the Commission several years ago.

We conclude that the United States, despite some recent progress, continues to face major competitiveness problems and we outline a comprehensive program that we think would deal with it.

We set several national goals for the United States. We think productivity growth has to be raised from the less than 1 percent rate of the last 20 years to at least 2 percent over the next few years. We think economic growth has to be increased to at least a 3 to 3.5 percent average, and we want to eliminate the external deficit that has led the United States to become the world's leading debtor country.

Now I preface my remarks with this because these goals are essential to the investment tax credit proposal which we support before the committee today. One of the areas of our competitiveness strategy, which goes beyond what the administration has proposed, is to support more private investment in the U.S. economy.

Our recommendation to double or more national productivity growth requires a significant increase in both the quality and quantity of private investment in the economy. All of our proposals for improving education, training, public infrastructure spending, technology supports, improved corporate governance and the like seek a bigger bang for every investment buck.

But in addition, we have to increase the share of the economy that is devoted to investment. The U.S. invests less than any of our major competitors, less than half as much as Japan. And in some recent years, Japan has invested more than the United States in absolute terms, with half the population.

A modest part of the needed increase in U.S. investment will come from public spending on infrastructure. The bulk, however, has to be private investment in plant and equipment. Our council concludes that the United States must increase the investment share of our economy by at least 5 percentage points of the GNP in order to meet our goal of doubling national productivity growth. That is a conservative estimate.

Many observers—the CED in its recent report, Marty Feldstein in work he has done, would argue that a much larger shift of resources, on the order of 6 to 8 or even 10 percent of the GNP needs to be shifted into private investment to get productivity growth up, to increase our standard of living, to get the kind of economy we want.

Now we know that the cost of capital is crucial in determining the national investment rate. In fact, the user cost of most types of production equipment has risen sharply over the past decade due to tax increases on investment and equipment.

So our council proposes three new tax incentives for private investment to reduce the user cost of capital, as well as to channel private investment in the most productive directions.

First is a 10-percent equipment tax credit, limited to equipment so we call it an equipment tax credit; and permanent for all firms on either an incremental or a first dollar basis.

We also propose reinstatement of a permanent R&D tax credit and more realistic depreciation periods. But I will focus today on the investment tax credit since that is before your group.

I would point out that our proposals were formulated by our full council of the quadri-partite nature I mentioned, and backed up by a 29-member sub-council on manufacturing, composed of experts from all walks of life. Members of that subcouncil included four Senators—Bingaman, Levin, Lott and Roth—two members of the House—Nancy Johnson and John LaFalce—and also Laura Tyson, now Chairman of the CEA, who was then in the private sector.

Our council recommends a permanent equipment tax credit to induce companies to invest more than they otherwise would in high payoff investment equipment. We analyzed all the arguments against this policy tool and found that most of them are aimed at a temporary credit, rather than the permanent credit that we endorse.

We agree that a temporary credit would lead to a bunching of investment rather than a permanent modification of incentives. So we do not support the temporary credit.

By contrast, we believe a permanent equipment tax credit would permanently increase the share of investment in the economy. This, we believe, is an essential component of any competitiveness strategy for the country's economy and we strongly recommend it.

We believe that a permanent equipment tax credit would work. During past periods when such a credit was in place, growth in equipment spending rose strongly, in sharp contrast to periods when the credit did not apply. There has been extensive research that clearly shows a high correlation and highly probable causation between equipment, investment and economic growth, suggesting a very high rate of investment bang for buck of ETC tax expenditure.

We believe that an equipment tax credit would reduce tax revenue in the shortrun. We strongly favor reasonable budget policies and would want to pay for that in the overall budget package. But it is important to understand that a well-designed effective equipment tax credit should pay for most, if not all, of its initial costs within a few years by generating new production and employment and we lay out the numbers that would permit that to happen.

Finally, three points in designing an equipment tax credit. Most of our Council members believe that it is desirable, to put it that way, to trade off a slightly higher corporate tax rate for an equipment tax credit, and the other targeted tax credits that we propose.

Second, the equipment tax credits should not be covered by the alternative minimum tax because that would truncate its impact.

And finally, in deciding whether to go incremental or first dollar, which incidentally we had a split on within our group, we recommend you talk to the corporate CEO's who are going to implement the thing and see what their best judgment would be.

Thank you.

The CHAIRMAN. Thank you, sir. My goodness, that was a prodigiously productive 5 minutes. [Laughter.]

[The prepared statement of Dr. Bergsten appears in the appendix.]

The CHAIRMAN. Dr. Gravelle?

STATEMENT OF JANE G. GRAVELLE, PH.D., SENIOR SPECIALIST, ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC

Dr. GRAVELLE. Thank you. I thank you for the invitation to appear here today.

The President's proposal includes a temporary incremental tax credit for equipment purchases of large businesses, and a permanent non-incremental credit for small businesses.

The permanent credit for small business is the single, largest permanent subsidy for business in the tax package. The temporary large business credit is a short-term stimulus program. And since it does not introduce permanent changes, increases in spending are likely to be borrowed from the future.

A temporary incremental credit should have more effect on increasing spending per dollar of revenue loss than a regular credit. There may be a case for such a fiscal stimulus, although some economists may feel that such a stimulus is not needed this late in the business cycle.

Some reservations, however, can be voiced about the temporary credit. First, will it be successful and stimulating and increase spending? There is not much evidence that the investment tax credit operates effectively as an investment stimulus. One of the reasons typically advanced for this weak, short-run effect is the planning lag for capital expenditures.

For this reason, and because the credit will be retroactive, much of the credit would inevitably accrue as a windfall to investments that would have been made in any case.

Second, is the stimulus worth the administrative complications? The credit has all the complications of a regular investment credit in defining eligible assets, plus additional complications brought about through its temporary and incremental aspects.

An incremental credit, in particular, creates problems in application to new firms, firms that merge and split, partnerships and leasing firms.

During 1992 there was discussion of a permanent incremental investment tax credit. A permanent incremental tax credit is probably impossible to design and would have certain economic drawbacks, including a built-in tendency to exacerbate business cycles and increase industry concentration.

Making the credit temporary avoids these problems and lessens the general administrative problems associated with an incremental credit since firms have less of an incentive to manipulate the base. At the same time, however, a temporary credit adds its own set of complications in defining what expenditures fall within the time frame.

A final question is what the implications for fairness are of large differentials and benefits across firms that will occur in part because of their past investment histories.

In assessing the economic benefits surrounding the permanent small business tax credit there are two issues that are both separate and related. The first issue is why a subsidy should be directed to equipment investment. The second is why an equipment credit should be targeted to small business.

Turning to the first issue, conventional analysis of capital income taxation usually suggests that providing subsidies for particular types of investment is inefficient. The notion that tax neutrality across investment contributes to economic efficiency was a fundamental philosophy behind the design of the Tax Reform Act of 1986, which repealed the investment credit in favor of lower tax rates.

Now one recent claim that has attracted some attention is the argument that equipment investment contributes especially to economic growth, largely based on a statistical study across countries that showed a relationship between investment in equipment and growth rates, especially with a subcategory of "high productivity" countries.

While such new research is always intriguing, experience suggests that one must be cautious about new statistical findings until they are subject to scrutiny by others and replicated. The statistical relationship found in this study, in particular, appeared to be heavily influenced by the behavior of only a few countries.

A subsequent study found, in fact, that the relationship disappeared among the high productivity countries when they were restricted to OECD countries. Moreover, the relationship between non-OECD countries became statistically insignificant if one country, Botswana, was eliminated from the sample. [Laughter.]

I do not want to take a lot of time with this study, but it is, I think, a study Fred mentioned and a study that has been mentioned frequently as a justification for this credit.

Another argument for an investment credit is that it will increase savings. This argument does not constitute an argument for favoring equipment, per se. And there is, unfortunately, little evidence that private savings rates are affected by changes in taxes.

The revenue devoted to subsidizing equipment investment would probably be more likely to contribute to the savings rate if it were used to reduce the deficit.

The second issue is why a subsidy should be directed to small business. Small businesses are largely unincorporated and are generally subject to lower taxes than are large businesses that operate in corporate form. The credit will simply increase an existing favorable treatment.

One argument is that small businesses create most new jobs. The perception that existing small businesses create a large fraction of new jobs dates from a study that has since been found to be incorrect.

But even if this argument were correct, and increasing small firm jobs were the object of the investment credit, why subsidize capital rather than wages? A subsidy for equipment could even reduce employment and encourages a substitution of capital for labor.

Some distributional issues might also be raised. Despite our image of small business as struggling "mom and pop" enterprises,

as a statistical average owners of small business have five times the wealth and almost twice the income of the average American.

Indeed, the smallest of small businesses will not benefit from the investment credit because current law already enables them to expense up to $10,000 of equipment investment and they would not also receive the credit.

This discussion is not meant to imply that there may not be legitimate concerns about small businesses, such as access to capital and regulatory and paperwork burdens. But the investment credit will not address these concerns.

There are two final observations that might be made about the small business credit. The first is that, as currently designed, there is a notch problem since firms lose all credits when their receipts rise above the dollar limit.

Second, whenever a tax provision for businesses is limited by size, it tends to create some administrative problems. One such problem is the treatment of multiple ownership of firms. Another problem is that taxpayers will have an incentive to arrange the timing of receipts and investments in order to qualify.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Gravelle. We are going to have learn more about Botswana and future samples.

[The prepared statement of Dr. Gravelle appears in the appendix.]

The CHAIRMAN. Mr. Sullivan, you are next.

STATEMENT OF HARRY SULLIVAN, CO-CHAIRMAN, TAX REFORM ACTION COALITION, WASHINGTON, DC

Mr. SULLIVAN. Thank you, Mr. Chairman. My name is Harry Sullivan. I am the senior vice president and general counsel of the Food Marketing Institute. But I am also the co-chairman of the Tax Reform Action Coalition and it is in that capacity, with TRAC, that I appear today.

Prior to the enactment of the Tax Reform Act of 1986 very wide disparities existed in the effective tax rates paid by different economic sectors and even by individual firms within the same sectors. While some businesses could substantially reduce their tax obligations through credits and deductions, others with the same taxable income could not because their activities, which generated those credits, were not a significant part of their natural business operations.

TRAC was founded in June of 1985 by business associations and corporations which were committed to enacting tax reform which would substantially reduce the then-existing statutory rate, both the individual and corporate, in return for a reduction of the preferences in the Code.

The coalition's membership grew rapidly. By the time Tax Reform was enacted, TRAC's membership had grown to 250 corporations and associations. All told, the coalition's original membership represented more than 100 of the Fortune 500 industrial companies and over 1 million businesses nationwide.

Today, TRAC is even more broad-based, with 339 association and corporate members. Our current membership roster is attached to my written statement. TRAC enthusiastically supported the 1986

Act because of the substantial reduction in marginal tax rates which the Act provided in return for base broadening. This was both fair and a desirable compact.

Throughout the process, TRAC focused solely on the issue of tax rates and the coalition retains that focus today. Mr. Chairman, as you so well know, TRAC worked closely with members of this committee to enact what was one of the most significant pieces of legislation in modern political history.

The CHAIRMAN. If I may say, Mr. Sullivan, really primarily with Senator Packwood and Bradley.

Mr. SULLIVAN. But we are recognizing you as a very important part of the committee at the time.

The CHAIRMAN. Fine.

Mr. SULLIVAN. As well as others who were in the Senate at the time.

Senator BRADLEY. We certainly recognize that. [Laughter.]

The CHAIRMAN. Enough productivity.

Mr. SULLIVAN. As a fellow Irishman, I admire your modesty, sir.

The Tax Reform Act of 1986 represented much more than a revamping of the Tax Code. It represented a victory of principal over special interest and demonstrated that American politics can work to the benefit of all the people, not a chosen few.

As you begin consideration of the tax components of the President's proposals, it is important to remember that the core of the Tax Reform was the shift of investment decisions to an economically motivated basis from a tax motivated basis. The President's proposals reflect a reversal of the stunning achievements of the 1986 Act, namely restoration of special preferences and an increase in the rates.

This tears at the fabric of tax reform. It will recreate the unfairness and inefficiency of the pre-1986 law. TRAC strongly urges you and the committee to not do this. In furtherance of this viewpoint, we urge you to abandon the proposed temporary ITC and leave corporate tax rates alone.

The ITC has virtually no support in the business community, retaining the corporate tax rate at its current level certainly does.

TRAC wishes to note that the increase in the individual rates will also have a devastating effect on businesses which pay taxes as individuals. Most of these businesses are small to medium-sized and have provided the largest share of new job in the country over the past 10 years.

This increase in their taxes will seriously undermine the ability of small business owners to reinvest profits from fledgling enterprises and create new jobs and grow. Indeed, in many respects smaller businesses are the hardest hit by the President's proposals.

In conclusion, TRAC supported the 1986 Tax Reform Act because of the rates it contained and the promise that those rates held were sound economics and tax equity. We supported base broadening through the elimination of preferences. This was the lynch-pin with the 1986 compact.

With profound respect for this landmark legislation, we strongly urge you to not increase the rates, not restore the preferences.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Sullivan. And thank you in particular for Appendix B which is an exorbitantly interesting comparison of the spread between individual and corporate rates.

We now have the lowest corporate rates in our history with the exception of 1 year. This, of course, is very much due to the work of Senators Packwood and Bradley and the committee.

[The prepared statement of Mr. Sullivan appears in the appendix.]

The CHAIRMAN. We will go right ahead to Mr. McNeish who is testifying on behalf of the Small Business Legislative Council.

Senator PACKWOOD. Let me say something on behalf of Senator Bradley and myself. You were correct in Senator Moynihan's part in that act. We had a little, small working group that would meet each morning and he was part of that. New York had more interest that did not want us to do what we did in any other single State and every single thing we did affected one of Pat's constituents in one way or another.

And it was Pat that introduced us to the passive loss concept of—who was that fellow that was President of the New York Tax Bar Association who came here and testified at your suggestion.

The CHAIRMAN. That is right. But need you remind me of that? [Laughter.]

Mr. McNeish, good morning, sir.

STATEMENT OF PETER McNEISH, SECRETARY AND MEMBER, BOARD OF DIRECTORS, SMALL BUSINESS LEGISLATIVE COUNCIL, WASHINGTON, DC

Mr. MCNEISH. Thank you, Mr. Chairman, Senator Packwood, Senator Bradley. In my full-time job I am president of the National Association of Small Business Investment Companies. Today I have the pleasure to testify on behalf of the SBLC in my capacity as an officer and member of the board of directors of that organization.

SBLC is a coalition of some 100 trade and professional associations that share a common commitment to small business. Our members represent interests in some 5 million small firms in such diverse economic sectors as manufacturing, retailing, professional services, finance, construction, transportation and agriculture.

At the outset I would like to make two general observations. First, SBLC is on record as commending President Clinton for offering the Nation and small business a vision for economic change. Certainly there are items in this package that give us serious concern, but we are very hopeful that the legislative process can refine and smooth out those problems.

Second, for the last 3 years SBLC has vigorously pursued a four-point strategy for economic recovery. Our four-point plan includes incentives to restore consumer confidence, incentives to restore business confidence, to increase affordable credit for small business and to eliminate unnecessary government regulations.

For our purposes today, the most relevant aspect of our plan is to call for incentives to restore business confidence. And one of SBLC's guiding principles in that regard is that the Tax Code should be used to direct economic activity which will encourage the growth of small business.

This certainly includes our consistent support for and incentive in the form of a meaningful and workable tax credit for small business investment in plant and equipment. We believe that if a permanent ITC is properly structured it will reduce the marginal cost of capital sufficiently to promote increased investments by small business and productive plant and equipment.

In turn, these additional expenditures will create new jobs and stimulate growth in the economy.

Let me just turn to the President's specific proposal for the small business ITC. At first glance the proposed permanent ITC for firms under $5 million gross receipts would seem to hit the market in terms of a viable, economic constituency.

If based on size, most small businesses in that universe would be eligible for the credit. And you might ask, why isn't the small business community jumping for job. I must tell you, the enthusiasm of our membership is not overwhelming. This is from a group that has said it will work with the President on his proposal and an organization that has long supported the ITC.

We do believe that ITC will restore business confidence as I indicated before. But truly the devil is in the details. In our view, the proposed credit must be modified in several material respects to achieve this goal. We see four basic reasons for change.

One relates to the qualification standard of the credit. The second involves the structure of the proposed credit itself. The third relates to the expansion of direct expensing as an option. The fourth involves the impact of the President's overall tax proposal.

As to the qualification standard, the statistics suggest that a substantial number of small firms important to the job creation process would fall outside the President's size definition of $5 million or less in gross receipts. This is particularly true in such fields as manufacturing and construction, where even SBA's definition of small firms includes companies with a $7 million to $17 million in annual receipts.

In our view, it would be a mistake to admit these productive job creators. We recommend the qualification threshold for the small business ITC be raised to at least $10 million and possibly $15 million.

As to the structure of the ITC, the proposal simply has too many restrictions attached to it to have the desired user impact. While the credit structure is a nominal rate of 7 percent for the first 2 years and 5 percent thereafter, in fact, it yields a much lower effective rate.

The value of the credit is materially diluted by tying the graduated rate structure to the recovery class life of the assets. It is further diluted in value as a result of the required basis adjustment to the asset.

When all is said and done and a permanent nominal 5 percent rate is in force, depending on the assets involved and the taxable income bracket of the taxpayer, we are looking at an effective rate for small firms ranging from slightly more than 1 percent to just under 4 percent in 1995 and thereafter.

Depending on the assets involved and the tax status of any business, expansion of direct expensing under Section 179 may provide a better opportunity for small business to make capital expendi-

tures. Currently, that section allows small business to write off the first $10,000 of such expenditures in the first year.

In the absence of an ITC, this provision allows small business to weather the streams of immediate capital asset acquisitions by allowing that immediate writeoff. The history is that the two White House conferences on small business strongly supported those expensing provisions and their increase, and even pairing them with a new effective ITC.

For some small firms increasing the Section 179 deductions to $25,000 may be a preferable option to the ITC, particularly with an ITC with the restrictions as proposed by the President.

In the absence of an ITC, we would be rather fanatical supporters of expanding a direct expensing provision. However, we do believe the best option is to have an expanded direct expensing provision that augments ITC. Both serve a value purpose in slightly different ways and accommodation of the two incentives, mutually exclusive in terms of the user, would increase the number of small businesses able to avail themselves of some immediate cost recovery.

Finally, we need to look at the overall impact of the President's tax proposals. The enthusiasm of the small business community for the ITC is seriously tempered by the rest of the President's package. I would be hard pressed to say there is a real balance between the two.

As a practical matter, the ITC is the principal item in the plus column. On the negative side, the vast majority of small business owners, as sole proprietors, partners or as S corporation shareholders, are most directly affected by personal rate changes.

The basic problem is that both personal wealth and business earnings for many small firms are taxed to the personal rate structure. Only 2 million corporate taxpayers pay taxes on a corporate rate business and all other businesses use the personal rate structure.

And although it may appear on a personal return, taxable income of a small firm are the retained earnings of a company poised to make capital investments and create jobs.

This creates a significant competitive disadvantage with the individual rate structure at 39.6 percent; the corporate rate structure is significantly less, either 34 or 36 percent.

In conclusion, Mr. Chairman, we believe that appropriate changes in the Tax Code can effectively stimulate small business to the economy and create jobs. We would like to help work with the committee to change those margins.

Thank you.

The CHAIRMAN. We thank you very much, Mr. McNeish.

[The prepared statement of Mr. McNeish appears in the appendix.]

The CHAIRMAN. Now to conclude our panel, an old friend of this committee, a distinguished public citizen, a public servant over years, and at one time the Commissioner of the Internal Revenue Service, Mortimer Caplin. Good morning, sir.

STATEMENT OF MORTIMER M. CAPLIN, PARTNER, CAPLIN & DRYSDALE, WASHINGTON, DC

Mr. CAPLIN. Good morning, Mr. Chairman, and members of the committee. It is a real pleasure to be back here again. I did serve as Commissioner of Internal Revenue under Presidents Kennedy and Johnson during the 1961–64 time frame and I am now a member of a law firm here in Washington, Caplin & Drysdale.

I am pleased to appear at your invitation. I will not read my full statement, which I leave for the record, and I will focus on my summary.

I suggest to the committee that it should eliminate both the proposed investment tax credits—the 2-year incremental credit——

The CHAIRMAN. Now you were involved in the establishment of the first investment tax credit; were you not, sir?

Mr. CAPLIN. Yes, and I am going to comment on that right now. I feel the permanent ITC for small business, as well as the incremental, should not be adopted. My views are based upon my experience with the credit. Dating back to the 1960's, I participated in the development of the ITC concept, first as a member of President-elect Kennedy's Task Force on Taxation and later as Commissioner of Internal Revenue, called on to help draft regulations and to police the whole application of ITC.

The House Ways and Means Committee had rejected our suggestion for a 15 percent incremental ITC as too complex and erratic in its application and it finally emerged as an across-the-board ITC for new and, to a limited extent, used equipment, tangible personal property. We excluded any "building and its structural components."

Now throughout my years as a lawyer, and a former tax collector, and a member of a number of corporate Board of Directors, I have never been impressed by the impact that the ITC had on decisionmaking to increase investment. Most businessmen I know make acquisitions of machinery and equipment to enhance production, not for a 7 percent or a 10 percent ITC.

The on-again, off-again history of the ITC provides little proof that by itself it has a large affect on capital formation. Ms. Gravelle has studied that issue carefully and I have leaned on some of her studies.

Although the timing of the expenditures may be affected, much of the prior ITC was wasted on investments that would have been made in any event.

Economists differ sharply on whether an ITC is an efficient, cost-effective means of stimulating the economy and contributing to long-term growth. Some have concluded though that for each dollar spent by the Treasury on the ITC considerably less than $1 of increased investment was, in fact, produced.

I should say that administering an ITC and overseeing compliance with its terms are a nightmare. It is difficult and it is costly. Drafting the statute and the regulations, as has just been pointed out, to define new tangible personal property and separate it from "structural components" of a building is complex and demands some very fine line drawing.

Then, taxpayers will distort their normal decisionmaking to squeeze themselves, squeeze their transactions, into the ITC mold.

And not unknown is the mislabeling and the use of misleading terminology to avoid IRS detection. So some of these projections on the revenue loss are really greatly understated.

There was an injunctive proceeding against a major firm which had been recommending some of this mislabeling. Concrete block walls, which were not qualified, were told to be labeled "knock-out panels." A section of roof on building were told to be labeled "equipment support." Fixed walls, call them "movable partitions-gypsum;" and doors, call them "movable partitions-wood."

Now it is amazing the games people play to try to craft themselves into the ITC.

The CHAIRMAN. Being a tax collector, as you say, can be a disillusioning experience.

Mr. CAPLIN. Well, it gives you a realistic view of the world. Let's put it that way.

Besides using traditional machinery and equipment—that is what everybody is talking about as a base for ITC claims—taxpayers have been before the IRS and the courts defending claims on a broad range of questionable items.

I have given you a few examples here—movable ceilings, ski slopes and earthen ramps, catwalks, amusement park rides, bath houses and fixtures, egg processing structures, drive-up tellerbooths, gasoline pump canopies, master film strips, "reproduction masters" of original Picasso works, book rights, et cetera. The government has won all these cases, but the courts were clogged.

Although the 1986 Tax Reform Act went a long way in curtailing tax shelter abuse, there is still room left for creative packaging of tax shelters and reenacting ITC's would act as a stimulant to the whole tax shelter industry.

I would like to say that the President's proposals taken as a whole contain enough essential ingredients to whet the appetites of hungry tax shelter promoters. Just take a look at the package: higher tax rates tied to an already broadened and tougher tax base; capital gains preferences with a 30-percent reduction in the top rate for higher taxpayers plus a 50-percent exclusion for targeted capital gains for "qualified small business stock;" partial repeal of the passive loss rules for real estate professionals; introduction of the ITC's; and even the enterprise zone benefits—all available to be packaged together for the right customers.

In such a setting adroit and ingenious tax planning should not be underestimated.

I would just like to summarize with this. The ITC's run completely counter to the philosophy of the 1986 Act. It turns the clock back. The 1986 Act was aimed at broadening our tax base while coupling it with a lower marginal rate structure—and a 1-percent rate increase today is much more potent than it was before 1986.

The CHAIRMAN. Oh, yes.

Mr. CAPLIN. The 1986 Act was grounded on eliminating tax preferences and avoiding micro-management of the economy by selecting particular activities or industries for special rates or other tax benefits, and encouraging taxpayers to make business decisions based on sound economic criteria rather than tax inducements.

Our Nation would better be served by a tax system that continues in the 1986 Act direction—one not diverted by a temporary or

permanent tax incentive heralded as an imagined economic stimulant.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Caplin appears in the appendix.]

The CHAIRMAN. We thank you, sir. It certainly will be a relief to many people out there in Gucci Gulch to know that the opportunities for adroit and ingenious tax planning will not dry up. [Laughter.]

The CHAIRMAN. I must say that Dr. Bergsten has to leave by 10:20. If our committee would address questions to him with that in mind, that would be helpful.

I would like simply to make just a general question to you. Dr. Alan Greenspan came and opened this series. We asked him about this question that troubles us all, this issue, that we are in a recovery after a recession where the business cycle is up. But employment is scarcely moving.

You know, that this is a jobless recovery, as it has been called. He offered the thought that in this cycle, the largest contribution to the economic growth has come from productivity increase.

Dr. Gravelle, we know you followed that very carefully; and, Dr. Bergsten, that is your full concern in life. I asked him to send the information on it. He just sent little bar charts which show that—of the contribution of productivity growth to output growth, going back to the 1961 recovery—that the highest by far has been the most recent one.

He suggested that computer programs were breaking into a lot of sectors that had not been before and this is one of the prime movers. I would ask anyone who has any comments; first, you, sir, of course.

Dr. BERGSTEN. Well, one question is to ask how much of this recent burst in productivity growth that did stimulate the recovery in recent quarters is permanent and how much is temporary?

Economists have not been very good, frankly, in discerning the causes of productivity growth and what may be motivated in the future. But one of the best students of that is Robert Gordon from Northwestern University who has done the most careful analysis of the recent productivity burst, and asked how much of it is permanent and how much is temporary.

He concluded, and Charlie Schultz at Brookings who commented on a paper he gave recently, tended to agree that a little bit of the burst is permanent but not much. To use round numbers, U.S. productivity growth over the last 20 years has been 1 percent a year, compared with 2.5 in the earlier post-war period. Our council says we have to get it back at least to 2 percent a year.

Last year it came in at about 3 percent. How much of that 3 percent is permanent? What Gordon and Charlie Schultz basically concluded is that maybe two-tenths of 1 percent of it was permanent. Maybe we are up from 1 to 1.2 as a result of the restructuring that has gone on in industry, some of the other changes that have been made, perhaps including tax changes, but we are still a long way from getting back to anything like the permanent productivity growth rates that we need for standard of living improvements and restoration of American competitiveness.

The CHAIRMAN. I do not want to keep my other Senators from asking questions. But does anyone else wish to comment?

[No response.]

Senator Packwood?

Senator PACKWOOD. No, go ahead if they want to comment.

Dr. GRAVELLE. Well, I think I agree with Fred. It is very hard to explain. We have been notoriously bad at understanding why productivity rates change.

The CHAIRMAN. It is not the worse problem to have, explaining why.

Dr. GRAVELLE. No. Unless you have it because unemployment is up, then it is bad to have.

The CHAIRMAN. No, I mean if you have to explain a problem, the problem of 3 percent productivity is not bad.

Dr. GRAVELLE. That is right. But we had productivity drop dramatically in the mid-1970's and we have really never understood for sure why. So it is not an easy question to answer. It is not an easy thing to explain.

The CHAIRMAN. Could I tell just one war story? Mortimer Caplin would be interested. In 1963, for the first time ever, a group of Americans, the American Sociology Association, was invited to send a delegation to the Soviet Union, at a time when this did not happen.

They went over and they met with their great academic counterparts and they thought that there would be intense discussions of Marxism and alienation and all the issues that had been bothering them all these years. They were fascinated to hear what people they had not heard from in half a century had to think.

The only thing the Russians wanted to talk about was productivity. That is the only thing the American academics knew nothing about. [Laughter.]

Productivity was what we had, you know. Doesn't everybody have productivity? They came back just absolutely shattered. They had been a complete disappointment to their guests, and their hosts, and were frustrated themselves. But we had it and now we do not have it. Maybe that is what we know about it.

Dr. BERGSTEN. But you are also saying they thought it was a sociological phenomenon.

The CHAIRMAN. Oh, sure. Yes. I mean, they saw it as the central problem. I was then Assistant Secretary of Labor in charge of the Bureau of Labor Statistics—nominally in charge. You know, the productivity data would come in every year and you would say, okay, fine, put it there, thank you. It was up again. You know, it was always up again, nothing interesting about that.

Then as we found out with them, it was a preoccupation. They could not get productivity out of their system. They knew it. Everybody in Russia, all the Russians knew it. The only people that did not spot it was the CIA, which had their productivity roaring ahead.

Senator Packwood?

Senator PACKWOOD. Dr. Bergsten, what is equipment?

Dr. BERGSTEN. Well, that is a good question. I am not a lawyer who tries to define it in the terms that you need for implementing tax law.

Senator PACKWOOD. Give me whatever definition you can. But then I am going to ask Mr. Caplin a little later on to use his fertile mind and give me some examples as to what he thinks you might try to do if you had an equipment definition, and some of the things you might try fit into the equipment definition.

Go ahead.

Dr. BERGSTEN. I basically equate it to productive machinery.

Senator PACKWOOD. What does that mean?

Dr. BERGSTEN. Well, those are hard——

Senator PACKWOOD. Are they personal computers that you have on your desk?

Dr. BERGSTEN. They could include that.

Senator PACKWOOD. Do they? I am kind of curious if we are going to adopt this definition as to what it is.

Dr. BERGSTEN. I would include that in my definition.

Senator PACKWOOD. Would everybody?

Dr. BERGSTEN. I think most would.

Senator PACKWOOD. Okay. What else?

Dr. BERGSTEN. As Senator Moynihan said, the advent of widespread computer usage probably has been one of the sources of this productivity pickup of late and we would want to encourage that.

Senator PACKWOOD. Here is what I am afraid of. We adopt your definition and you are not sure what it is. So we say equipment gets this credit. We just say equipment. Now what is going to happen? I was intrigued with Mr. Caplin's movable walls or doors or something like that. Are people going to try to define everything as equipment?

Dr. BERGSTEN. Let me just note that in the studies several of us have referred to that have underpinned this case that investment in equipment pays off heavily, it has been defined largely as machinery.

Senator PACKWOOD. For United Parcel Service, are trucks equipment?

Dr. BERGSTEN. I would call that transportation equipment. It is so defined in most of the statistical series.

Senator PACKWOOD. So it would fit within your definition?

Dr. BERGSTEN. I think so.

Senator PACKWOOD. Their airplanes would fit within your definition?

Dr. BERGSTEN. Yes.

Senator PACKWOOD. Well, what would not fit within your definition other than building?

Dr. BERGSTEN. Buildings, real estate.

Senator PACKWOOD. No, other than buildings or real estate. What would not be equipment?

The CHAIRMAN. Well, I just want to interrupt right there. How could a building not be equipment? If you take a seven-story building out of lower Manhattan where people have to use freight elevators to go up and down and move stuff around on trucks and you go out to New Jersey and it is not like that in the suburbs out there, surely that is a piece of equipment that produces more product. [Laughter.]

Senator PACKWOOD. I think you could make a good argument. But I do not think Dr. Bergsten means that building to be equipment, do you?

Dr. BERGSTEN. We do not and we do not mean most kinds of real estate investment.

Senator PACKWOOD. But this was never an investment for the investment tax credit under the old law?

Dr. BERGSTEN. That is right. I was going to say, this issue has been answered in the past because of what the credit——

Senator PACKWOOD. What you are going back to in terms of definition is basically the old law.

Dr. BERGSTEN. In very large part, that is right.

Senator PACKWOOD. Then you are going back to the old tax credit definition of what gets the credit?

Dr. BERGSTEN. That is basically right.

Senator PACKWOOD. Okay.

Dr. BERGSTEN. That is basically right.

Senator PACKWOOD. I like it all the less now.

Dr. BERGSTEN. We wanted to highlight the fact that it is equipment and not real estate. We wanted to call it that to highlight the fact. But in substance, you are right.

Senator PACKWOOD. The reason I asked you that is because several groups have been around very narrowly defining equipment as something that fits into just their business and they say it does not apply to personal computers, it only applies to die stamping machines used east of the West Meridian or something like that.

Dr. BERGSTEN. Right. Senator Packwood, it is equipment, too.

Senator PACKWOOD. I think so. I think that is exactly it.

Dr. BERGSTEN. It gets pushed, too, by various taxpayers. They want to include their item. The whole motion picture industry, whether or not a film qualifies for the investment tax credit. It was finally put in the statute and there will be more and more pressure for more items to go into the statute.

The CHAIRMAN. I simply made the point about buildings because one thing you know about productivity in the United States is the advent of the automobile assembly line and that is a building. It has never been considered equipment, but it clearly is related to productivity.

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

There are a lot of things to cover. Let me just ask a point of clarification from the last question. Quickly, Dr. Bergsten, you said the 3-percent productivity growth really added only 2 percent permanent.

Dr. BERGSTEN. Two-tenths of 1 percent.

Senator BRADLEY. Two-tenths of 1 percent permanent. What was the rest?

Dr. BERGSTEN. The Bob Gordon analysis suggested it was the typical catch-up phenomenon that occurs in recovery periods.

The CHAIRMAN. But it had not occurred earlier, Dr. Bergsten.

Dr. BERGSTEN. No.

The CHAIRMAN. In the last 30 years.

Dr. BERGSTEN. What you should do is actually have Gordon up and put his analysis in the record. But his basic conclusion is that

in the late 1980's we had an abnormal turn down in productivity growth, some of which was then recouped in the recovery period in the last year or 18 months.

But we essentially simply got back to that one point per year growth path that we have been on for the last 20 years with maybe a little more. That is the basic conclusion of his analysis.

Senator BRADLEY. Well, I do not want to use all of my time on that. But I was curious to kind of get in at a little deeper level. If anyone wants to help me through that with some note or some comment, I would appreciate it.

Mr. Sullivan, does the ITC penalize corporations who invest in worker retraining as opposed to equipment or fixed investment?

Mr. SULLIVAN. Yes. It makes the cost of labor, versus capital and equipment, more expensive vis-a-vis each other.

The CHAIRMAN. Mr. Sullivan, would you say that a little more emphatically. It is a matter we want to get clear. You said yes. [Laughter.]

Mr. SULLIVAN. Yes. [Laughter.]

It very much does.

Senator BRADLEY. Okay.

Mr. SULLIVAN. While there are other things happening that will increase the cost of labor and cost pressures, whether they are fringe benefits, costs of health care, all the other pressures on labor, the difficulty of finding new jobs and financing them, we would be tilting the other way.

Senator BRADLEY. And does it not penalize service firms as opposed to manufacturing firms?

Mr. SULLIVAN. It tilts that way. In my own situation, I work with supermarkets and I sat here and sympathized with Commissioner Caplin as the tax collector. I know how much effort they put into collecting that.

Senator BRADLEY. Right.

Mr. SULLIVAN. As supermarket operators, we, naturally, if it is in the Code want to qualify and much of that did not qualify in the previous Code.

Senator BRADLEY. Right. Now does not an incremental credit also penalize those firms who have been making investment, over the base period of time? If you have been out there making investments and you have been, according to the authors of the ITC, a good citizen, and the incremental comes along, you do not get anything? Right? You are penalized, are you not?

Mr. SULLIVAN. Relatively speaking, if you have been doing zero in terms of investment, you are better off now under the new situation than those who have been having a steady stream, plowing money back into the firms.

Senator BRADLEY. Right. But if you have done nothing, if you have not invested in equipment to give your workers a better chance to be more productive, are you not rewarded with this incremental credit?

Mr. SULLIVAN. Your timing is excellent then. If it were enacted and then you invested, your timing would be excellent.

Senator BRADLEY. Okay. That kind of sets a perverse set of incentives.

Let me ask Dr. Gravelle, there are claims that this is a stimulus. What is your reaction to the thought that a $15 billion tax incentive for a narrow category of investment is a stimulus to a $6 trillion economy?

Dr. GRAVELLE. Well, it is pretty small potatoes, obviously.

Senator BRADLEY. Pretty small potatoes?

Dr. GRAVELLE. That is right. It is certainly not going to appreciably affect the course of this recovery and, of course, that is even assuming it works. Again, when we try to uncover statistical evidence that an investment credit works, it is very hard to find that kind of relationship.

Senator BRADLEY. Could you just once more make the point for some of the members who just arrived? You did an interesting little analysis in which you took only those high productive countries that are in OECD.

Dr. GRAVELLE. Right. The original study divided countries into—looked at all the countries together and found this relationship between investment in equipment and growth and then they divided them into so-called high productivity countries and low productivity countries. They have had a much more powerful relationship in the high productivity countries.

So all you have to do is look at their scatter diagrams and you can see that there are just a few countries that are sort of dominating this relationship.

So another set of researchers—one of them was Alan Arbach—said let's take the sample and just split it into a sort of typical split, OECD countries and non-OECD countries. The relationship disappeared with OECD countries and in the non-OECD countries it disappeared if you removed one country, Botswana, from the sample.

Senator PACKWOOD. You mean it just appeared in the OECD countries whether or not they had the investment tax credit or not.

Dr. GRAVELLE. Well, they were trying to look at a relationship between equipment investment and growth rates. Basically, the statistical relationship disappeared in that case. So we would say this is not a robust piece of evidence.

Senator BRADLEY. In a Third World country if you replace a horse with a truck, you increase your productivity. If you replace a 1956 truck with a 1957 truck in a developed country, there is a marginal impact on your productivity. Along those lines.

Dr. GRAVELLE. Well, that is what you would think. Yes.

Senator BRADLEY. One other point that you made that I think is very important and I was a little surprised about: that was your point about small business not being the engine of jobs and also in terms of being already the recipient of significant tax benefits.

You know, there are two kinds of investment tax credits in this package and one is for small business. To what extent can you help us think that through again?

Dr. GRAVELLE. Well, there was a study that was done about, I guess, a little over 10 years ago that said small businesses created the vast majority of jobs. There was a mistake made in the study in classifying businesses apparently.

But when researchers went and looked at this again, what they found is it is not that existing small businesses create jobs, it is

that new businesses create jobs and new businesses are born small. They do not start big, usually. That is important, for one thing because new businesses do not usually benefit from any kind of tax subsidy because they usually have losses and many of them fail. About 60 to 80 percent of these new businesses fail before they can even use the credit.

So the ordinary ongoing small business does not create a disproportionate share of jobs. Again, as I said in my testimony, even if you wanted for some reason to stimulate jobs in small businesses, I do not understand why people are talking about investment credits, which is for a competing factor, a substitutable factor.

If we go back to what I would call the default position in economics—that you want to be neutral—then what you discover is that on average unincorporated businesses have about half the tax rates of incorporated businesses. So they are already subject to favorable tax treatment.

What a lot of economists spent a lot of time analyzing and made their careers out of is analyzing the affect of this differential between corporate and noncorporate taxes.

Now with the equipment tax credit, this effective tax rate will fall from about half to about a quarter of the effective tax rate of large businesses.

Senator BRADLEY. Now on the last small business point. If I could just ask Mr. McNeish, you do not support the investment tax credit that was proposed in this package.

Mr. MCNEISH. We would support it with modifications.

Senator BRADLEY. But you do not support it as it is now written?

Mr. MCNEISH. Frankly, our membership is very mixed on the issue and would strongly recommend improvements on it, yes.

Senator BRADLEY. But you do not support it as it is now written?

The CHAIRMAN. Come on, Mr. McNeish, you may say yes.

Mr. MCNEISH. Yes, sir. [Laughter.]

The CHAIRMAN. No, not yes, sir. We have your testimony, sir. [Laughter.]

Mr. MCNEISH. Yes, sir. If I could, Mr. Chairman, though to take issue with Ms. Gravelle's comments on small business creating jobs, I think recent government studies, as well as the private study she referred to 10 years ago, which were challenged and rechallenged—and I am not sure that original issue was resolved—but even the government studies, including those of the Small Business Administration show clearly that small business is the great creator of jobs in this country, and is the engine of job creation.

The CHAIRMAN. I think Dr. Gravelle made what was for me an illuminating point, which is that new businesses create jobs and new businesses are small.

Why don't we ask each of you, invite you and urge you to give us data.

Mr. MCNEISH. We would be pleased to do that.

The CHAIRMAN. And we can always contact you, Dr. Gravelle, because happily you are the Congressional Research Service.

Dr. GRAVELLE. That is right.

The CHAIRMAN. Dr. Bergsten?

Dr. BERGSTEN. I would like to give one sentence of response, if I could, to three of Senator Bradley's questions.

The CHAIRMAN. Please.

Dr. BERGSTEN. First, the question about the incremental credit, a firm that has already invested a lot could still be induced to do more if you define incremental as the previous investment to sales ratio. To me that is a sensible way to do it. We came out agnostic between incremental and first dollar. But you can design it in a way that would still give an incentive for more investment for firms that have invested a lot in the past.

Second, you asked about the short-term stimulus. Our council at least thinks you should not view the investment tax credit proposal as a short-term stimulus. Either do it on a permanent basis as an effort to raise the share of investment in the economy for the long run to get productivity up or do not do it.

Third, on the study we have discussed, I have a little different reading than Ms. Gravelle. The coefficients coming out of the study itself show that when you look at the OECD nations only you still get a reasonably strong correlation with machinery investment. Not as strong as when everybody is in, but still reasonably strong.

But second, if you go back and take the whole array of countries at an earlier base period, say, 1950 when Argentina, Uruguay and others were in the high-income category and ask why they stayed behind and others went ahead, equipment investment plays a big role in that outcome.

Senator BRADLEY. Politics played no role.

The CHAIRMAN. Trade, politics.

Senator BRADLEY. Governments, you know.

Dr. BERGSTEN. There are lots of variables. I have mentioned only two countries. There are more. The point is, if you take the long swing, which you should in looking at productivity growth, not just cyclical and short-term developments, one reason why countries have diverged over long periods of time is the amount of investment they put in this regime.

The basic point Senator Bradley makes is right. You have to look at an investment tax credit or any proposal in this area as part of a broad economic strategy to improve our productivity and competitiveness. The only point is, that getting private investment up substantially has got to be an important part of any such strategy. It is not going to save the day by itself. But without it, you are not going to get very far with your other things.

Senator BRADLEY. Would you rather reduce the deficit or have an investment tax credit?

Dr. BERGSTEN. I would rather reduce the deficit.

Senator BRADLEY. Thank you.

Dr. BERGSTEN. But I think the two are complimentary.

The CHAIRMAN. Dr. Bergsten, this is just to say we do know of your scheduling problem and if you have to go we will understand that.

Dr. BERGSTEN. I will wait a few more minutes.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. Thank you very much. I would like to thank the panel. I am sorry I missed your testimony. I am sure it was right on target.

Let me ask not a technical question at all, but make a political observation. Anybody who wants to comment on it, I would like to hear you. Every week and every day and every hour we are besieged by constituents and people that we represent asking us to do one thing or the other, or perhaps to not do one thing or the other.

It seems to me that on this proposal the small business investment tax credit at $16 billion and the incremental investment tax credit at approximately $13 billion, that no one is beating down our doors or calling us hourly or daily or weekly at all saying that this is essential. They have a lot of other priorities.

It almost looks like we are in a position of forcing them to take it. I do not think we have the luxury to force anybody to take something that costs almost $30 billion. I guess my point is, does anyone have any overriding reasons to do away with that point?

Dr. BERGSTEN. I understand the politics of it and I understand why many people in the business community would rather keep lower corporate rates and not have these targeted incentives.

Senator BREAUX. I would also add to that quotient, there are a lot of middle income people who would suggest that a BTU tax could be reduced instead of giving $30 billion to businesses who apparently do not really want it.

Dr. BERGSTEN. I would make two points, and this is also some of Ms. Gravelle's language.

I do not regard this as a subsidy to business. If you are going to do this you do it because you think it is going to increase national productivity growth and create jobs. If you do not believe that, then you do not do it.

But I do not think it is analytically correct to think that a subsidy to business has got to strengthen the economy and create jobs if you want to do it. The studies I believe in think it will do that, but it is admittedly an issue of debate.

But the other point is the following, I think public policy has to focus on what is good for the national economy. What is good for the national economy has got to be increased productivity, higher economic growth, and higher standards of living over time. You should try to put together programs that you think will achieve that. I think, with Senator Bradley, that the first step is to reduce the budget deficit, in part because it will mean lower interest rates. That, too, will increase investment. But I believe that targeting private investment spending to high pay-off equipment investment rather than "whatever they want to do with the money" makes sense from a national economic standpoint. I, therefore, understand that you are not being deluged with requests for it. If I were a corporate CEO, I probably would rather have the bucks to do whatever I wanted to do with them as well.

From the standpoint of the national economy, I believe these targeted efforts do pay off. I am a little surprised at Mr. Caplin's statement. I understand all the horror stories about administering a credit which he told us. But the facts clearly show that the investment tax credit that his administration put in place in the early 1960's led to an annual growth rate of producers' durable equipment spending of almost 12 percent a year, higher than in previous or subsequent periods.

Now there are obviously other variables. You cannot say this was the whole story. But it is a little hard for me to conclude from that one experience that the credit was a failure, despite the movable walls.

Mr. CAPLIN. Well, let me respond to that. When we designed the first investment tax credit, part of President Kennedy's desire was the number one thing—to get this economy moving. We were in the pits of the Eisenhower years. We were just really down low.

It was not the investment tax credit that was the most dramatic thing. We made a revolutionary change in the depreciation policy of this country. What we did was to dramatically change old Bulletin F—where we had 5,000 items, with varying useful lives for depreciation schedules; and businessmen had to pick out where they were. We reduced that to 75 specific classes of useful lives.

The average businessman could actually, through these groupings, have three or four classes and satisfy his entire depreciation requirements. We reduced the lives of equipment and machinery about 17 percent. It was a very dramatic move with tremendous publicity. There was a great psychological surge over the depreciation reform being done administratively, immediately followed by ITC legislation in October of 1962. It was an entirely different picture than today.

There has been no hard evidence that this investment tax credit really increases productivity and significantly enhances the purchase of new equipment. I think Ms. Gravelle's studies buttress that.

Senator BREAUX. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. You know in my constituency I am hearing two very different things. Number one, the vast majority of the businesses in my State are small businesses—98 percent of them would qualify for the full investment tax credit. I find a fair amount of enthusiasm for it.

Larger corporations, we have very few of them in my State—I think we have only 13 with more than 500 employees—show no interest in the incremental ITC. So I find a real divergence.

Fred, maybe I could ask you this question. When we compare the average age of plant and equipment in this country to our major competitors, what do we find?

Dr. BERGSTEN. U.S. plants are considerably older.

Senator CONRAD. Could you give us some range of relationship? I am told that our average age of plant equipment in this country is about double that of our major competitors.

Dr. BERGSTEN. That was the number that came to mind. I am not sure of my source, but about double is probably right.

Senator CONRAD. What set of policies could we pursue that would encourage our companies to modernize plant equipment, assuming more modern plant equipment means a more competitive economic position for our country?

Dr. BERGSTEN. I think three things are crucial to get new investment, which is what you are talking about. One is permanently lower interest rates, and that means budget correction first and foremost in my view.

But secondly then, targeted incentives. Investment tax credit, I believe, would do that. But I also agree with Mr. Caplin on the importance of depreciation allowances. Those were deliberalized to some extent in the 1986 Act. And in our package, from our Competitiveness Policy Council, we proposed reduction of the depreciation lives in addition to the investment tax credit, in addition to budget correction, because we think all are so important to get new investment for exactly the reason you say.

Senator CONRAD. So if we were constructing an entire package what we would do is dramatically reduce the budget deficit, have targeted incentives for new plant and equipment, and we would alter depreciation schedules? I mean, if we were to construct an overall strategy and plan that would make sense, those would be the components.

Dr. BERGSTEN. Those would be the components of the private, physical capital side of it. The really comprehensive strategy includes some more infrastructure investment by the government and investment in human capital—education and training programs as we have designed in our report. Private investment, which is absolutely central because without it you are not going to get the whole outcome you want, would focus on those three variables.

Senator CONRAD. Would other members of the panel want to comment on that? In terms of an overall structure and strategy.

Dr. GRAVELLE. Yes.

Senator CONRAD. Go ahead, Ms. Gravelle.

Dr. GRAVELLE. Well, I think the whole framework that Dr. Bergsten is proceeding from is something that I would like to question.

I think the position that most economists tend to take, unless you can find a reason to deviate from it, is that businesses should make the decisions about how to allocate their savings, how to allocate funds available, without the interference of the government.

So if it is advantageous for you to spend some money to modernize your plant, if you can make a higher rate of return at that than some other use of your money, you would do that. So I think the fundamental perception that he has of how capital should be allocated, I do not think you would find wide agreement on.

I think it is hard to argue in most cases that the government should be interfering in the allocation of capital. There are some exceptions. R&D is a good exception where the government certainly should play some role.

But in general, you should have your investment allocated to where the highest pre-tax rate of return is in order to maximize your social welfare and that means you want to have the same tax rate applied to every investment, whether it is a building, a high-rise in New York, a factory, or all these personal computers or cars or trucks, whatever you are talking about.

So I do not agree with that judgment.

Mr. CAPLIN. Senator, I just want to respond. I can understand why your constituents would like an investment tax credit. After all, it is a tax reduction. But I have been practicing law for a long time and in the tax world I have yet to meet anybody who really

buys a piece of equipment because of that 7 percent or even a 10-percent investment tax credit.

They think, do I need this machine, can it enhance my productivity, and if you give me a tax reduction, that is great. It is like a price reduction in buying the machine.

Dr. BERGSTEN. Could I challenge that frontally? [Laughter.]

Dr. GRAVELLE. Better than a stab in the back.

Dr. BERGSTEN. My Competitiveness Council went into some great depth and our Manufacturing Subcouncil in particular depth. A fundamental competitiveness problem the country faces is that American industry insists on much higher threshold rates of return than investors in other countries. The ratio is three or four times as great as in Japan, for example.

How do you meet your threshold rate of return? One way is lower cost of capital. And that gets to interest rates fundamentally. But it also gets to the taxation of your capital spending.

And I hear lawyers say all the time that they have never seen a business who invested because of a tax rate. Ms. Gravelle even says it. How can that be? Why do they, therefore, scream so much to you about their tax rates? It cannot be both. The cost of capital is a critical variable in determining investment. The taxation of investment is a critical element in the cost of capital. It simply cannot be that it is irrelevant.

Now they are not going to go out and buy something that has no payoff just for tax reasons. But at the margin, determining how many additional investments to make, or which kind of investment to make, you are going to tell me that 10 percent on the cost of the equipment makes no difference, I just do not believe it and I do not think studies show it.

I am interested that Ms. Gravelle likes R&D intervention by the government. I do, too. But she seems to think that it is okay and equipment incentives are not. And the studies, to the extent they are any good, show that equipment investment pays off more than R&D investment.

Senator CONRAD. Mr. Chairman, if I may just make a concluding comment.

The CHAIRMAN. Would you, please, sir? [Laughter.]

Would you, please, sir? You may do it frontally or laterally. [Laughter.]

Senator CONRAD. Well, I like Fred coming at it frontally. I think that was fair.

Let me just say, Mr. Chairman, I think as a country we had better figure out a way to close the gap with our competitors when their plant and equipment is far more modern than ours.

I have seen Japanese plant and equipment. I have seen German plant and equipment. And it would be very hard to persuade me that the fact that their plant and equipment is half the age on average as ours does not give them a competitive advantage.

The CHAIRMAN. Thank you, sir.

Mr. MCNEISH. Mr. Chairman, if I could just respond to his general question.

The CHAIRMAN. Yes.

Mr. MCNEISH. Your policy matrix I would throw in, if you will, Senator Bumpers targeted capital gains reduction as well. Because

the seed capital for small growth companies in this country has dropped off materially since capital gains exclusion was lost and is an essential requirement.

The CHAIRMAN. We would just like to take notice of the fact that there is a distinction made and I think accepted between management decisionmaking and the forces of those decisions and macro economics. Not many managers seem to invite professors of economics in to talk about what to do next.

I think that the somewhat anecdotal statements about why managers make decisions has, you know—it has a certain authority before this committee because everyone says the same thing. What Mortimer Caplin reports is what everyone reports to us—that businessmen make decisions in terms of if they can sell the stuff they are going to make, and not because of the tax specific issues.

Senator Chafee? Senator Durenberger has left, but he will be back.

Senator CHAFEE. Okay, thank you, Mr. Chairman. I came a little late and I was not here for all the discussion, which I regret. Let me just say, Mr. Chairman, that I am a veteran of the Tax Reform Bill of 1986. I think we did the right thing. As you know, we lowered the rates and got rid of many of the special credits, exemptions and deductions.

The CHAIRMAN. If I may say, you would have heard this most emphatically from some of our earlier witnesses.

Senator CHAFEE. So when I hear us going down that trail again, that is reversing everything in 1986, and including an increase in the corporate rate, which I understand has not been discussed to a great degree here; this morning and we are going to have these goodies given back, such as the investment tax credit, I must admit that I am skeptical.

The CHAIRMAN. The point was made, and I think I would just like to call attention to it. But a 1-percent increase in the corporate rate today is a more consequential matter than a 1-percent increase in the old pre-1986 Code, because you have to pay it. [Laughter.]

Senator BRADLEY. Fewer leaks in the boat.

Senator CHAFEE. I am sorry Senator Conrad has left because to me it is no surprise his people are for it. Who is against some goodies?

But also, we hear this testimony from different folks that come before us, and usually not from the manufacturers, but you would think that the American manufacturing system was similar to a Third World nation in the event of its lack of modernization and everything else.

Mr. Bergsten indicated some concern in that direction. I am not sure that is totally accurate.

Dr. BERGSTEN. Certainly not totally accurate to equate U.S. to——

Senator CHAFEE. Well, I must admit you are equipped with facts and I am not. All I have is elevation here and nothing else. [Laughter.]

Dr. BERGSTEN. Your instinct is totally right. I am not equating the United States to a Third World nation. But if you compare it with our industrial country competitors, we invest much less than

they do. The age of our capital stock is much older than theirs. Our productivity growth is much slower than theirs.

Senator CHAFEE. Well, is that true?

Dr. BERGSTEN. Yes.

Senator CHAFEE. Okay. [Laughter.]

Dr. BERGSTEN. And, therefore, we need to do something about it. Let me give you one number that is interesting. Productivity growth in the last 20 years has been less than 1 percent a year. My council says we have to make a considerable effort to get it up to 2 percent. It sounds like a small difference—1 versus 2 percent a year productivity growth. In one generation that difference would increase per capita income in the country by a third.

Put it the other way around. Great Britain's long-term relative and absolute decline in economic terms resulted not from a cataclysm in terms of its economy, though the war is obviously costing a lot, but something like 1 percent a year less productivity growth than Germany over a period of half a century or more.

These small numbers add up to a tremendous amount.

Mr. CAPLIN. Does the fact that Germany and Japan have been bombed out so completely and started with new equipment have any bearing on these statistics at all?

Dr. BERGSTEN. In the 1950's and maybe into the 1960's, sure. There was a one-shot catch-up. But you cannot explain differential productivity growth in the 1980's and 1990's from what happened in the 1940's and 1950's.

Senator CHAFEE. Well, we could spend a lot of time on this and I am not sure that the difference between Great Britain and Germany is all attributable to the investment rate. I think there are a host of other matters.

I noticed Mr. Caplin cheering me on with a smile because I was agreeing with much that he had to say. But let me just say, that while I agree with much of what Mr. Caplin said, I do not quite buy the idea that the country was in a shambles before President Kennedy came in. [Laughter.]

Mr. CAPLIN. I will stay silent on that. But I do want to commend you for the work you did and the attitude you had about the 1986 Act. It was a very dramatic improvement in our tax policy.

Senator CHAFEE. And here is the principle author of it right here.

Mr. CAPLIN. What we forget is how important to this Nation our tax-raising machine is, a machine that despite all its defects raises over $1 trillion a year—and over 95 percent of that comes from what people report themselves.

No other nation comes close to that. Taxpayer confidence in that system is terribly important. And I am concerned about it, as we give a preference here and a preference there, and the potential build up of tax sheltering again—which was a horrendous episode in our tax history—and I am concerned what that does to taxpayer compliance.

The IRS admits that close to $120 billion a year in taxes, year after year—$118 billion I think was IRS' last published number—is lost through bad reporting from legal sources. This is not illegal income that is escaping income taxes, but bad reporting of legal income—resulting in $120 billion in lost tax revenue a year.

If we weaken compliance, we do a terrible disservice to the country. I think the 1986 Act went a long way to strengthen compliance attitudes in this country and I hope we will continue that way.

Senator CHAFEE. Thank you.

The CHAIRMAN. Thank you, Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. And we thank this most distinguished panel.

Senator BRADLEY. Mr. Chairman?

The CHAIRMAN. Excuse me one moment, Senator Bradley would like just another moment.

Senator BRADLEY. Could I just ask one last question? Just because this is going to come up over and over again in our committee. That is, cost of capital and what is the most effective way to reduce cost of capital. Tax is one. Interest rates is the other. And if you are in the comparative mode, exchange rates are the third.

Now, how would you weigh each of those and do you have anything else to add?

The CHAIRMAN. Why don't we go down the panel in order of appearance? So we would ask Dr. Bergsten first and then Dr. Gravelle.

Senator CHAFEE. What is the question, sir? I am sorry, Mr. Chairman.

The CHAIRMAN. There are three components with respect to cost of capital. They are interest rates. They are taxation rates and they are exchange rates. Senator Bradley asked what weight the panel would give to the present situation. We will say today.

Dr. BERGSTEN. I would submit by far the most important is interest rates. Therefore, the policy priority should be to reduce or, in fact, eliminate the budget deficit in order to achieve a long-term reduction interest rates.

On the international comparison, the exchange rate is critical. When the dollar was massively over-valued in the first half of the 1980's, we went from a current account surplus to a deficit of $160 billion, accumulated to $1 trillion over the last decade. So internationally that is critical.

The CHAIRMAN. Not to make any political points, but we had a Secretary of the Treasury who every time he thought he heard that the dollar had strengthened he thought America was stronger and then the terminology got him a little confused.

Dr. Gravelle?

Dr. GRAVELLE. Well, I would just like to make two points about your question. First of all, it is clear that interest rates are a more powerful component compared to taxes because of our tax rates.

But I would challenge anybody to do a very good job of doing international cost-of-capital comparisons. I have looked at these and nobody has precise measures of risk factors across countries that enables them to do a very careful job in the first place.

So I would just treat all these international comparisons with a grain of salt.

Second, I think we are looking at the wrong issue. When we are concerned about what we are doing to increase our future standards of living and the welfare of our children, we should be talking about the savings rate, not the investment rate.

The investment that is imported into the United States by foreign owners of capital accrues to them, not to us. And the most direct, clear way of increasing the national savings rate, I believe, is to reduce the deficit. So I would put that very high on the list of things to do.

The CHAIRMAN. Thank you, Doctor.

Mr. Sullivan?

Mr. SULLIVAN. Senator Bradley and Senator Chafee, on behalf of the Tax Reform Action Committee, and we testified, in our testimony we expressed concern about those corporate rates as well as individual rates, but I would have to say tax rates.

First, the interest rates are subject to market influences in the market forces. The exchange rates, too, with competitive forces, those things that we have control over, statutory tax rates, is most important. That is something that we can affect without interfering with the market.

The other part about it is the neutrality of it. It lets businesses and individuals make their own investment decisions being driven by economics by what their consumers are buying, rather than being tax-motivated in how they spend their money.

The CHAIRMAN. Thank you, Mr. Sullivan.

Mr. McNeish?

Mr. MCNEISH. Clearly, for small business access to capital across the board is essential to the livelihood and the ability of those firms and interest rates play back to that, certainly primary, and taxes certainly a second place.

The CHAIRMAN. And finally as a wrap-up, Mortimer Caplin.

Mr. CAPLIN. I would underscore this last comment. I think the important considerations are cashflow, availability of capital, low interest rates, and the economic needs of the moment in terms of that businessman making that decision about that equipment.

The CHAIRMAN. Thank you all. You can see from the response of the committee how much we have learned and how much more we are going to learn when Dr. Gravelle and Mr. McNeish send us in their papers. Thank you very much, indeed.

I would ask our room to come together now. We have our second panel of the morning. This is going to address the subject of the proposed change in the deductibility of meals and other business expenses.

Mr. Berman, why don't you move over next to Mr. McIntyre. It will not do you any harm. It might do him some good.

We have a very distinguished panel again. We have Mr. Berman, who speaks on behalf of the National Restaurant Association; Mr. Juliano, who represents the Hotel and Restaurant Employees International Union, AFL–CIO; Mr. Wachtel, who is director of research and government relations for the League of American Theatres and Producers; and lastly, and well known, of course, to our committee, Robert McIntyre, who is the director of Citizens for Tax Justice.

So in the order of appearance, Mr. Berman, good morning, sir, and would you proceed?

STATEMENT OF CHARLES BERMAN, ON BEHALF OF THE NATIONAL RESTAURANT ASSOCIATION, WASHINGTON, DC

Mr. BERMAN. Thank you, Mr. Chairman. My name is Chip Berman. I co-own and manage the Outta the Way Cafe in Rockville, MD. We are a neighborhood restaurant that sells a little rock-n-roll and a lot of cheeseburgers, nothing fancy and three things on the menu over $11.

You might be wondering why someone like me is testifying on business meal deductibility. You probably expected Duke Zeibert or Mo Sussman. Well, every day a great many business people bring clients to my restaurant to help market their services and close their deal.

Today I speak for thousands of middle class restaurateurs and their employees. Today I represent Suzetta Harrison and Brenda Bishop, a line cook and a waitress in my restaurant, both single parents with two children. Suzetta is with me here today. Unfortunately, Brenda could not be. She is home with a sick child.

The CHAIRMAN. Would you introduce your associate?

Mr. BERMAN. This is Suzetta Harrison.

The CHAIRMAN. Good morning, Ms. Harrison.

Mr. BERMAN. These are my people and this is what this is about. I might sell rock and roll at night, but at lunch I serve business customers. They are not drinking three martinis, they are working. They are getting in an extra hour doing business by doing it over lunch.

The reduction in the business meal deduction is being billed as a last remaining loophole for rich folks in three-piece suits dining at fancy restaurants, while writing it off on an unsuspecting public. But the facts are that a majority of business meals take place in low- to moderately-priced restaurants like my own—78 percent.

A majority of those using the business meal deduction are small businesses. And one-quarter are self-employed. In other words, the perception that the only people using the business meal deduction are the proverbial fat cats is a myth.

According to an independent study commissioned by the National Restaurant Association, a reduction in the business meal deduction to 50 percent means that $3.8 billion will be lost in business meal sales causing an estimated 165,000 people nationwide to lose their jobs.

I know it will hurt the kind of business lunch trade I do because it is very price sensitive. It will cut into my sales and that will cut into jobs.

Why is government making it so difficult to employ people if our goal is to increase employment?

Every restaurant person I know has cut payroll in the last year. Labor is the only controllable cost left. I cannot change my rent or my utilities or my insurance premiums. I cannot reduce food and beverage costs. I cannot increase the prices I charge my customers.

But I can cut payroll. What will Brenda Bishop, a waitress, do if her tipped income is reduced? What will Suzetta Harrison, who has been with me for 8 years, do if she cannot work at all?

Mr. Chairman, I hear a lot of government policymakers talking about how everyone has to contribute to the economic recovery and pay their fair share. I might remind you that the restaurant indus-

try has already lost 20 percent of the business meal deductibility as a result of the 1986 Tax Reform Act.

I also want you to know that when you add up the 25 fees and taxes that I pay to government at all levels, not counting all the other tax measures in President Clinton's package, the government gets five times more tax-home from my business than I do and I own it.

Local, State and Federal Governments have no clue about the actions each other take that affect my business dramatically. The administration's BTU tax will increase my energy bill an estimated 4.5 percent and cost my business $768 a year.

But last year my local government slapped an energy surcharge on me that already cost an additional $1200 a year. In the last 2 years government has increased my cost of doing business in so many different ways that I have watched our earnage shrink by 46 percent while my gross sales went up 11 percent.

Those of us who have survived this recession know we cannot raise our prices. In fact, my customers are still complaining about the 1991 price increases caused by the increase in the Federal excise tax on alcohol. The assumption that businesses will be able to simply pass along tax and fee increases to our consumers does not cut it in restaurants like mine. Customers are simply too price conscious.

Let me express it in cheeseburger logic. My restaurant sells cheeseburgers for $5.25. Of that $5.25 I net 20 cents. We are already saving as much as we can without cutting our food quality or our labor costs. I cannot raise my prices.

So if we sold only cheeseburgers and could pay for these new government costs just by selling more of them, how many additional cheeseburgers would I have to sell? I have a list before you. In all, it adds up to more than 150,000 cheeseburgers next year.

People love our cheeseburgers, but I do not think that is realistic. I ask you to please consider the overall impact of what you are doing. I know my business has to pay some taxes, but I cannot even do that if you are going to pass laws like reducing the business meal deductibility that will keep people from coming in.

So, Mr. Chairman, it all boils down to jobs. If I am left with the choice of reducing labor costs or surviving as a business, which of my people am I going to lay off and why is my own government asking me to make that choice?

Simply put, if the government is going to impose yet another set of new taxes on restaurants, then maybe the government should also tell me who to lay off, Suzetta or Brenda.

On behalf of the National Restaurant Association, I would like to mention our support for the FICA tax on tips tax credit you passed twice last year and the permanent extension of the targeted jobs tax credit.

I thank you, Mr. Chairman.

The CHAIRMAN. We thank you, Mr. Berman.

[The prepared statement of Mr. Berman appears in the appendix.]

The CHAIRMAN. Our next witness, Mr. Juliano.

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL AND RESTAURANT EMPLOYEES INTERNATIONAL UNION, WASHINGTON, DC

Mr. JULIANO. Thank you, Mr. Chairman. I would ask your permission that the full statement be made a part of the record.

The CHAIRMAN. It will be placed in the record as if read.

Mr. JULIANO. Thank you.

[The prepared statement of Mr. Juliano appears in the appendix.]

The CHAIRMAN. You proceed exactly as you wish.

Mr. JULIANO. Also, Mr. Chairman, when we testified on the House side, the American Hotel and Motel Association was part of our panel. They are in convention. But they have a statement coming. So if you would keep the record open, I would be most grateful for that also.

The CHAIRMAN. We most certainly will.

Mr. JULIANO. Thank you.

The CHAIRMAN. I am sorry. I did not realize that. I was not aware of that. Thank you for telling us.

Mr. JULIANO. Thank you.

[The statement of the American Hotel and Motel Association appears in the appendix.]

Mr. JULIANO. On behalf of Edward T. Hanley, general president of the Hotel Employees and Restaurant Employees International Union and all the members we are privileged to represent, it is once again a pleasure to appear before this distinguished committee as it deliberates on President Clinton's economic package.

We do not support the Presidential package because it includes a proposal, reduces the deductibility of legitimate business and entertainment expenses from 80 to 50 percent that would create a significant loss of membership for our union.

Also, it will create a disproportionate negative impact on urban America because the majority of businesses affected by this proposal are located in major urban areas.

Treasury testified recently that there will not be one single job lost or one less penny spent by consumers if this proposal is adopted. The implication was clear that there was no affect in reducing the deductibility from 100 percent to 80 percent and that, therefore, there would be no affect if you reduce it from 80 percent to 50 percent.

I believe that there has already been economic dislocation within the industry. In total candor, some laws can be attributed to the reduction from 100 percent to 80 percent, but also there is no question that the sluggish economy which created some recessionary cycles between 1987 and 1993 is also responsible.

As it relates to Treasury's assertion that not one job was lost by reducing the deductibility from 100 percent to 80 percent, I have to tell you, without blaming any single factor, that our union from January 1987 to February 1993 has suffered a loss of 30,000 to 35,000 members. This loss is predicated on an average membership throughout the country between 300,000 and 325,000 members.

The $1 billion a day that travelers spend pays the salaries of nearly 6 million Americans, making the travel industry the second

largest employer in the country, exceeded only by the health services industry.

Moreover, the travel industry provides a disproportionate number of jobs for the traditionally disadvantaged in this country. African Americans, Hispanics and women comprise a major part of our industry.

Since most objective analysts agree that the drastic cut from 80 percent to 50 percent would lead to a considerable drop in consumer spending, if we put it in today's terms, we would be talking about $3.5 billion in lost business revenue.

A reduction of expenditures of this magnitude would directly translate to a job loss of between 50,000 to 160,000 and roughly a quarter of that would be our union.

So what is the problem? Well, the problem is perception. I talked to many of you and your colleagues and we talked on the House side. The merits are fine, but it is the perception. Now the base closings issue, most members I have spoken with can enumerate at the drop of a hat, this is a jobs issue because we will lose boilermakers, steamfitters, pipefitters, right on down the line. Critical, it is a jobs issue.

What about the waiters and waitresses and bartenders? It is a phony issue. It is a fat cat inside the beltway. Well, I am sorry, we disagree strongly with that perception. They might try telling that to workers in the real world who needs jobs to provide for their livelihood and that of their families.

Before the Sheraton Chicago opened last year there were approximately 5,000 people waiting in line in freezing temperatures to be interviewed for jobs that numbered between 500 to 1,000. This response touched a national nerve and was widely reported by most of the major media across the country.

So apparently there are still a large number of people who desire to work in our industry despite the administration's contention that these are "dead-end career jobs."

On behalf of our General President I want to let this committee and all the members of Congress know how terribly proud we are to have the privilege of representing these people every day. Of course, we do not represent policy wonks so that might be our problem.

With the greatest of respect, because of the impact it would have on the livelihood of so many people, both within our union and without, I would urge this committee to consider rejecting the proposal and dropping it from the economic package, just as the Congress is likely to do with the investment tax credit.

We hope that an amelioration can be reached in this issue with an enlightened Congress, and that we can roll up our sleeves and help get the necessary votes needed to pass an economic package that will truly help a nation, which is in much disrepair, and truly in need of a legitimate moral boost.

You can do nothing that is more important for the tourism industry and its workers than to provide a healthy economy for our country.

Thank you for your time and attention. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Juliano. I take it it is your view that policy wonks send out for their pizza. Is that it? They do not actually go to restaurants.

Mr. JULIANO. That is correct.

The CHAIRMAN. Mr. Wachtel?

STATEMENT OF GEORGE A. WACHTEL, DIRECTOR, RESEARCH AND GOVERNMENT RELATIONS, THE LEAGUE OF AMERICAN THEATRES AND PRODUCERS, NEW YORK, NY

Mr. WACHTEL. Thank you, Mr. Chairman, Senators Packwood, Bradley, and Breaux. I am honored to be here this morning.

I am the director of research and government relations for the League of American Theatres and Producers, which is a national trade association for broadway theatre.

I represent not only the League, however, but the Actors Equity Association, which is a 36,000 member union for actors; the International Alliance of Theatrical Stage Employees, a 75,000 member union of primarily stage hands and other stage employees; the League of Resident Theatres, which are non-profit professional theatres; and the National Alliance of Music Theatres.

Now what many people may not know is that while about 8 million people a year attend Broadway shows in New York, another 20 million see them in over 100 cities nationwide. And an additional 16 million people attend non-profit professional theatre; and an additional 10 million people attend other regional musical theatre and dinner theatre throughout the United States. So the total professional theatre attendance each year exceeds 50 million people.

What does all this theatre attendance mean? First, it means theatre and performing arts generate jobs. Jobs not just because of the direct employment of the theatres or the performing arts center, but jobs from all the businesses that support theatre activity. When a theater goer goes out, he inevitably will eat in a restaurant, frequently stay in a hotel, use public or private transportation, and shop for retail goods.

I found this past week when I happened to be in Oklahoma City where there was an arts festival. Then on Monday I was in New Orleans after the jazz festival and I found myself a local consumer. The sale of retail goods in markets to go along with tourism and tourist travel is something that I think has not been properly evaluated.

Second, where do these jobs take place? They take place primarily in and around urban centers where socially and economically these jobs are most important today.

And thirdly, how does the theatre make a contribution that isn't often thought about? The fact is that commercial theatre creates a favorable balance of payments by licensing the rights for productions in other countries and by touring English language productions.

For example, the third national company of Les Miserables is going to go to Singapore in 1994. It is going to take 81 American actors and other stage people with them and it is going to play to over 150,000 Singaporeans and bring all that income back to the United States.

At the conclusion of my comments—I am going to lead up to two points. One which is, of course, to ask you to urge you to continue the present level of tax deductibility and also to ask you to protect the rich heritage, cultural diversity and economic stimulus that the arts provide.

Now a little about the arts in general. Nearly half of the Nation's nonprofit professional theatres ended the 1991 fiscal year in the red for an aggregate deficit of $2.8 million. The more recently released figures for the 1992 fiscal year, that deficit more than doubled, to $6.5 million. And over the past 5 years 25 nonprofit professional theatres have closed.

Now the Broadway theatre is different. The Broadway theatre receives no subsidy, no contributions, nor does it receive any broadcast revenues as do sports teams. It is virtually 100 percent dependent on ticket sales for its income.

The result of all this is that fewer new shows are being produced every year. In 1980–81 there were 60 productions on Broadway and in the 1991 season there were only 28. And Broadway theatre pays municipal, State and Federal taxes.

The theatre and performing arts budgets as you know are extremely labor intensive, 62 percent of every dollar of theatre expenditures on Broadway goes for labor or royalties.

Now the question today is, what will be the income loss from the reduction of the business entertainment deduction. There are roughly 20 shows playing on Broadway at any given time. But only a handful are outright hits. You know their names—Phantom of the Opera, Les Miserables, and others. But most shows, most shows, have runs and they rarely, they rarely, maybe one out of five times, pay back the initial investment on their show.

Sometimes they run for an extended period of time. They continue to employ actors. They bring in audience. They create spending in the urban area. But they are not financially successful. These are the shows that we are really concerned about.

In fact, about a third of the shows currently on Broadway would cease to exist, I believe, if this entertainment deduction went from 80 to 50 percent. The economics are very straightforward. If a show brings in maybe $400,000 a week, and let us say it costs on average $405,000 or $410,000 a week, if you dropped out 6 percent of their income, they would be forced to close.

The 6 percent of their income is what we calculate on average would be the impact of this bill based on a reduction in spending of business entertainment of 30 percent applied by the current tax rates.

The result of shows closing means lost jobs—lost jobs for actors, musicians, stagehands, ushers, and ticket takers, wardrobe personnel, hairdressers, box office treasurers—I am only reading the list to give you an idea of the extent to the diversity of the people who do work in the theatre and the ancillary businesses that support it.

The losses do not stop there. The theatre goers, as I mentioned before, they dine out. They travel to their destinations—49 percent of the people in New York visit from elsewhere in the United States and other countries. They shop at retail stores and they consume other entertainment.

The CHAIRMAN. Please, finish your statement.

Mr. WACHTEL. Thank you.

The Treasury Department has estimated that the impact of the reduction in the business meals and entertainment deduction from 80 to 50 percent at, I believe, in the order of $16 billion.

Our industry data suggests that ticket sales for theatre and other performing arts nationwide only accounted for 1.1 percent of that total. The point is, it is small in the big picture, but it would be decidedly hurt.

The total sales for the theatre and performing arts in America is estimated at $1.8 billion. We estimate that over the life of the entire projection, the impact on the Treasury would only be on the order of $150 million; and this gain would be offset by losses in Federal income tax revenues owing from people who have lost jobs in the arts industry as well as from employees of businesses which rely on the arts to general income, the restaurants, the hotels, transportation and retail stores.

So as I said I would lead up, I again urge you to continue the present level of tax deductibility to protect the rich heritage, cultural diversity and economic stimulus that the arts provide.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Wachtel.

[The prepared statement of Mr. Wachtel appears in the appendix.]

The CHAIRMAN. And now to wrap up the panel, Robert McIntyre of the Citizens for Tax Justice.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Thank you, Mr. Chairman. Boy, it is a friendlier looking committee than it used to be. I must say I am glad to be here, glad to see you here. I have a handout, by the way, that accompanies my testimony.

The CHAIRMAN. The Committee on Finance appears to be friendly. We may have to reconfigure our collective means.

Mr. MCINTYRE. If we cannot be friendly talking about business lunches, what could we be friendly over, right?

I want to make one comment about the previous panel if I could. I was on Fred Bergsten's Competitiveness Council's Subcouncil on Capital Formation and we had endless meetings in New York and here in Washington with distinguished people.

I recall during all of those meetings that not a single one of those distinguished people thought the investment tax credit was a good idea. So Fred did not get that from his capital formation advisors.

The issue before you today in this second panel, at least from an analytical point of view, is a fairly simple one. In terms of business meals, you first have to ask yourself: does it make tax policy sense? Does allowing people to deduct the cost of their eating and drinking and recreation better measure their ability to pay taxes?

Now if it is a legitimate deduction, that would end the discussion. But we have not heard any talk about that today from any of the panelists, perhaps because it is almost impossible to defend a deduction for these kinds of personal expenses in terms of ability to pay and in terms of measuring net income.

What we have heard about today instead is a lot about jobs. People have argued that this $10 billion a year subsidy for meals and entertainment makes sense as a government spending program. They say that we need to continue to buy lunches, buy golf, buy drinks, buy hockey tickets and football tickets for generally very well off people because it creates jobs for football players and restaurant workers and actors and others in the economy.

Well, first of all, we could subsidize anything to create jobs under that argument. We could buy people jewelry. That would create jobs in my hometown where they make it. We could buy people yachts. We could buy people all kinds of things that I assume create jobs in those industries. But we do not do it.

The CHAIRMAN. No, no. Hold it.

Mr. MCINTYRE. As I am sure Senator Chafee would agree, it would be nuts to be going around buying Americans yachts—despite the fact that the industry is a great one.

The CHAIRMAN. Mr. McIntyre, we have not done it yet. It depends on how Senator Chafee looks upon the entire proposition.

Mr. MCINTYRE. Now, perhaps we do think highly of encouraging people to buy these particular items—you know, alcohol and fancy meals and hockey tickets and so forth.

But what is going to happen if this deduction is scaled back? I think you should eliminate it entirely. The Clinton administration says you should scale it back a little bit, a little less than half as much, by the way, as you scaled it back in 1986. That is what my handout illustrates.

What would happen if this deduction is eliminated or scaled back slightly? Well, there are two possibilities. First of all, people may just go on doing what they have been doing. They will still eat. They will still go to the theatre. They will still go to hockey games. They will still play golf. And not much will change. That is our experience after the much larger cutbacks in 1986. Not much happened.

Well, what about the alternative scenario? Suppose all of a sudden that the smaller change this time has a major impact. As a result, people now are skinnier. They spend less time at hockey games. They do less of some of these other activities. But what are they going to do with the money they no longer spend on these things? Well, they are going to spend it on something else, which is going to create jobs somewhere else.

That is why all people who have seriously analyzed this have said there is no impact on jobs. There is probably not any impact on jobs in the industries affected, but if there is, those jobs will be replaced perhaps—by better jobs at better wages.

Now, of course, there may well be transition issues. We see that in the defense cuts. Whenever the government makes a major change in something—this is a minor one really, but any change—we have to worry about the transition. If, in fact, some people are dislocated, we should worry about that.

That is why it is part of the defense cuts that the President has proposed, he is talking a lot about retraining and relocation. I think it is a very good thing. But you cannot let the transition issues overwhelm you. Otherwise, you would never be able to change policy.

Now I would suggest here that you wipe this thing out entirely, and phase it out, say at 20 percent a year for the next 4 years. It is a subsidy that does not make sense, that the rest of us should not be paying for.

If you instead adopt the President's plan, it is so trivial, half of the 1986 change, I do not think you need a transition.

So we support the President's proposal as a step in the right direction. We think you should go much further. We believe this subsidy is one whose time has come to be ended and that any argument made for it just cannot stand up to analysis.

The CHAIRMAN. Thank you, Mr. McIntyre.

[The prepared statement of Mr. McIntyre appears in the appendix.]

The CHAIRMAN. And thank you all. We have time for questions. We turn first to Senator Packwood.

Senator PACKWOOD. Thank you, Mr. Chairman.

Let me address this to Mr. Berman and Bob Juliano. You heard what Mortimer Caplin said about the perception of the public and the perception of the public they see on meals and entertainment is gross pigging out. That is what they have in their minds.

I was intrigued with your figures, Mr. Berman. A drop in business meals affects more than fine dining restaurants. Low to moderately priced table service restaurants are the most popular type of restaurants for business meals. Seventy-eight percent of business lunches and 50 percent of dinners occur at these establishments. The average amount spent on a business meal per person—$9.39 for lunch; and $19.58 for dinner.

If we had to have this kind of a limitation, would it make sense to change it to a per diem limit rather than a percentage limit. Say you cannot deduct more than $15 for a lunch and $25 for dinner? But if you want to take 10 people, you can deduct $250. But do it on that basis rather than a percentage basis, which would take care of most of the lunches and dinners you describe and eliminate a perception problem of the absolute pigging out kind of dinner that frankly many of us have experienced.

Mr. JULIANO. We would be happy to go along with that, if you applied the same cap to furniture and depreciation and advertising and so many of the other issues that Mr. McIntyre did not address, that are considered legitimate business deductions.

So if you treat us as fairly as the rest of them, we would be delighted, Senator. I think they ought to drop tons of deductibility to 80 percent, you know, as costs of doing business.

Sincerely, he is right on one point, which I must be slipping to say that he is even right on one point, but I have to say that the problem is, we have gotten away from the real issue which is it is either a legitimate business deduction or it is not. And he is right on that, sincerely.

If somebody is faking, it should be zero. If it is a legitimate business deduction, it should be treated accordingly. We are trying to come up with figures just to raise revenue.

Senator PACKWOOD. I do not want to give the slightest perception that I like the President's tax program at all.

Mr. JULIANO. Thank you.

Senator PACKWOOD. And so when I ask my question, I do not want people to think, well, you know, maybe he is going to support it.

Mr. JULIANO. It is tough because what happens is, you would end up with regional warfare because you would be saying to people——

Senator PACKWOOD. I want to come back to the jobs issue in the restaurant industry.

Mr. JULIANO. All right.

Senator PACKWOOD. This does not address the theatre problem. It is a totally different issue in my mind.

Would we solve the jobs problem, or at least alleviate it tremendously, with a per diem limit rather than a percentage limit?

Mr. BERMAN. Senator, I am the operator of a single-unit restaurant. In this I am non-partisan. I am neither a Republican, nor am I a Democrat. Mr. Clinton is my President and I am a citizen here to represent the circumstances that tens of thousands of restaurateurs find themselves in.

There is in our world, at the very basic level where all of these policies that trickle down end up in our businesses and we have to deal with, no difference between the contractor or the traveling salesman or the small businessman using this as a legitimate marketing tool to do business than larger companies spending dollars on advertising or on other marketing expenses.

Seventy percent of the people who use this deduction earn less than $50,000 a year; 9 percent earn less than $35,000 a year.

I am intimately acquainted with the affects of the policies made here on Capitol Hill on my business. The burden that I bear now, the potential burdens that are on the table right now, have turned people in my industry into desperate and frightened people. We met yesterday with 300 restaurateurs from across the country.

For example, we have a value-added tax, an energy tax, a minimum wage tax——

Senator PACKWOOD. Can I interrupt for just a moment? What is the answer to my question?

Mr. BERMAN. The answer to your question is, that I am not in a situation where I could understand the difference between a per diem and a deduction for a promotional or an advertising expense. That is not my area of expertise.

I am here to testify on the behalf of restaurateurs about the impact.

Senator PACKWOOD. I do not want you to testify on this. I want to know what this will do to restaurateurs. To give you an example, we are going to make a decision sooner or later, I take it, to get rid of business deductions for all club dues. It has been spent a half a dozen times on a half a dozen different things.

We are going to make a policy decision that not enough business is justifiably done to justify a club dues exception in private clubs. Now the private clubs are going to argue jobs. They are going to argue we employ low income people, sort of the same argument the restaurants make.

I am trying to find out what the affect will be on restaurants, not does it legitimately deduct 100 percent of an advertising cost or 100 percent of a $10,000 painting. If it is limited to a per diem

that is significantly higher than what the average is of the average person who goes to the average restaurants, which appears to be the overwhelming bulk of the people who take these expenses.

Mr. BERMAN. Again, I do not know the answer to that question honestly. I would address that to Mr. Juliano.

Mr. JULIANO. All it does is, it would pit one group of Senators on the committee against the other.

Senator PACKWOOD. I do not follow you, Bob.

Mr. JULIANO. He'd be having a legitimate business meal and couch it in those terms, and merely by dent of where you are having it geographically, one people would gain and the other would lose.

Senator PACKWOOD. I do not follow you.

Mr. MCINTYRE. He means the prices are more in New York than they are in Des Moines.

Mr. JULIANO. You know, in different cities.

Senator PACKWOOD. Oh, all right, that part.

Mr. JULIANO. Prices vary.

Senator PACKWOOD. It costs more to eat in New York than it does in Keo Cacao.

Mr. MCINTYRE. Better urban areas would be——

Senator PACKWOOD. I would question that.

The CHAIRMAN. You would; I wouldn't. [Laughter.]

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Check Gourmet Magazine and see what they have to say about it.

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

I just have two questions. One is for Mr. Berman. You said something in your testimony that I do not know if I heard it right. Maybe you could tell me. You said that on a burger that costs $5 that your profit margin is 20 cents?

Mr. BERMAN. That is correct. In the State of Maryland, the average profit is 3.9 percent of gross sales. The retail sales tax, for example, in Maryland is 5 percent. Out of the gate, there is a 1-percent revenue benefit to the State more than the owner.

Senator BRADLEY. So you only make 20 cents a burger?

Mr. BERMAN. That is correct. That is the circumstances we find the industry in and that is why I am here to represent the industry today. Because I do serve the cheeseburgers; Suzetta cooks the cheeseburgers that I serve.

Senator BRADLEY. How many burgers did you serve last year?

Mr. BERMAN. Nowhere near 150,000, candidly. I bought a business 4½ years ago that was $300,000 a year. We are getting close to $1 million a year in sales. My goal, my ambition, is to become a multi-unit operator.

And I have to explain to you how extraordinarily difficult and burdensome it has become to try and retain enough capital because restaurants are on the bottom of the lending list of any credit institution. In order to grow, I am here to participate.

Senator BRADLEY. So you made about, what, $30,000?

Mr. BERMAN. I have three partners as well. There are four of us. The income that I make is well below the target that Mr. Clinton has addressed, set for middle class taxation.

I think you should understand also that the vast majority of these food service operations, almost three-quarters, are single-unit operations. So our income is derived directly from the profits of the store. In effect, everyone gets paid first.

Senator BRADLEY. Thank you very much.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. I think I would love your restaurant. Rock and roll and hamburgers. It has a great theme. Has the President been there yet? [Laughter.]

Mr. BERMAN. I actually did send him a letter and I did put a postscript on it. I did not mean to be flip. But we did ask him to drop by if he was in the area and hungry.

Senator BREAUX. He might have to jog out to Rockville and tour your place.

Well, I appreciate everybody's testimony. One of the things that your testimony really touches on, Mr. Berman, is we did this once before and you cite a study in your testimony that says—was commissioned—no, it was Mr. Juliano who cited a study that was done back in——

Mr. JULIANO. 1977.

Senator BREAUX. 1977?

Mr. JULIANO. Yes.

Senator BREAUX. That study predicted a significant loss in business expenditure should we decrease the deductibility. But we did. And it is my understanding, and I am trying to be on your side on this issue, that when we did it before that that did not happen. That restaurants increased their sales, increased the number of people who went to restaurants; and, in fact, really had a very good solid growth period.

Now, obviously, a lot of things affect that. But when we did reduce the deduction from 100 percent to 80 percent, restaurants did better. You have a study that says if we made that change, restaurants would not do better. But the facts are, they did better.

Mr. JULIANO. I cannot theorize like some of the people have mentioned earlier. From January of 1987, Senator, until February of 1993, we have lost 30,000 to 35,000 members.

Senator BREAUX. These are your union members though.

Mr. JULIANO. I am not pulling the figure out of the air, you know.

Senator BREAUX. But that is your union members. That is not necessarily all restaurant employees.

Mr. JULIANO. We represent a quarter of that segment of the industry. So you can extrapolate that figure to say how many more jobs are lost.

Now has there been growth in the industry? You bet. You know where? Fast food. Some people neglect to mention that that is not part of this deducibility issue. Have there been more jobs created? Sure, fast food, not the deductibility issue.

Senator PACKWOOD. You mean not many people go to those restaurants for business meals that they deduct?

Mr. JULIANO. Not that I am aware of, Senator.

Senator BREAUX. We are talking about the growth in the business. I think Mr. Juliano said yes, it has been in all the fast food restaurants.

Mr. BERMAN. If I might add, the growth statistic could perhaps be misleading. Close to nine out of 10 restaurants fail in the first 5 years of operation in my segment of the business.

So while you may have people opening and closing restaurants, leading to sales figures that look like they are improving, really we have people who get into my industry who do not understand the impact of all the different things it takes to turn a profit and the failure rate is extraordinary.

Senator BREAUX. But as I understand, too, under the proposal, I would say to my colleagues, that apparently you still would be able to deduct travel, you would still be able to deduct lodging. It would be interesting to see if the big hotels all of a sudden just make a package deal for lodging which includes meals so you can deduct the whole thing.

There are going to be 1,000 ways to get around this. You stay at the Hyatt over the weekend and the room rate is $300. It includes breakfast, lunch and dinner. Just deduct the whole thing that way. But you cannot do that, Chip.

Mr. BERMAN. No, I cannot. And I might add, the majority of people who use this are smaller people who do not have the sophistication to figure out how to fool the system.

Senator BREAUX. Let me ask another thing. I introduced the bill last year and have introduced it again this year, S. 573, rescinding the FICA tip tax credit, which is aimed at putting actual dollars in the hands of the restaurant owner. This deduction reduction does not do that. That proposal helps your customers go to your restaurant more.

How do you feel about the FICA tip tax legislation?

Mr. BERMAN. If I may, the FICA tip tax is a payroll tax on non-payroll dollars. A tip is a relationship between a customer and a server. They make declaration and we pay a full 100 percent on that amount.

Yet in terms of wages, we are only allowed a 50 percent credit. So within the Code, in terms of taxes it is 100 percent, but in terms of wages back for the business it is 50 percent, and resolving that discrepancy would obviously have a positive affect on the industry in general.

Senator BREAUX. Do you have any idea how much that would mean for your business?

Mr. BERMAN. I estimate to pay this year $5,400 in FICA taxes on tips. And again, those are net dollars. In effect, that is an income tax to my partners and me directly because the money has to flow through the business before I ever see it.

Senator BREAUX. So if you have a small business, that is a real problem for you because you are paying taxes on wages that you are not paying, which is not right.

The CHAIRMAN. You are paying taxes whether you have profit or not.

Senator BREAUX. Yes. And you do not control the tips.

Mr. BERMAN. And I might add, if the IRS comes back to audit your people a few years down the road, you can be held liable if

they undeclared their tips as well. So it makes it extraordinarily difficult to plan or to understand the impact.

Senator BREAUX. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Chafee, we would like to hear more of your views. We are considering deducting yachts and jewelry under the business expense and perhaps you want to talk more about it.

Senator CHAFEE. Well, Mr. Chairman, as you know, I am very, very careful not to use the word yacht.

The CHAIRMAN. Boat. Small boat. Small craft.

Senator CHAFEE. Let me start off, Mr. Chairman, by saying Mr. McIntyre, as perhaps he pointed out is from my State. He and his family and they are very distinguished. Not now, but I imagine you were born there, weren't you, Bob?

Mr. MCINTYRE. Just across the line in Massachusetts. But my in-laws live in Rhode Island. So it is close enough.

Senator CHAFEE. I knew his father, a very distinguished gentleman in our area.

I must say that I am troubled by the President's proposal. I know Mr. McIntyre's arguments and I think we can give Mr. McIntyre a lot of credit for what we did in 1986. The documents he brought forward and the research he did was certainly a big boost for us.

However, we go down these trails in thinking we are going to get the rich guy and we pick up a lot of people we did not expect to hit. I will harken back again to that so-called luxury tax on boats. We did not get the millionaire. They got off scot free. They bought boats in Europe and keep them down in the Caribbean and go down there and see them. They are very happy.

All we did was hit a lot of people who work in the boatyards, laying up the fiberglass and making the sails and making the winches and halyards and all the items that go into making a boat.

So what these gentlemen are saying, Mr. Juliano and others, is true. The people who work for these restaurants are low-income individuals who are getting started as Mr. Berman pointed out. I was not here when he introduced some of the folks that work with him.

The CHAIRMAN. Ms. Harrison.

Senator CHAFEE. So I think we have to tread very carefully. The proposal that Senator Packwood made, seems to me to have some merit. As I understand the present system, if I go in and host a banquet, costing $500 for some business guests, I can deduct 80 percent of the entire bill. Is that correct, Mr. Juliano?

Mr. JULIANO. Right.

Senator CHAFEE. And somehow that does gall a little bit. Why should the taxpayer help pay for me living so high on the hog? At the same time, we have a mileage deduction in automobile travel, whatever it is, 24.5 cents a mile or whatever. But it is not unlimited.

If you go out and you drive a Mercedes that gulps gas or diesel fuel and the depreciation is way higher than 24.5 cents, whatever the figure is, you cannot take it. So what about the approach suggested, mentioned by Senator Packwood. Mr. Juliano, what do you say to that? Whatever the sum is.

Mr. JULIANO. There is a provision in the Code already that refers to lavish and extravagant, and if it does not meet that test, you know, deductibility would be questioned.

Mr. MCINTYRE. In fact, Mr. Chafee, the way it works now is that it can't be too lavish, as Bob pointed out, which means you cannot spend more than $1,000 per person per meal, but it has to be lavish enough that it is more than you would normally spend. So it has to be somewhat lavish, but not too lavish. That is the current law on meals according to the 7th Circuit.

Mr. JULIANO. Forgive me, I represent working people, not tax books. But the result is, there are not any $500 banquets, nor are there any $1,000 banquets. That is absolutely ludicrous. But there are conventions and trade shows that go to every major urban center in America that provide thousands of jobs not only in our industry, but in other industries that affect the whole city.

So that is what we are talking about. I mean, the provisions are there. There was a question about compliance, Mr. Chairman, in 1985 and 1986. We advanced the concept of tightening up the Code. The committee thought it was a great idea and said you have to limit it. It has to be directly related to your specific trade or business. We are the ones that did it.

So why are we dropping 100 to 80? We need revenue. I do not want to insult you that it is not good tax policy, but how can you say it is the same tax policy if you are saying advertising deductibility 100 percent, you know, furniture, 100 percent. It is legitimate. Now the term is legitimate business-related and entertainment expense is 80 percent. Now they say drop it to zero. Right, because it is not legitimate.

Senator CHAFEE. I think the points you make are all strong ones about why pick on meals and what is lavish. I suspect if you go to a banquet that the Capitol Hilton could well cost $70 an individual.

I do not know, Mr. Chairman. I guess my basic view is we ought to be very cautious. You know a lot more about this than I do, coming from where you do. But in our State we are, like so many States, a tourist State and we want to be cautious because it is affecting a lot of individuals.

The CHAIRMAN. We very much agree. I want to say to Mr. Juliano first of all, do not feel that you are insulting this committee by telling us something is bad tax policy. People come before us and say things are bad tax policy all the time. If you think so, say so. We need to know.

I want to tell Mr. Wachtel we are very much aware of the issues you deal with. I mean, there are 35,000 members of Actors Equity, which maybe 3,000 have a job at this moment. I think that is about average.

In my youth I benefited from a tax-free provision, a cost-free provision, in Broadway shows. We used to live on 11th Avenue and 42nd Street, and I would go over as a kid and watch the third act, walk in with the third act, get up in the top row. Nobody bothered you. Seats were half empty in the third. I have seen the third act of more great plays. [Laughter.]

I never figured out how they began, but I know how they ended.

You are very right about the whole decline in deductions. This speaks to the culture as much as to the economy.

Mr. WACHTEL. May I also say that unless the show, at least how it exists today, unless the show proves itself initially on Broadway, the opportunity for touring rarely exists.

The CHAIRMAN. It will not get to Ossacaw.

Mr. WACHTEL. It not only does not get to Ossacaw. It does not get to New Orleans; it does not get to Providence; it does not get to Chicago.

Senator CHAFEE. I suppose, Mr. Chairman, that in the theatre realm we think that in other nations there are outright subsidies. Now I do not know whether there is in Great Britain. Certainly there is in the opera in the other nations. Federal subsidies, correct, a very significant amount.

However, I suppose others could say, Mr. McIntyre could say, with some legitimacy that this is indirect subsidy to make it deductibility. Is it 100 percent deductible?

Mr. WACHTEL. No, it is 80 percent since 1986.

Senator CHAFEE. That falls under the entertainment realm.

The CHAIRMAN. Yes, our problem in these matters is that it is not different than the problem in health. It is what is called Bohmo's Disease by economists. William Bohmo, is a professor of economics at NYU, Princeton. He and his wife are opera fans.

In the 1960's he got interested, in why the Metropolitan Opera was always broke and why the orchestra was always on strike. He was curious, why, since we all love it so.

He came up with this very important proposition, which he calls cost disease, his profession in a tribute to him calls it Bohmo's Disease, which is that at different levels, different sectors of the economy are subject to different rates of productivity growth and some very little.

The restaurant industry would be a wonderful example. It takes as much time to serve a plate of oysters in a restaurant in 1893 as it does in 1993. His example would be that a Mozart quartet in 1780 required four persons, four stringed orchestras and 43 minutes. Two centuries ago by it still takes four persons, four stringed orchestras and 43 minutes.

If you play the Minute Waltz in 50 seconds, it is just not the same. And in Shakespeare's day there is a very interesting thing. Bohmo found that real wages in England went down from the Black Death of the 13th century—went down, down, down. Real wages not get back to their 13th Century level until the late 19th century; and the real bottom was in Shakespeare's day. And you could make money out of a play that ran 10 nights in the Globe Theatre. That is why Shakespeare could have 37 plays produced in his life time.

A playwright today, it takes a year to get your money back in Broadway.

Mr. WACHTEL. Much more sometimes for a musical.

The CHAIRMAN. For a musical even more. This is something, you know, that you could explain. It is not perversity and it is not people misbehaving. It is just the way. A doctor looking at a well baby today is going to take 18 minutes to do so, going to look at it, move its fingers and check its eyes, and that is about what it took 50 years ago and it is different from what it takes to produce steel.

So we are sensitive. We know about these things. We also know about our deficit.

We thank you very much for coming. Ms. Harrison, it was nice of you to come down. We are very much aware of your concerns and they are legitimate. Thank you all.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

ADMINISTRATION'S TAX PROPOSALS (FOREIGN TAX PROPOSALS AND OTHER TAX MATTERS)

FRIDAY, APRIL 30, 1993

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice at 10:35 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Baucus and Packwood.

[The press release announcing the hearing follows:]

[Press Release No.–16, April 29, 1993]

FINANCE COMMITTEE TO CONTINUE HEARINGS ON ADMINISTRATION'S TAX PROPOSALS

Senator Daniel Patrick Moynihan (D–NY), Chairman of the Senate Committee on Finance, announced today that the Committee will continue hearings this Friday on the Administration's foreign tax proposals and other matters.

The hearing will begin at *10:30 a.m. on Friday, April 30* in room SD–215, Dirksen Senate Office Building.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good morning. Welcome panelists. You are here today to give testimony on the administration's foreign tax proposals and other tax matters.

Senator Packwood, two of the witnesses you requested. Would you like to welcome them?

Senator PACKWOOD. Welcome.

The CHAIRMAN. Senator Burns, welcome and we look forward to many such occasions.

STATEMENT OF HON. CONRAD BURNS, A U.S. SENATOR FROM MONTANA

Senator BURNS. Mr. Chairman and members of the committee, I thank you very much for allowing me this privilege of appearing before you on part of the situation we find ourselves in that is very near and dear to all of us, especially in the business of agriculture, and not being too parochial, but I mean the whole industry as it is today.

The production of food and fiber, Mr. Chairman, energy is at the very base of every level of production, level of process and, of

course, the level of distribution in this country. Energy is the life blood of this country. This Nation runs on the ability to be mobile.

No other country in the world can match our diversity and the use of technology to sustain a standard of living that we have became and we are starting to enjoy it.

According to the Congressional Office of Technology Assessment, 30 percent of the Nation's total energy is consumed by manufacturing plants, by mines, by farms, and by construction firms.

The President has put forth an economic blueprint that he feels will reduce the deficit as well as address the areas of need. I am pleased that the President has focused his attention on the deficit and is incumbent on each and every one of us in this Congress to work with him to attain the goals that he wants to attain. I congratulate him for confronting this problem.

However, in my view, the package may not help to reduce the deficit as much as we would like, plus it would have a profound negative impact on this business of agriculture and in more particular, to be more parochial, on my State of Montana.

Our top three industries are agriculture, mining and tourism. And all would be adversely affected under the President's proposal and specifically under the energy tax. President Clinton's energy tax would raise $71.4 billion in the next 5 years.

However, this tax is not exactly fair to all Americans. I think that is what we strive for here in this body, is a degree of fairness. It will hit the Western States particularly hard, far more than any other section of the country.

Not only do we in the west, and especially Montana, rely on energy to keep our homes warm during colder winters or longer months or longer winters, we also drive longer distances just to do our job. But our major industries rely heavily on energy.

For these reasons and others, I ask the committee to consider an off-road motor fuel tax exemption amendment. Mr. Chairman, in 1991 farmers and others consumed 1.4 billion gallons in gasoline, some 2.8 billion gallons in diesel fuel in off-road uses, such as our farm machinery and operating our farms and ranches.

Mr. Chairman, nobody has to tell you, and I think you understand it as well as anybody that I know in our conversation, that farmers are price takers. They cannot pass price increases along to the ultimate consumer of food. If the price of input goes up, they, the farmers, absorb that cost.

And what we have to remember is, consumers in this country dictate food prices through the food processing industry. Add this tax to farmers and you run the risk of destroying the food chain at its very base. I have often said that farmers and agriculture, we sell wholesale; we buy retail; and we pay the freight both ways.

The affects on agriculture would be devastating. And I could go on and address the proposed tax it would have on industry related to coal production, oil production and, of course, hydroelectric power. In States where we are energy producers and we are high energy users, we get hit doubly hard.

I want to emphasize my concern over the affect of apply the energy tax consumed as a part of the manufacturing production process. I am referring to the manufacturing process that utilize energy sources one of two ways—as a raw material that is transformed

into a product, or as a direct input to affect a chemical or physical change that turns the raw material into a finished product.

In either case, we would be taxing the basic feed stock utilized in the production process that may not be only able to be redesigned at great difficulty or at great expense or even possible at all.

But one last area that has not been given enough consideration in this debate on how this tax will affect small business, which comprise 98 percent of my businesses in the State of Montana. As a State, Montana has started to take hold of export opportunities that will incur because the energy tax will increase the vulnerability of small business in foreign competition. The energy tax will reduce American business's international competitiveness and reduce economic recovery and increase unemployment.

The energy tax as it is put forth in this plan is a regressive tax to the Western States and will result in less production and, therefore, less economic activity. The less there is in growth, the greater loss in future tax revenue. We lose on both ends of the formula the President has recommended to deal with the deficit spending situation that we find ourselves in.

Mr. Chairman, on my amendment, I would seriously ask that the committee take a look at off-road exemptions while you are dealing with this monumental task that you have to deal with. I understand your situation, too.

What we are asking for is fairness, just fairness. I thank you, Mr. Chairman. And I would answer any questions or try to answer any questions that you might have at this time.

The CHAIRMAN. Well, we thank you, sir. That was a very graphic presentation. I have, of course, heard you before make that powerful point that the farmers are price takers. That issue would define much of American politics in the latter part of the 19th century. What do you do about that and the organization of the railroads which took the farm produce in the high plains back east?

As you know, on our committee your views are well represented. The ranking Democrat member, your colleague and ours, is Senator Baucus, from Montana. We have a representative Senator from your neighbors, North Dakota and South Dakota. I would not imagine, apart from the Agriculture Committee itself, that you are better represented anywhere else in the Senate than on the Finance Committee.

I will first ask Senator Packwood.

Senator PACKWOOD. I have a couple quick questions, Senator. Last week a fellow named Bill Drummond appeared from the Public Power Council in the Northwest. He was estimating increases in the northwest and he said that Montana had the sixth highest burden per capita. In that 30 percent above the national average, and he attributed much of this to the impact on the use of hydro power in Montana. Do you agree with that assessment?

Senator BURNS. I would. And especially, you know, with the situation that we have out there now, and, of course, some of that is being encountered in the State of Oregon, we are very concerned about our REA's and our power consumption.

We have an aluminum plant that is at Columbia Falls Montana that employs some 700 people. And that is a very margin business as it is right now because it is on the world market. Aluminum

prices are not set here in the United States, but it is a world price and that is very marginal.

I am also concerned with the treatment of hydroelectric power. We are very high users of hydroelectric power here in the United States but it is a world price and a very high user of hydropower from that same grid. So I would agree with that assessment.

Senator PACKWOOD. Second question, just comparative statistics. Senator Conrad was talking about farm income in North Dakota and he said his average farmer makes about $17,600 a year and would pay $1,200 under the President's tax proposal. Is that roughly equivalent to your experience in Montana?

Senator BURNS. That would be, and I think that is probably the grain farms. Of course, they are a high consumer of their machinery and operation. But I would agree with that. It may cost us just a little more in the State of Montana. But the average income of those grain farmers and, I think, we saw a figure of around $4,000 a year when you get into the large grain farms would cost.

And yet we have to take everything and put it into perspective. We were selling wheat in 1949 for higher prices than we are selling wheat today. And, yes, the agriculture machine is a very efficient machine, but we can only stand so much before it becomes very regressive and we just cannot afford to produce it all.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Senator Baucus, you have strong views on this subject as we know well and we respect them greatly.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Mr. Chairman, first I want to thank my colleague from Montana for joining us this morning. He is stating a particular problem that we have in the Rocky Mountain States, the high plain States. Namely we are natural resource States. So we are States where we have not much manufacturing, very little manufacturing, compared with many other States.

In fact, in the State of Montana, Mr. Chairman, about 95 percent of our State's economy is comprised of natural resource industries—that is timber, it is mining, it is agriculture. Very little of it is manufacturing. In fact, in our State I think only 5 percent of the economy is manufacturing.

Tourism and recreation is becoming a growing industry. As attractive as that is, it still is a very small part of our State's economy. And as a natural resource State, we find that we have certain disadvantages.

Number one, the proposed Btu tax tends to hit us very strongly because as a natural resource based State, certainly in agriculture and in aluminum, those are industries that cannot pass on cost increases. They have to take whatever the international market price is.

In the case of aluminum, the London metals exchange basically sets the price. And in addition to that, the former Soviet Union, Russia and some other countries are dumping aluminum on the world market with low cost to them.

The CHAIRMAN. We have heard that.

Senator BAUCUS. They use it as a machine to generate hard currency for themselves and to meet other needs. American aluminum producers face that predicament. They cannot pass on cost increases.

And as the Chairman knows, power, electric power, is a very, very high component, our largest cost component, of aluminum production and if the Btu tax is slapped on, it obviously is disadvantageous to the industry.

The same would apply for farmers. Montana farms first must pay the Btu tax that goes into the fertilizer and raw materials that they use. Second, the tax will increase the price of machinery that we have to purchase. Beyond that it affects transportation. Distances are much greater for us in the Rocky Mountain west than for other people.

So as a natural resource State, that tends to mean that our distances to markets are much greater; therefore, we pay much more transportation costs, tax versus add-on, again to industries that are unable to pass on cost increases.

On the other hand, obviously, I commend the President for his efforts, very significant efforts, at deficit reduction—$500 billion over 5 years is very significant.

Second, I commend the President for trying to promote energy conservation as well as basic deficit reduction. The Btu tax is the one proposal that tends to lean very much in that direction.

We only ask, Mr. Chairman—and my colleague and others made this point—that there be geographic balance, industry balance, and overall working in that direction. I would also note that my colleague from Montana is attempting to work in the same direction, too. He, too, wants to work with the administration so long as the solution is balanced from a geographic as well as from an industry point of view.

I thank my colleague for coming here before us.

Senator BURNS. Well, I appreciate your comments, too, Senator Baucus. I think we are at the end of the line. We originate and work the end of the line. So it makes for a very difficult situation in our case.

I think as a government goes, I would footnote that we try to make policy that one size fits all. That is pretty tough to do when we start trying to make a farm bill work or food policy. Sometimes one size does not fit all. There are certainly exceptions.

The CHAIRMAN. I wonder if I could, just before you leave, sir, perhaps tell you about my role in the economic development of Montana. [Laughter.]

It is not to be laughed at. Just after the Second World War, a bunch of fellows and I got out of the Navy and bought an old hearse. We set out to mine gold in Alaska, but we never got any further than Hungry Horse, Montana where they were clearing the back water for the Hungry Horse Dam.

I got a job cutting brush on that vast area. I went to work and I worked harder in one week than I have ever worked in my life, before or since. And then came Saturday and it is payday and the foreman passes out the pay. And he says, Moynihan, and I said,

yes, sir, and he said, you are fired. I said, well, all right, but what did I do. He said, that is just it, you did not do nothing. [Laughter.]

The CHAIRMAN. So, you know, you might remember that. That could jaundice a fellow. But then just in the nick of time it all got better because after awhile my best buddy and I decided we were not going to make it out there. We just were not making it out here in Hungry Horse. So we decided we would go back home and we would hitch a freight car.

We went over to Kalispell and we crept down at night, down the siding, and we found a box car and we jumped in and went right in the back. About an hour later we heard crunch, crunch, crunch, one of the bulldogs was coming along and he had a flashlight.

Suddenly the light flashed into our car and caught us right there. What are you guys doing here? We are going back to New York, sir. He says, well, you can stay here if you want, but this car is not going to move for a month. If you want to go to New York, you had better come with me and he put us on a car. I would still be in Kalispell to this day if it was not for that. [Laughter.]

Senator BURNS. Mr. Chairman, I appreciate that. You know, we have all had to do hard work and your experience is most appreciated here. I have always been sort of like Mark Twain about hard work and doing. The man that picks the cat up by the tail learns much more of the cat than one who sits and observes.

So we appreciate your experience in Montana. And I thank you, Mr. Chairman.

The CHAIRMAN. We thank you very much, sir. You know you are well represented on the Finance Committee.

Senator BURNS. Thank you.

[The prepared statement of Senator Burns appears in the appendix.]

The CHAIRMAN. Now we are going to hear the panel that we had scheduled for Wednesday. It will be dealing with the questions of the passive royalty provision, and other foreign trade aspects of the President's proposal.

We are going to hear from Michael Boyle, who is director of taxes with Microsoft Corp. May I say, that Bruce Hyman, who was with Mr. Boyle on Wednesday cannot be here today, but wanted to be. He had to be out on the west coast. He wrote me to say that.

Murray Scureman, who is vice president of government affairs for the Amdahl Corp. Mr. Scureman, welcome. And Erik Nelson, vice president for financial operations of Procter and Gamble. Mr. Nelson, welcome.

Mr. Boyle, if you would proceed first. Let's see, you are going to present Mr. Brown's testimony; is that it?

Mr. BOYLE. That is correct.

The CHAIRMAN. Good. In case there is any question about your views, this is a statement on the serious adverse impact of taxing royalties as passive income. There are no ambiguities there.

Mr. Boyle, we welcome you.

STATEMENT OF MICHAEL P. BOYLE, DIRECTOR OF TAXES, MICROSOFT CORP., REDMOND, WA

Mr. BOYLE. Thank you, Mr. Chairman. I am Mike Boyle and I am director of taxes and tax counsel for Microsoft Corp. I greatly

appreciate the opportunity to testify before the committee and I will be brief, and I will not be overly technical.

Microsoft develops markets and supports a wide range of systems and application software for personal computers. From a start-up company founded in 1976, we have grown to employ 10,000 people in the United States, and another 3,000 people overseas.

Around the world we sell more than 100 products developed in 25 languages. Last year more than 55 percent of Microsoft's almost $3 billion in revenues came from foreign sales. Moreover, Microsoft's success at exporting is not unique. The American software industry dominates world sales and in some segments holds an estimated 75 percent market share.

This success is one of the reasons the software industry contributes more to the economy than all but five manufacturing industries. Indeed, today it is the fastest growing industry in the United States.

I am here this morning to urge reconsideration of the proposal to tax royalties as passive income for purposes of the foreign tax credit limitation. I do so for two principal reasons.

First, the proposal is directly at odds with the way America's computer software companies do business. Second, despite Mr. Session's assurances on Tuesday, the proposal is likely to lead to precisely the opposite result of that intended and will actually encourage American companies to move their software development offshore.

Let me explain. It is essential to understand the fundamental aspect of any software program is the intellectual property that it embodies. The work of researching, writing, testing and perfecting a software program is very labor intensive.

Moreover, practically all the software development work is done by Microsoft in the United States. It involves precisely the type of highly skilled, highly paid jobs that this country needs.

When we sell our programs, we are essentially selling the right to use this intellectual property. We do not, however, sell the program itself because with every personal computer able to make copies, we soon would be out of business. As it is, software piracy is extremely serious. The industry estimates its revenues would double overnight if we could end piracy.

At the wholesale level, American software companies sell their programs overseas by licensing them to computer hardware manufacturers who pay a royalty for the right to load programs into their machines. Not only is this an efficient way of distributing programs, but it also significantly reduces the piracy problem.

A computer manufacturer selling a naked machine, with no software programs, is essentially inviting the purchaser to use copied programs.

At the retail level, we sell our programs over the counter in shrink-wrapped boxes. Once again, however, these products contain a license for the purchaser to use the software. Thus, some might characterize income from even these transactions as royalties for purposes of the Tax Code.

In short, all of Microsoft's income, whether royalty or sales, is earned from selling software and it should not be treated differently for tax purposes. Yet, under the administration's proposal

a significant share of the foreign earnings of America's software companies will be affected by this provision.

Unfortunately, the result may cause U.S. software companies to move their software development offshore in order to avoid having our business income characterized as passive royalties. This is the opposite result of what we understand was intended.

This is not idle speculation. The Wall Street Journal recently reported on U.S. companies moving research facilities outside the United States. Companies can significantly reduce costs by employing professionals in other countries.

I can tell you from personal experience that a number of countries have strongly urged Microsoft to establish research centers in their countries. To date, Microsoft has avoided moving its research facilities outside the United States. But the royalty provision calls into question the fundamental issue of whether Microsoft will be forced to create jobs offshore.

Relocating research and development is not a desirable alternative. But Microsoft and other software companies must be able to compete in a global economy.

Before I conclude, I would like to make just three quick additional points. First——

The CHAIRMAN. Mr. Boyle, take your time. We had to put you off for 2 days. Go ahead.

Mr. BOYLE. First, the passive royalty proposal also is likely to encourage U.S.-based companies to invest in operations in foreign countries because of the additional tax costs of remitting those funds to the United States.

Second, the growth in royalty payments since 1986 is, we believe, directly attributable to tax law changes which required companies to pay substantial royalties, not from an increase in tax-motivated transactions.

Finally, the proposals adverse impact is not limited to software companies. It similarly affects other leading American companies who must manufacture outside the United States to service their foreign customers.

Thank you. I would be happy to answer any questions you might have, Mr. Chairman, or other members of the committee.

The CHAIRMAN. We thank you, sir, for very careful and very lucid testimony. We will have questions at the end of the testimony of the panel.

The CHAIRMAN. Now, Mr. Scureman. Good morning.

STATEMENT OF MURRAY S. SCUREMAN, VICE PRESIDENT, GOVERNMENT AFFAIRS, AMDAHL CORP., WASHINGTON, DC

Mr. SCUREMAN. Good morning, Mr. Chairman, members of the committee. I am Murray Scureman, vice president of government affairs of the Amdahl Corp. I am a businessman with 25 years of experience in the computer industry, nearly 15 of which have been spent at Amdahl in a variety of line and staff positions.

I would like to thank the Finance Committee today for the opportunity to testify on these important international tax proposals because the computer industry is not healthy today.

For the first time in our history, Amdahl lost money last year, as did our main competitor, IBM. In addition, both companies had a terrible first quarter.

Although Amdahl is affected by the royalty provision we just heard about, I am here today primarily to discuss the deferral proposal, which would place an unprecedented, retroactive tax on offshore passive assets which are in excess of 25 percent of the total assets.

Since 40 percent of Amdahl's revenues are derived outside the United States, I would like to explain, one, why Amdahl had to open a European plant; two, why our business requires offshore cash reserves; and three, why the retroactive 25-percent test is harmful to some high-tech companies.

By way of background, Amdahl is a $2.5 billion high technology American company. It was founded in 1970, primarily to manufacture large-scale mainframe computers. Today, Amdahl spends nearly 15 percent of sales on development, which makes us one of the Nation's most R&D intensive companies.

Why do we have a plant in Europe? We knew pretty much from the beginning that we had to be successful in both the United States and the European markets to be able to cover the cost of operations and our large R&D costs.

Many of our customers were uncomfortable becoming dependent on a product that was built only in earthquake-prone California. In addition, all of Amdahl's competitors already had European plants. So our European customers demanded local sourcing. So we had to build a second plant, and for marketing service and logistics reasons, would have to be in Europe, not in the United States.

Ireland was chosen. I would like to point out that Amdahl did not flee the United States to seek lower wages. In fact, Irish and American wages are comparable. And today the cost of manufacture of a mainframe is essentially the same in either plant. Also, an Irish built mainframe is imported into the United States only to respond to an emergency customer situation.

So why is it necessary to have offshore cash reserves? Well, contrary to Mr. Sessions' assertions last Tuesday, it is not done to avoid paying U.S. taxes. We need the money to run the business.

For example, between 1978 and 1991 the Irish plant was relocated, expanded and modernized at a total cost of $115 million. Secondly, Amdahl, Ireland has reimbursed Amdahl corporate about $400 million to date as part of an ongoing R&D cost-sharing arrangement.

The final reason is business prudence. By year end 1992, 2 years of unprofitable Irish operations had reduced our offshore reserve by 40 percent. Our plans to use that reserve to fund a European leasing operation had to be shelved for two reasons. One was the weak mainframe market in Europe, but the other was the need to devote these reserves to working capital.

So why isn't 25 percent a sufficient cushion? Well, the problem as we see it is, this proposal discriminates against certain asset structures. For example, a company with large, active assets or companies who choose debt financing may not have a problem with this proposal.

One of the characteristics of a high-tech company like Amdahl is that we are capable of generating large revenues from very modest tangible assets. And if in addition we use the reserve for equity financing purposes we are apt to fail the test.

In addition, companies will also have the added administrative burden of monitoring their assets quarterly to ensure that normal business decisions do not cause passive assets to exceed the limit. This costly process is often followed by prolonged battles with the IRS over the value of assets. I would like to point out that none of our foreign competitors are burdened by such activities.

In summary, I believe that tinkering with the international tax code is a bad idea, particularly in light of the EC 1992 investment build up by our foreign competitors. These proposals only weaken America's competitive capabilities by increasing costs. As you just heard, by creating a tax structure that will motivate some companies to permanently invest offshore.

As a final thought, at Amdahl, foreign investment means U.S. jobs. Several hundred jobs were created in California to support Amdahl's operation overseas. These are highly skilled technical, administrative and staff jobs that represent the kind of employment that the Clinton administration is committed to creating.

I might point out that these jobs are all in addition to Amdahl's R&D—97 percent of which is performed in California.

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

[The prepared statement of Mr. Scureman appears in the appendix.]

The CHAIRMAN. Thank you, sir. This is the first time the issue of being earthquake prone has come before this committee. I do not know what we can do about that. But be sure not to tell them downtown, they will think up a program.

Senator PACKWOOD. Give them a tax incentive.

The CHAIRMAN. Yes.

Let's now hear from Mr. Nelson. We welcome you, sir.

STATEMENT OF ERIK G. NELSON, VICE PRESIDENT FOR FINANCIAL OPERATIONS, PROCTER AND GAMBLE, CINCINNATI, OH

Mr. NELSON. Thank you, Mr. Chairman, members of the committee. My name is Erik Nelson. I am vice president of financial operations for the Procter and Gamble Co.

I am pleased to testify on behalf of the Committee on Royalty Taxation, referred to as CORT. The 15 U.S. multi-national companies which are CORT members are listed on our written statement.

CORT supports the administration's economic objectives for accelerated economic growth, job creation and a significantly reduced Federal budget deficit. CORT is concerned, however, about the possible negative affects on the economy of the administration's proposal to treat all foreign source royalty income as passive income for foreign tax credit purposes.

We believe this change is unwise. It is inconsistent with longstanding tax policy. And we believe it could produce exactly the opposite affect of what the administration seeks to accomplish. Now, specifically, it could cost high-paying U.S. jobs that will reduce cash

flows to the United States. It will make U.S. multi-nationals less competitive in world markets. And it will provide a disincentive to conduct research and to own the related technology in the United States.

As the committee knows we live in an increasingly seemless global economy. CORT members, like P&G, find themselves competing directly in the United States and in many other markets throughout the world against global and local competitors. Tax policy must not restrict our ability to compete on an equal footing.

This proposal affects U.S. multi-nationals but not their foreign multi-national competitors by reducing the after-tax returns U.S. competitors can earn on their foreign investments. Accordingly, U.S. companies will be forced to restructure their operations to maintain adequate financial returns.

Now let me examine for a moment what this proposal will do. It will severely impact U.S. multi-national companies who receive both dividends and royalties from foreign operations.

These companies are critical to our economic progress, operating globally, often in high technology fields and providing U.S. jobs and a positive balance of payments.

By prohibiting them from using otherwise available tax credits, active income, which has already been taxed abroad will be taxed again in the United States, frequently resulting in taxes in excess of 50 percent. I simply cannot imagine that that is what the administration intended.

U.S. multi-national companies are in direct competition with multi-nationals from all parts of the world. Profit margins are tight. Pricing flexibility is limited. We simply cannot raise prices to recover higher taxes. That would only erode our market share.

So U.S. multi-nationals will be forced to restructure to get out from under this burden. Bear in mind, this is very important, that no one in CORT wants to take these measures. They run counter to what is good for the country. But these measures are steps we will have to take in order to remain competitive.

First, companies will consider eliminating U.S. R&D jobs or relocating them abroad to reduce our after-tax costs. These are high skilled, high paying jobs. There will be a ripple affect throughout the economy since jobs at suppliers who helped develop new technology and often supply equipment to the foreign operations will also be affected.

Second, as technology development moves offshore, royalty flows will be reduced and sometimes reversed. Royalty income right now averages about $15 billion to $16 billion annually into the United States. We would expect this to decline dramatically.

So, too, will dividend flows. Companies will not pay dividends if they have to pay stiff additional taxes to do so. They will simply invest these funds abroad.

And finally, over time we are going to see an erosion of the U.S. technology base, and this is something none of us wants to see.

Some would argue, and I think you heard this from Mr. Sessions, that the increase in royalty payments since the 1986 Tax Act is indicative of tax planning that has harmed the U.S. tax base. In our view, changes in royalty flows are responsive to many factors that have nothing to do with tax considerations.

Let me give you an example that is specific to my company. Since 1986 our foreign royalty income has grown almost 300 percent. I believe that Mr. Sessions quoted a number of 300. But that is an index, and actually his number is 200 percent. So our royalty income has increased more than the government is claiming their total royalty income has increased.

Our foreign sales to which royalties are tied, have increased by about 225 percent over this same period. The difference is caused by product mix, and I can explain that later, and also the lifting of restrictions on royalty payments by some countries which did not permit them prior to this period.

So I think you can see from this that the increase was not tax driven. It relates directly to the growth in our international business.

The CHAIRMAN. Mr. Nelson, take your time.

Mr. NELSON. I am just about there. I appreciate the extra couple of minutes.

The CHAIRMAN. Take your time.

Mr. NELSON. A strong international business should be encouraged. I think we all agree with that. it strengthens our U.S. business, producing the jobs and the economic growth we all so desperately want.

So to summarize, this change places an unwarranted tax burden on global companies like the members of CORT. The United States stands to lose jobs, capital inflows and technical capability. This is a lose/lose situation. It is not what the administration wants and it is certainly not what the Nation needs.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

[The prepared statement of Mr. Nelson appears in the appendix.]

The CHAIRMAN. Now, I would like to ask the panel if they would just help me with my own understanding of the subject, which is anything but solid. Royalties for Microsoft, for Amdahl, royalties in return for the use of software really are not that different in structure than just plain receipts for sales, aren't they? Is that not what you do? You sell these things and people pay you in the form of royalties.

I am just curious. Why do you take royalties instead of just cash? I am sure there is a reason.

Mr. BOYLE. Well, Mr. Chairman, our business has essentially two main components. One is where we license other companies, similar to Amdahl, although we deal with personal computer manufacturers, where they create our product and simply pay us cash in the form of royalties.

Additionally, what we do, Mr. Chairman, is we——

The CHAIRMAN. So you license a manufacturer?

Mr. BOYLE. Correct. And additionally, the other half of our business is where we create boxtop product, where if you were to walk into any retail chain here in the Washington, DC area you would see boxes of software products that anyone walking in off the street would buy.

The CHAIRMAN. Well, Mr. Boyle, I am afraid if I walked in off the street, I would not buy. But some will, yes.

Mr. BOYLE. You might window shop.

But the transaction where we are selling the boxtop product, we think could be considered to be a sale transaction rather than a license for tax purposes. Although it is unclear in many tax jurisdictions how that is specifically treated.

The CHAIRMAN. But it is what you make? You program and develop.

Mr. BOYLE. Correct. And the reason that it specifically affects us, Mr. Chairman, is because unlike other companies we really deal in intellectual property. So our product is really intellectual in nature rather than being something very tangible, such as a mainframe or a computer.

So it particularly affects us because our product is really, to a very large extent, intellectual in nature.

Is that helpful?

The CHAIRMAN. Well, in what respect is your software program different from an LP record?

Mr. BOYLE. Well, in many instances we think that we are comparable to the record industry and should be treated comparably to the record industry.

The CHAIRMAN. I see. Mr. Scureman? I am just asking for help here.

Mr. SCUREMAN. Yes. The way I have always looked at it is, when you rent an Amdahl mainframe, that comes in like you thought, which is cash. But when you have a piece of software for which the owner is maintaining the control on intellectual property and servicing of, that is considered a royalty.

In other words, the monthly payments for the use of that proprietary piece of software is considered a royalty; where the monthly use of the hardware is considered rent.

The CHAIRMAN. But yet Hargrove's Dictionary would give us an entirely different meaning for rent—in any event, the technical economist's concept of rent.

Mr. SCUREMAN. Right.

The CHAIRMAN. It seems like sales to me. You are selling something people want and they pay for it in a different manner. But it is something you produce and sell.

Mr. SCUREMAN. But the way I understand the accounting for software is it is considered a royalty payment.

The CHAIRMAN. Right.

Mr. SCUREMAN. As opposed to hardware is considered sales like you think.

The CHAIRMAN. Mr. Boyle?

Mr. BOYLE. In some sense, Mr. Chairman, it depends on the nature of the transaction. If, essentially, it is just a limited grant of rights, that can be viewed as a sale for tax purposes.

The CHAIRMAN. Right. Right.

Mr. Nelson, did you want to comment?

Mr. NELSON. Mr. Chairman, do you have a specific question you would like to address to me? My royalty situation is somewhat different from theirs.

The CHAIRMAN. Well, explain the difference. My object is to help us get a sense of universe with it.

Mr. NELSON. Well, in our case, we are operating internationally through subsidiary companies—52 in all right now—who actually

manufacture locally and sell the product to the consuming public. So our royalty is from that subsidiary. They are paying us for the use of the technology, which the parent company owns, as well as trademarks and other know how.

Senator PACKWOOD. All of these are your subsidiaries?

Mr. NELSON. That is correct.

Senator PACKWOOD. So these are not licensed companies owned by somebody else?

Mr. NELSON. That is correct.

The CHAIRMAN. Thank you.

Senator Packwood?

Senator PACKWOOD. All of you can answer this if you want. When the Treasury Department testified earlier this week, decided its statistic that—and I will quote it—"Royalty payments have risen more than 300 percent since the Tax Reform Act of 1986."

And Treasury indicates—they did not quote this, what I say now—the Treasury Department indicated that this rise in royalties connected to the tax treatment of royalties received by the U.S. parent companies from their foreign companies.

Is it your experience that the tax incentives have much to do with the increase in royalties?

Mr. NELSON. Not in my company's experience or in the experience of the members of CORT. In our view, the growth in royalties is directly attributable to the globalization of the world economy. The fact that so many countries are opening up, and companies like ours are going in to take advantage of those opportunities.

Our sales, for example, international sales 10 years ago I think were about 20 percent of the total company. They will be 50 percent this year and they will likely be two-thirds by the end of the decade. So I think you can see from that the growth of our international business. And I cited the statistics in my comment, that our royalties have increased 300 percent since 1986.

And, in fact, they have increased, I think, eight times since the late 1970's.

Senator PACKWOOD. It is a lucky business. You are increasing very well.

Mr. NELSON. We are doing very well internationally and that is what all of us want to do.

Senator PACKWOOD. Mr. Scureman, let me ask you, you went to Ireland in 1978.

Mr. SCUREMAN. Correct.

Senator PACKWOOD. Let's assume you fail the 25-percent test. You have to go back now 15 years. Do the records even exist? Could you go back to 1978 and on a deferral basis figure what you owe in taxes? Are those records even around?

Mr. SCUREMAN. I can find out for you. I am not sure.

Senator PACKWOOD. In any event, would it cause you a significant difficulty trying to piece together through the years of retroactive deferral?

Mr. SCUREMAN. Yes, it would.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Scureman, as I understand your point, cash reserves overseas are necessary for working capital and capital development. Before you mentioned your Irish operation. Could you give us a sense of what your cash reserves are overseas compared with the cash reserves held domestically, as a proportion of, say, net worth or some other guide?

I am trying to determine, you know, whether cash reserves are, in fact, held overseas to avoid taxes or whether they are held overseas to, in fact, achieve the purposes you have stated.

Mr. SCUREMAN. I think in answer to your question, there is no given number as my testimony points out. You are constantly using and accruing cash, depending on how the business is doing.

We have had times when the amounts of cash were roughly the same. But then you must understand that we do 40 to 45 percent of our business overseas.

Senator BAUCUS. So you report, therefore, 40 to 45 percent of your cash reserves overseas?

Mr. SCUREMAN. Compared to the cash reserves in the United States. We have had times when they have been equivalent. Right now, we are using cash. In fact, we just announced our financial results on Wednesday and we lost about a quarter of a billion dollars, just like IBM did.

Senator BAUCUS. What about assets?

Mr. SCUREMAN. Pardon me?

Senator BAUCUS. Assets. What is the ratio of foreign/domestic?

Mr. SCUREMAN. Well, that is the point I tried to make about a high technology company often has the characteristic with fairly low tangible assets being able to generate large revenues. So our tangible assets are, say, around $115–$125 million for the plant and at the moment our passive assets are about $100 million higher than that, but coming down rapidly.

Senator BAUCUS. Mr. Nelson, just following up on the question Senator Packwood asked, Mr. Sessions indicated this figure as 300 percent. He said it in part was because of the changes in the 1986 Act, that is due to clamping down a bit on transfer pricing and also these baskets set up in the 1986 Tax Act, how foreign passive income is treated, basically saying the reason for the 300 percent royalty increase is due to changes in the Code.

The CHAIRMAN. And if I could interject, Mr. Boyle says the same thing.

Senator BAUCUS. So if that is the case, could you again tell us, you know, as persuasively as you can why the 300-percent increase in royalties is due to foreign sales and to growth and so forth and to the nature of business, rather than being tax driven?

Mr. NELSON. Well, I think the 1986 Tax Act did require or impose some requirements on the payment of royalties. If that is what Mr. Sessions is referring to, it may have had some affect.

But you can see from our figures that what drove the increase in royalties was an increase in business. It was an increase in international sales.

Plus, we had a mix affect in the sense that we bought a company in the mid-1980's that is in the health care business and over-the-counter drugs, in our case, carry a somewhat higher royalty than do detergents and diapers.

Then, thirdly, we were able to convince some countries that they should permit us to pay royalties back. Not all countries do that. But now we are getting royalties back from, I think, all of the countries in which we do business.

The CHAIRMAN. From India?

Mr. NELSON. I believe we are. Let me ask my expert. He will nod if we do.

No?

The CHAIRMAN. I thought not.

Senator BAUCUS. The India question caused me to forget my next question.

The CHAIRMAN. I am sorry.

Senator BAUCUS. I was so focused on special 301 and our——

Mr. NELSON. If I could just make a couple of other comments. We have been paying royalties for 30 years or so from our subsidiaries and always trying to get a royalty from our subsidiaries because it allows us a steady stream of cash from these businesses, so we are getting some return. They do not always earn a profit. So we cannot always pay dividends, especially in start-up situations.

So our motivations for getting royalties back are to get cash back out of these businesses.

Senator BAUCUS. Could you generally address—I know this is a very complicated subject—but just in layman's terms explain to us as best you can, how level is the playing field internationally for U.S. companies versus our major competitors in your industry from a tax perspective?

How do other countries tax their multi-nationals in their industry as compared to how the United States taxes multi-national in our industry? I mean, is the playing field from that perspective roughly level or not? Whatever light you could shed on that would be helpful.

Mr. NELSON. It is difficult to generalize. But I think that by and large in our experience most countries have a form of cross-crediting where they allow various streams of active income and the offsetting of excess credits in one stream of income against another. So that is a very common practice.

Now another part of your question is how level is the playing field, and it is difficult to get a clear picture of that. But there have been studies that suggest that the tax that U.S. multi-nationals pay on their foreign source income is generally above the statutory rate. The General Accounting Office study said 37 percent versus 34 percent.

So we are not getting any kind of a break from the current tax system.

Another study that was done by Price Waterhouse, where they tried to compare a company operating in the United States versus in other countries, but having the same general sales around the world, and in that case, companies operating outside the United States had a lower tax on their foreign income than the U.S. companies had.

So all of this suggests that the playing field is relatively level, but it tends to be stacked against U.S. multi-nationals.

Senator BAUCUS. Thank you.

The CHAIRMAN. Mr. Nelson, what is your industry?

Mr. NELSON. We are in disposable consumer products. We make Tide, Pampers.

The CHAIRMAN. Do you also make pharmaceuticals?

Mr. NELSON. We are small in the pharmaceutical industry now.

The CHAIRMAN. I was just saying that a large corporation such as yours becomes diversified in its products as well as locations.

Mr. NELSON. That is correct.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No further questions.

The CHAIRMAN. We have a problem here and we thank you very much. That was very lucid testimony, very thoughtful testimony, very temperate testimony. It is about as complex a judgment that we are going to have to make in terms of what the administration has sent us. We are very much in your debt. We appreciate this. We particularly thank you for coming back in the way that you have done, gentlemen.

Mr. NELSON. Thank you.

Mr. BOYLE. Thank you.

Mr. SCUREMAN. Thank you.

The CHAIRMAN. As you depart, gentlemen, half the former staff directors of the Finance Committee depart with you. [Laughter.]

The CHAIRMAN. We are now going to have a concluding panel for the morning. We have a distinguished economist and an accountant as witnesses. They are here to just advise us more than anything else. Dr. J.D. Foster, who is the chief economist and director of the Tax Foundation, and Mr. Harvey Coustan, who is the chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants.

I think it was Senator Packwood who asked these gentlemen to come, was it not? Would you like to welcome them?

Senator PACKWOOD. Gentlemen, welcome.

Dr. FOSTER. Good morning.

Mr. COUSTAN. Good morning.

The CHAIRMAN. Dr. Foster, you are listed first, so proceed.

STATEMENT OF J.D. FOSTER, PH.D., CHIEF ECONOMIST AND DIRECTOR, TAX FOUNDATION, WASHINGTON, DC

Dr. FOSTER. Thank you, Mr. Chairman, and good morning to you and the members of the committee. My name is J.D. Foster. I am Chief Economist and Director of the Tax Foundation.

The Tax Foundation is a non-profit, non-partisan research and education organization that has monitored fiscal policy at all levels of government since 1937. We have approximately 600 contributors consisting of large and small businesses, charitable organizations and individuals.

The Tax Foundation does not lobby for specific tax legislation. Our appearance here today is intended solely to promote sound, fiscal policy. It is an honor to appear before the committee today on behalf of the Tax Foundation to discuss President Clinton's proposals, particularly those to raise the personal and corporate income tax rates, and to discuss the history of forgotten lessons and the lessons of forgotten history.

There are probably no members in the Senate, except possibly the President pro tem, who have a better appreciation of history than the chairman of this committee and the ranking member.

It is very easy to be caught up in the moment, to believe that each political battle is the first, the biggest, or the last of its kind. This is not the first and it will not be the last time we debate changing income tax rates.

To consider these proposals reasonably demands we consider the historical context. And in this case, the history is very recent and much of it took place in this very room. It is easy to find many rights and wrongs in tax policy over the last 15 years or so. But the one change about which I think there can be no debate is the tremendous progress that was made in reducing income tax rates on individuals and corporations.

Beginning in 1981, we made great progress in ERTA in cutting tax rates, progress that was continued dramatically in 1986. The speeches made in the Finance Committee alone during this period in support of lower tax rates could number in the hundreds, possibly the thousands. Indeed, some of its members were at the very leading edge of the effort to reduce tax rates.

And each of the ideas expressed here was echoed many times over on the Senate floor. Nations around the world followed our lead and reduced their tax rates. There was even talk at the time of the United States reaping an unfair advantage because it was cutting its income tax rates; and there was talk of a new kind of trade war in which rate cuts in one country forced tax rate cuts in others.

Unlike most trade wars, which are essentially defensive in nature, promoting industries at home because they cannot compete, the trade war in competitive tax rate cuts was essentially offensive in nature. If the United States cut its rates, its industries would become too competitive and they would flood foreign markets.

While concerns about tax-based trade wars proved exaggerated, the central theme of cutting income tax rates to spur growth and competitions was right on target.

The basic laws of economists governing how individuals respond to incentives have not been repealed. The reasons for keeping tax rates as low as practicable have not changed in 7 years. What has changed is the focus of our attention.

We appear to have forgotten the lesson once well learned. High tax rates discourage all sorts of legal economic activities. They create a disincentive to work. At first blush, it may be hard to believe that higher tax rates on individuals with higher incomes could significantly affect their behavior.

To such doubters, I would point to the arguments for raising energy taxes on the basis that it would discourage energy consumption; and I would point to the luxury tax on boats, which apparently has done so much damage to the recreational boat industry.

There is nothing unique about boats and oil that tax disincentives work their magic on these goods and yet are ineffectual with respect to labor income. Upper income individuals are the most able to respond to changes in tax disincentives. They face the most freedom of all of us in choosing to work on an afternoon or to go play golf.

An individual's economic contribution to society is, to the first approximation at least, fairly well measured by his income. With a struggling economy producing slow improvements in productivity, amazingly we have before us a proposal to increase tax rates, to increase the disincentive to work facing the most productive individuals in the country.

I suspect the members of the committee have heard about the NBER study done by Feldstein and Feenberg in which they found that personal tax receipts would rise by only about a fourth of the amounts predicted by the Treasury. Their lower estimates are due solely, as I understand them, to the fact that the NBER model takes changes in individual behavior into account, such as those I just described.

Let me talk for a moment about saving and investing. I know the members of this committee have well-placed concerns over our National saving rate. The decision to save or consume income is one of opportunity costs. What will I receive tomorrow if I forego consumption today?

As tax rates rise and my after-tax returns on saving decline, I have less reason to forego consumption. A great many taxpayers, particularly low and middle income taxpayers have only limited ability to save. Their basic costs of daily living absorb most of their income.

What group has the most discretion? Upper income taxpayers. By raising tax rates on upper income taxpayers, we would be discouraging those who are most capable of making discretionary savings decisions and who, in fact, do most of the saving at the individual level. Make no mistake, private savings will decline if tax rates rise.

We need to raise our level of investment. More investment, properly made, means more jobs, more growth and so forth. The only question is how to go about raising investment levels. Higher tax rates, however, will substantially reduce investment in the United States, unless offset by appropriate and substantial investment incentives.

Mr. Chairman, I understand the very real need for a fair tax system. But fairness must be balanced with a need to promote economic growth and jobs. Lost jobs and wages due to higher tax rates cannot advance the cause of fairness. This is the lesson we once learned and taught the rest of the world.

It has been a great pleasure for me to address the committee this morning. As you consider the balance between fairness and economic growth, let me repeat a little bit of country wisdom I once learned when I was sitting in one of the chairs behind you—you have to grow an apple before you can cut it up.

Thank you, Mr. Chairman. I would like to request the balance of my testimony be placed in the record.

The CHAIRMAN. Of course.

[The prepared statement of Dr. Foster appears in the appendix.]

The CHAIRMAN. Let's hear from Mr. Coustan and then let's talk about these matters.

STATEMENT OF HARVEY L. COUSTAN, CHAIRMAN, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Mr. COUSTAN. Thank you. I am Harvey Coustan, the chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants and I am privileged to be here today in representing our 310,000 members. I want to thank you for asking us to appear and a special thanks to you, Senator Packwood.

The AICPA has for some years now been urging simplification of our tax system. Year after year statistics indicate that approximately one-half of individual taxpayers feel it necessary to hire a professional preparer to comply with their tax return obligations.

Many of our members are beneficiaries of this fact. Nonetheless, we advocate simplicity as an important tenet of a tax system that aims for voluntary compliance. We acknowledge that we live in a time of highly complex financial transactions and that considerations of economics and equity cannot be ignored.

We understand there will necessarily be some complex tax provisions. However, Congress needs to carefully consider whether we are approaching a point of diminishing returns—no pun intended—concerning respect for the tax system and for voluntary compliance.

Let me emphasize here that the government's interests, as well as those of taxpayers, are served by less complexity. Document matching alone cannot replace the lack of IRS audit resources in a tax world as complex as ours.

In short, complexity carries a real cost to the tax system through lower levels of compliance by taxpayers, whether inadvertent or intentional, combined with the inadequate resources of the IRS to provide appropriate monitoring. Complexity and lowered respect for the system also come from back door approaches to tax policy.

We believe our government can and should be more open with the American people. For example, rather than imposing a 10-percent surtax on individual taxable incomes greater than $250,000, why not just create a 40 percent or perhaps a 39.6 percent, to be precise, bracket in Section 1 of the Code.

Instead of making permanent the personal exemption phaseout and the 3-percent limitation on itemized deductions, why not recognize that this is a back door marginal tax increase on individuals at particular levels of income and translate that into a direct rate increase that would affect that approximate group.

In overview, a simpler tax system is one that first defines the tax base more directly and then raises revenue through adjustment of the rates, something that political and other considerations seem not to have allowed in the past several years. We believe that should change.

Just 2 weeks ago, on April 16, my organization issued a Tax Complexity Index to enable lawmakers to measure the degree of complexity and, therefore, the potential for taxpayer confusion in any tax proposal being considered.

Copies were sent to all members of the tax-writing committees. We hope you will use that index in your forthcoming deliberations on a 1993 tax bill. While space constraints on today's written statement did not permit our attaching a copy to our testimony, we will

be happy to include the index in our supplemental comments for your hearing record.

Speaking of the need to simplify, consider the investment tax credit, both permanent and incremental in the administration proposal. The complexities inherent in that proposal, especially the incremental credit, are such that a disproportionate amount of taxpayer and IRS resources will be required to ascertain that compliance levels are correct. All for what to a specific taxpayer may well be a relatively modest benefit. Thus, we suggest a direct, rather than an incremental credit, should be employed, if possible.

Perhaps, and more importantly, the proposal seems to promise more than it is likely to deliver to most taxpayers. Our written comments on page 2 give an example of what we believe will be a fairly typical situation where the presumed 7-percent credit really amounts to approximately 2 percent.

I would like to continue with a few comments on a proposal which is not part of the administration's submitted program, but that also involves simplification.

As advisers and return preparers, we and our taxpayer clients have had great difficulty in working with the individual estimated tax changes enacted in 1991. Those changes require that some individual taxpayers estimate the current year's tax without the traditional safe harbor which has been in the law since 1954.

The CHAIRMAN. Safe harbor, meaning what?

Mr. COUSTAN. That safe harbor, Senator, involves paying 100 percent of last year's tax in order to avoid a penalty regardless of how high this year's tax comes out to be.

Since the group affected by the 1991 provision includes selected individuals with adjusted gross incomes above $75,000, many small businesses conducted as S Corporations, partnerships or proprietorships are finding themselves trapped by this provision. They are required either to come up with a very accurate guess as to what their taxable incomes will be by the end of the year or compute actual taxable income for each estimated tax period, a task which has proven impossible for many.

S. 739 introduced at the beginning of this month by Senator Bumpers, and co-sponsored by Senator Hatch of your committee, would make this part of the tax law workable again by requiring truly upper income individuals, those with adjusted gross income above $150,000 who have experienced a significant increase in income, to use 110 percent of last year's tax as their safe harbor for avoiding penalty rather than 100 percent.

But since the calculations are made by reference to last year and the preceding year, and not the current year, taxpayers will know at the start of the year what estimated tax rules apply to them—that is 100 percent or 110 percent—something that is not the case under current law.

We strongly support S. 739 and hope you will, too.

May I continue?

The CHAIRMAN. Please do. Yes, sir.

Mr. COUSTAN. We are also concerned with the two proposals that raise the standard for accuracy related and preparer penalties and modify the tax shelter rules for purposes of the substantial understatement penalty.

This area of the law was amended after a well thought out collegial review of penalties by the Congress, Treasury, IRS and professional organizations that took almost 3 years and concluded only in 1989. It is entirely reasonable for taxpayers to have the right to take a position on a tax return without risk of penalty, provided that the position is not clearly wrong and that the position is disclosed.

If the law were black and white, without the uncertainties in gray areas that presently exist, our view on this might be different. However, given the fact that the law is subject to much interpretation, taxpayers should not be precluded from taking positions they believe have merit.

A stated reason for the change in the Treasury release is that taxpayers and preparers should try to comply with the tax laws in a reasonable manner. Given the nature and state of tax law today, that is an alarmingly simplistic statement.

Is it unreasonable for a taxpayer to take a position where the law is unclear if the position is fully disclosed to the IRS? Shouldn't the taxpayer have the right to a day in court without actually paying the tax and suing for a refund?

Courts do decide cases in favor of taxpayers, who should not have to face a choice of giving in to an IRS interpretation or going to court to avoid paying a penalty. Ironically, under the proposal before your committee, taxpayers will no longer have an incentive to disclose their positions where the law is unclear.

Once again, we appreciate very much the opportunity to present our views here today and we stand ready to assist you in any way. We have commented specifically on various other provisions in the administration's proposal in our written testimony.

[The prepared statement of Mr. Coustan appears in the appendix.]

The CHAIRMAN. Well, sir—speaking to both of you, but perhaps especially to Mr. Coustan—you speak to my part in these matters. We have in the United States a self-assessed tax. And it is remarkably effective. But you put it at risk when things become too complex to the individual. There is no longer the relationship that—I know what my taxes are. I can figure it out and I pay them.

If others have to figure it out for you, then relations are ambiguous and a measure of trust that keeps society together is lost. It is not very common for many lawyers come before this committee and suggest the tax laws are too complex.

For the accountants to do it is a permissible thing. The AICPA is well respected.

Mr. COUSTAN. Thank you.

Dr. FOSTER. Thank you, sir.

The CHAIRMAN. And they should be. I must say that the 7-year investment tax credit example on page 2 is pretty discouraging.

Mr. COUSTAN. We thought so.

The CHAIRMAN. And we have problems of the earned income tax credit, which I know was enacted when my friend, Senator Packwood, was chairman of this committee in 1986.

But if you can fill out the forms that entitle you to an earned income tax credit because of your poverty you are not poor. You are

an accountant. I mean, there is a place for you at Price Waterhouse.

The government has gotten into this pattern. Social Security became like a tax when the Federal Contribution Act was enacted in 1977.

Bob, I just keep thinking of this. In 1977, the Social Security amendments moved the system from a pay-as-you-go to a partially funded system. That fact was kept secret. It might as well have been kept secret.

I was a member of the conference committee at that time. I signed the conference papers, and I did not know that. I do not know anybody that did know it. I mean, Bob Myers knew it and Bob Ball knew it; and that was enough that they knew, because they knew best.

But we put on a revenue stream that would buy the New York Stock Exchange. That is not a small sum. And no one knew it. No one made any plans to deal with it. No one said, all right, now we are going to have these surpluses coming in regularly until about the year 2015. What will our National policy be?

Now we have these surpluses and we are just using the money as general revenue.

The earned income tax credit was designed to offset an increase in the FICA tax. I ask, don't we just cut the FICA tax and not take the money away in the first place. But that is too complex a thought. [Laughter.]

Senator Packwood, these are your witnesses.

Senator PACKWOOD. Well, let me pursue with Mr. Coustan. We thought the 1986 Tax Act made things somewhat simpler than they did before and at least the evidence seemed to be that more people now file a 1040 or a 1040 than they used to. The complexity comes not from people making $15,000 or $20,000 so much as people making $150,000 or $200,000.

But as somebody who has advised these people, let me ask you: Do you ever get many complaints from your clients about complexity if the complexity favors them?

Mr. COUSTAN. Yes.

Senator PACKWOOD. You do?

Mr. COUSTAN. Yes. In the example, Senator Packwood, that I mentioned, I alluded to in my prepared remarks, of the estimated tax safe harbor, I consider complexity to be not only structural complexities, but also complexities in the ability to gather information, have information available.

Taxpayers who are disturbed because they have to provide information which is difficult to get their hands on, find it very complicated. And even though it often results in a benefit to them, they get annoyed about it.

Senator PACKWOOD. Let me give you a specific example. As I recall, Mr. Chairman, the IRS at one time testified that almost 25 percent of their man hours went on the issue of capital gains, studying whether these were capital versus.

The CHAIRMAN. Yes.

Senator PACKWOOD. And they were very happy they thought when we were going to get rid of capital gains. There is no question that capital gains makes things more complex than if you did not

have it. And yet almost every upper income taxpayer I talk to wants the capital gains differential.

Now why is that if they want simplicity?

Mr. COUSTAN. Well, I heard Senator Dole say, no one turns away a give away. But I imagine that people want it because it results in a lower tax. But that kind of a complexity—although I agree that it is a complexity—is not the sort of thing that Senator Moynihan was referring to, Senator Packwood.

Senator PACKWOOD. No, no. I understand. But I want to pursue this a bit further.

If you want to get away from complexity altogether we will go to a flat tax and we will tax everybody. The figures I used to have—I do not hold many of these now; these are 7 or 8 years old—at about a 19-percent level, we could raise what we now raise from the personal income tax if there were no deductions and no exemptions and we treated Social Security and fringe benefits as we treat them now.

As I recall, we could get down to close to 16 percent if we taxed fringe benefits and Social Security as a private pension. That would be simple. It would mean, assuming you are at the 19-percent level, the widow with $10,000 of income would pay $1,900 in tax, who probably pays nothing now.

Are you suggesting that?

Mr. COUSTAN. No, I am not in favor of such dramatic regressivity.

Senator PACKWOOD. But it would be simple.

Mr. COUSTAN. The regressive nature of that kind of a tax I think would be impossible to deal with. Plus, I am realistic enough to understand that things cannot all be simple. I think that we have said that.

Senator PACKWOOD. All right. So in some cases we have to add a bit of complexity for the sake of——

Mr. COUSTAN. To accommodate complex transactions and equity.

Senator PACKWOOD. Well, no. Or for the sake of fairness.

Mr. COUSTAN. Yes, equity.

Senator PACKWOOD. All right. Now, let me ask you the next question because I will pose this frequently to the Lions Club or to the Rotary, when I get the question about complexity I will say all right, let me lay it out to you. I will go through this 19 percent. It is a simple tax. How much did you make last year? You put it on the first line—19 percent, put it on the second line. Send in a check with your postcard.

I say to the audience, now you understand this means no deductions for your seven children, no deductions for your home mortgage, no deductions for your charitable contributions, on and on. But it would be simple.

How many people here support that? It is consistently about four to one against it. Now why is that if they want simplicity?

Mr. COUSTAN. I am not in the minds of the people that you talk to at the Rotary Club, Senator Packwood. But I would suggest it is for the very reason that I think you are leading up to, that complexity has to also be balanced with equity.

Senator PACKWOOD. Well, in this case they might not be paying anymore taxes. As a matter of fact, my hunch is, they would be

paying less because these again are the figures from 7 or 8 years ago. The straight flat tax, those above $30,000 paid less than they now pay; those below $30,000 pay more. So they would be getting both less taxes and simplicity.

Mr. COUSTAN. I know many people would probably pay less taxes. There may also be a little bit of suspicion in something as simple as that. We are living in a very complex——

The CHAIRMAN. A.J. Whitehead once pronounced, seek simplicity and distrust it.

Mr. COUSTAN. That is my point.

Senator PACKWOOD. I think also part of their fear is, you take away the deductions and then the rates will go back up and they will not have their deduction.

Now let me ask Dr. Foster, you quoted Marty Feldstein's report and I think it is a good report. It takes behavior into account.

I do not know if I told you, Mr. Chairman, maybe I did, in 1990 I sent to the Joint Tax Committee a letter asking them if they would estimate for me how much money we could raise if we confiscated all income above $100,000 and then above $200,000, 100-percent rate, and it would be a perpetual 100-percent rate.

They sent me back a letter indicating how much. I am paraphrasing, but I think in the first year over $100,000 we could raise $127 billion; in the second year it was $160 billion; and in the third year it was $220 billion. They made a 5-year estimate and then it came to about $1 trillion, $200 billion.

I called up Mr. Pearlman, who was then the director of the Joint Tax Committee, and I said, Ron, how on earth can we get this over 5 years at a 100-percent level of taxation. He says, we presume no change in behavior.

So I said, do me a favor, at least put that in. They did not want to attempt to do an analysis based upon change in behavior. I said, at least then put in an asterisk and a paragraph and indicate that, and indicate what you personally might think.

Well, it is a long, convoluted paragraph, but it says at the end of it, if by chance the taxpayer thought there was no hope of deferring income, and no hope that the 100-percent rate would ever leave, and that they were going to pay this rate forever, then we would expect a downturn in economic activity and a downturn in Federal revenues.

Now the reason I ask this is this—and I want to get to your concept of taxes on the rich and savings and disincentives because I have always thought the Laffer Curve got a bum rap in terms of its theory.

The CHAIRMAN. The Laffer Curve is no joke.

Senator PACKWOOD. Very clearly, at a 100-percent rate of taxation, we are not going to realize for any length of time, I think, any great amount of revenue. You might catch some people the first year, and maybe a few of them the second year, but I do not think it would be a long stream of revenue.

Dr. FOSTER. I think that is right, Senator. Anyone you would catch at that point, you would catch by accident.

Senator PACKWOOD. That is what I mean.

Dr. FOSTER. Because they are in arrangements that they could not avoid. And I thank you for bringing up that example. I confess

to having known of that beforehand and having mentioned it probably 100 times in other occasions.

Senator PACKWOOD. It is a wonderful letter. Do you have the letter?

Dr. FOSTER. No, sir.

Senator PACKWOOD. I will give you the letter.

The CHAIRMAN. Well, we can put it in the record.

Senator PACKWOOD. I will get it and put it in the record because the explanatory paragraph is so wonderful. We might expect a downturn in economic activity.

Dr. FOSTER. In somewhat of a defense, the Joint Tax Committee and Treasury use the same methodology.

Senator PACKWOOD. Yes, for static revenue.

Dr. FOSTER. For static revenue. They defend it as saying, well, it is quasi-static because we make a few paltry adjustments. But they assume that the general trend of the economy, the general flow of income, is unchanged. Also, what applies in their case to a higher confiscatory tax on labor income would apply equally to capital.

Senator PACKWOOD. I agree. I really have no objection. If they want to say this is a static estimate, so long as we understand their premise, that is fine.

Conversely to the 100 percent, at a zero rate of taxation we probably would not collect very much money either.

Dr. FOSTER. Unless by accident again.

Senator PACKWOOD. Unless by accident, yes.

As I understand the Laffer Curve, all he is saying is that some place between zero and 100 percent is a level of taxation that produces the optimum amount of revenue for the government. And it clearly is some place below 100 percent and above zero.

How do we figure out what that point is so that we do collect the maximum amount of revenue and at the same time encourage the greatest amount of worthwhile activity?

Dr. FOSTER. Well, it would require a very complicated analysis, extending the work that Feldstein and Feenberg did, and that Lindsey did before them. And having started with an initial point, it would be trial and error over a long period of time and we would never be successful in getting very close because as the economy changes and evolves over time, whatever that tax rate is in 1993, it will not be the same rate in 1994 or 1995.

Senator PACKWOOD. That is true. I have no other questions. Give me your card and I will send you the letter. I will get it.

The CHAIRMAN. Put it in the record. I would like to say we had a very respected economist, Dr. Gravelle, testify the other day. She would disagree with Dr. Feldstein and say that when you change tax rates, people will do a very great deal to maintain their standard of living. If you raise tax rates, they work harder.

Dr. FOSTER. Mr. Chairman, if I could just take a moment. I have Ms. Gravelle's study here and I would like to read one sentence out of her statement.

The CHAIRMAN. Go ahead.

Dr. FOSTER. "While some reduction in reported income is possible"—the key word possible—"the important question is how likely such an outcome might be."

I think that sentence tells us a lot about Ms. Gravelle's analysis. She is not convinced at 100 percent.

The CHAIRMAN. Anyone who is convinced on such matters has no business in the profession. By that I mean, it involves probabilities and propositions, and being able to change as events change are likely.

Thank you very much, sir.

Dr. FOSTER. Thank you, sir.

The CHAIRMAN. Thank you both. With that we will close our hearing.

[Whereupon, at 11:59 a.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR MAX BAUCUS

As I have stated previously, I commend the President for compiling an economic package that seriously addresses three of the most important issues facing this nation: the deficit, jobs, and long-term capital investment. I am committed to working with the President and his team to see that long-term economic growth and deficit reduction become a reality.

I respect the Administration's decision to choose the BTU tax as a revenue-raising proposal most likely to achieve a mixture of policy goals ranging from energy conservation to enhanced national security. However, over the longer term, more significant steps will be needed to encourage corporations and individuals to save and invest more and at the same time borrow less. Specifically, this means that a new tax, based on consumption, will have to be enacted along with relief from the income tax for working class Americans and corporations.

I am encouraged by the Administration's willingness to work to see that the impact of the proposed BTU tax is fair from a geographic and an industry perspective. This commitment to fairness is clearly shown by the modified version of the proposal that shifts the collection point of the tax and repeals the supplemental tax on home heating oil.

If the BTU tax is to become law, however, other legitimate problems must be addressed. For example, I am very concerned about the effect of the energy tax on the international competitiveness of energy-intensive industries, such as aluminum. The U.S. aluminum industry will not be able to pass on the cost of the BTU tax to consumers because prices are determined in the international marketplace. As a result, imposition of the tax may result in the loss of jobs in Montana and numerous other states.

The proposed BTU tax also places a heavy burden on the U.S. agriculture industry. Farmers will get hit by the tax in all phases of their work. They would pay the tax on the energy used for irrigation and operation of equipment, on the raw materials of food production such as fertilizer and crop protection chemicals, and on the transportation required to get products to market.

Hundreds of Montanans have called me and even stopped me on the street about the Btu tax. Farmers and ranchers are concerned that it won't be fair and balanced, and that it won't be sensitive to their needs. But as the senior Democrat on this committee from a farm state, I am committed to ensuring that the Btu energy tax is fair and balanced. And as we work on this committee in writing this tax legislation, I will work to ensure that the legitimate concerns of farmers and ranchers are addressed.

As a result, I join other members of this Committee in emphasizing that some relief from the BTU tax for the agriculture industry is necessary; necessary to insure that Americans continue to enjoy the safest, most abundant, and most low cost food supply in the world.

Overall, it is incumbent on this Committee to be certain that the BTU tax satisfy its environmental and other objectives without unfairly burdening any group of American taxpayers. I look forward to working closely with my colleagues on this Committee on achieving that goal.

PREPARED STATEMENT OF C. FRED BERGSTEN

The Competitiveness Policy Council is a twelve-member federal advisory commission established by Congress to recommend policies to improve US competitiveness. The council includes three top business executives, three union presidents, three

government officials (both federal and state) and three representatives of the public. It is fully bipartisan. The group was appointed equally by the President, the joint leadership of the House and the joint leadership of the Senate.

In our first report to Congress and the President, issued last year, we outlined a comprehensive strategy to restore America's competitiveness and improve the country's standard of living. Last month, the council presented the details of this strategy in our second report to the congress and to President Clinton.

The Council concludes that the United States continues to face major competitiveness problems despite recent pickups in the growth of both the economy and national productivity. Our work suggests that those problems have been growing for over twenty years and cannot be solved overnight. We believe that the American public wants and will support a serious attack on the problem, and that the present period offers a rare opportunity to launch the needed reforms.

The Council recommends several key national goals for the year 2000:

—*raising national productivity growth to an annual average of 2 percent* from the 0.7 percent rate that prevailed from 1973 to 1991, thereby increasing family incomes by one third in a single generation;
—*achieving annual economic growth of at least 3–3½ percent,* to create enough high-wage jobs to restore full employment and a rising standard of living; and
—*eliminating the deficit in our external balance,* halting the reliance on foreign capital that has turned America into the world's largest debtor nation.

To achieve these goals, the Council supports many of the investment proposals made by President Clinton. There are three specific areas where we would go considerably beyond the proposals of the Administration. Two of these are education reform and trade policy, which are not on today's agenda. One of our major emphases, however, is on precisely the topic of this hearing: increasing private investment in the United States.

PRIVATE INVESTMENT

Our recommendation to double the growth of national productivity requires a significant increase in both the quality and quantity of private investment in the economy. All of our proposals for improving education, training, public infrastructure spending, technology supports, improved corporate governance and the like seek a bigger bang for every investment buck.

In addition, we must increase the share of the economy that is devoted to investment. The United States invests less than any of our major competitors and less than half as much as Japan. In some recent years, Japan has invested more than the United States in absolute terms though it has only half as many people.

In particular, the United States has devalued the importance of manufacturing the sector that provides our highest wages, most of our R&D, and the bulk of our exports. Our real investment in industrial equipment grew by barely more than one percent annually in the 1980s, down from four percent in the 1970s and 1960s and from more than five percent in the 1950s.

A modest part of the needed increase in investment will come from public spending on infrastructure. The bulk, however, must be private investment in plant and equipment. *We must increase the investment share of the economy by at least five percentage points to meet our goal of doubling national productivity growth.* Many observers would argue than a much larger shift of resources, on the order of six to eight (or even ten) percent of GDP, will be necessary to achieve such a boost in productivity growth.

The cost of capital is crucial in determining the national rate of investment. The user cost of most types of production equipment has risen sharply over the past decade due to tax increases on investment in equipment. Hence we propose three new tax incentives for private investment that will reduce that cost as well as seek to channel private investment in the most productive directions:

—a 10 percent Equipment Tax Credit, limited to equipment (hence we now call it an *Equipment* Tax Credit) and permanent for all firms on *either an incremental or "first dollar"* basis;
—reinstatement of a permanent research and development tax credit; and
—more realistic depreciation periods.

Our proposals were formulated following careful analysis and debate both by our full Council and by a twenty-nine-member subcouncil on Manufacturing composed of experts drawn from industry, labor, federal and state governments, and public interest groups from across the country. Members included Senators Bingaman, Levin, Lott and Roth; House Members Nancy Johnson and LaFalce; and now-CPA

Chair Laura Tyson. All of these meetings were open to the public in line with the Council's statutory mandate to be a national "competitiveness forum."

THE EQUIPMENT TAX CREDIT

The Council recommends a permanent Equipment Tax Credit to induce companies to invest more than they otherwise would. We analyzed all of the arguments against this policy tool and found that most of them were aimed at a temporary credit rather than the permanent credit that we endorse. We agree that a temporary credit leads to a bunching of investment rather than a permanent modification of incentives. Hence we would not support that approach.

By contrast, a permanent ETC. should permanently increase the share of investment in our economy. This is an essential component of any competitiveness strategy for the country's economy and we strongly recommend it.

We know that a permanent ETC will work. During past periods when such a credit was in place (1962–66, 1967–69, 1971–74 and 1975–85 at a higher rate), growth in equipment spending rose strongly—in sharp contrast to periods when the credit did not apply. Extensive research, some conducted by current Treasury Under Secretary Larry Summers, clearly shows a high correlation—and highly probable causation—between equipment investment and economic growth. These studies suggest a very high rate of investment bang per buck of ETC tax expenditure.

An Equipment Tax Credit of course reduces tax revenue, at least in the short term. The Council strongly favors responsible budget policies and has in fact called for complete elimination of the budget deficit in order to increase national saving by enough to finance the essential rise In national investment. therefore we would want any ETC to be fully "paid for" by cutting government spending or raising other taxes.

Yet it is important to understand that a well-designed and effective Equipment Tax Credit should pay for most or all of its initial costs within a few years by generating new production and employment. According to DRI, each $1 of equipment Tax Credit could potentially pay for itself by generating $2.50 of new investment which would in turn contribute $3.75 to national income through job creation (e.g., ⅔ through investment plus ⅓ trough Consumer spending) which could in turn produce approximately $1.05 in new federal tax revenue. These feedback effects may not register in budget scorekeep models but they are real in economic terms and must be kept fully in mind in evaluating the proposal.

We would stress three important points in designing the ETC. First, most of our Council members believe that it is desirable to "trade off" a slightly higher corporate tax rate for an ETC (and the other targeted tax credits that we propose). As noted above, the United States must get a much bigger bang for each investment buck if we are to achieve the needed increases in national productivity An ETC, along with a new R&D credit and faster depreciation should channel scarce national resources into more productive types of investment in the future.

Second, the ETC should not be covered by the alternative Minimum Tax (AMT). Such inclusion could sharply truncate its impact in generating new investment. This issue has not arisen before because the AMT entered the Tax Code only in 1986 when the previous Investment Tax Credit was eliminated.

Third, we have no firm opinion on whether the new ETC should be applied on an incremental or "first dollar" basis (of course at a lower rate, to avoid a higher tax expenditure cost). Our Manufacturing Subcouncil strongly urged a "first dollar" basis (as did, similarly, our Technology Subcouncil for the R&D credit). Our full Council, however, opted for the incremental approach. We recommend that the Committee get the best advice it can from the corporate decision-makers who will implement the program and then decide which alternative appears to be superior.

CONCLUSION

We urge the Congress to adopt an Equipment Tax Credit as proposed here. Promoting new investment is one of the fastest ways to increase economic growth and create jobs. According to DRI, enacting the credit by mid-summer would boost GDP at the end of 1994 by an additional $40 billion or $425 per household.

I would close by re-emphasising that I speak today not as an advocate for any industry or special interest but rather as chairman of a bipartisan quadripartite Council created by the Congress. The support in our Council and its relevant Subcouncils for an Equipment Tax Credit includes corporate CEOs, labor union leaders, elected national and state officials and representatives of the public interest. We support an Equipment Tax Credit because it will lead to new investment, create jobs, and help rebuild a more competitive America.

COMPETITIVENESS POLICY COUNCIL,
Washington, DC, May 13, 1993.

Hon. PATRICK MOYNIHAN, *Chairman,*
Senate Finance Committee,
U.S. Senate,
Washington, DC

Dear Mr. Chairman: It was a great pleasure to testify before the Committee recently on the investment tax credit. I greatly appreciate your giving me an opportunity to express the views of the Competitiveness Policy Council.

I was later informed that, during a subsequent panel at the same hearing, Mr. Robert McIntyre characterized my support for the investment tax credit as "his own idea" rather than representing a broader viewpoint. Mr. McIntyre, whose views I deeply respect, is a valued member of the Council's Capital Formation Subcouncil. He is correct that this particular Subcouncil does not endorse an investment tax credit.

However, both our Manufacturing Subcouncil and Critical Technologies Subcouncil strongly recommend such a tax incentive for equipment investment. More to the point, the full Competitiveness Policy Council endorses the idea and emphasizes it in our recent Report to the President and Congress. On page 30, we indicate at the top of our list of six specific proposals "to promote new investment, especially in manufacturing": "first, we need an incremental and permanent equipment tax credit." In the accompanying press release (copy enclosed), we highlight this proposal as the first of several where we suggest that "the Council's latest recommendations go considerably further than those of the Administration."

As noted, I have high respect for Mr. McIntyre and have greatly valued his participation in some aspects of the work of the Competitiveness Policy Council. However, his testimony on the Council's support for the investment tax credit was in serious error and I believe it is essential to correct the record. I respectfully request that you include this letter in the record of the hearing.

Sincerely,

C. FRED BERGSTEN, *Chairman.*

PREPARED STATEMENT OF CHIP BERMAN

My name is Chip Berman. I co-own and manage **The Outta The Way Cafe** in Rockville, Maryland. We're a neighborhood restaurant that sells a little Rock & Roll and a lot of cheeseburgers. Nothing fancy and nothing on the menu over $11 bucks.

You might be wondering why someone like me is testifying on business meal deductibility. You probably expected Duke Zeibert or Mo Sussman. Well, everyday a great many business people bring clients to my restaurant to help market their services and close a deal.

Today I speak for thousands of middle-class restaurateurs and their employees. Today I represent Susetta Harrison and Brenda Bishop, a line cook and a waitress in my restaurant and both single parents with two children each. Susetta and Brenda are here with me today.

I might sell Rock and Roll at night, but at lunch I serve business customers. They're not drinking three martinis. They're working. They're getting in an extra hour doing business by doing it over lunch.

The reduction in the business meal deduction is being billed as a last remaining loophole for rich folks in three-piece suits dining at fancy restaurants; while writing it off on an unsuspecting public. But the facts are that a majority of business meals take place in low- to moderately-priced restaurants like my own.

A majority of those using the business meal deduction are small businesses. And one quarter are self-employed. In other words, **the perception that the only people using the business meal deduction are the proverbial "fat cats" is a myth.**

According to an independent study commissioned by the National Restaurant Association, a reduction in the business meal deduction to 50% means that $3.8 billion will be lost in business meal sales causing an estimated 165,000 people nationwide to lose their jobs in restaurants, including 2,916 in Maryland.

I know it will hurt the kind of business lunch trade I do because it is very price-sensitive. It will cut into my sales, and that cuts into jobs.

Why is government making it so difficult to employ people if our goal is increased employment?

Every restaurant person I know has cut payroll in the past year. Labor is the only controllable cost left. I cannot change my rent or my utilities or my insurance premiums. I cannot reduce food and beverage costs. I cannot increase the prices charge my customers.

But I can cut payroll. What will Brenda Bishop, a waitress, do if her tipped income is reduced? What will Susetta Harrison, who has been with me for eight years, do if she can't work at all?

Mr. Chairman, I hear a lot of government policymakers talking about how everyone has to "contribute" to economic recovery and pay their "fair share." I might remind you that the restaurant industry has already lost 20% of business meal deductibility as a result of the 1986 Tax Reform Act. I also want you to know that when you add up the 25 fees and taxes I pay to governments at all levels, not counting all the other tax measures in President Clinton's package, government gets five times more "take home" from my company than I do . . . and I own it!

Local, state and federal governments have no clue about the actions each other takes that dramatically affect business.

The Administration's BTU tax will increase my energy bill an estimated four and one-half percent and cost my business about $768 a year. But last year my local government slapped on an energy surcharge that already costs me an additional *$1200* a year.

In the last two years, government has increased my cost of doing business in so many different ways that I have watched our earnings shrink by 46% while our gross sales increased by 11.2%.

Those of us who have survived this recession know we cannot raise our prices. In fact, my customers are still complaining about the 1991 price increases caused by the increase in the federal excise tax on alcohol. The assumption that businesses will be able to simply "pass along" tax and fee increases to our consumers doesn't cut it in restaurants like mine. Customers are simply too price-conscious.

Let me express it in Cheeseburger Logic. My restaurant sells cheeseburgers for five and a quarter. Of that $5.25, my net profit is twenty cents.

We are already saving as much as we can without cutting our food quality or our labor costs. I cannot raise my prices. So if we sold only cheeseburgers and could pay for these new government costs just by selling more of them, how many additional cheeseburgers would I have to sell?

- The proposed BTU tax will cost me $768. So netting 20 cents on each cheeseburger, I'll have to sell an additional 3,800 cheeseburgers to pay for it.
- An increase in the minimum wage people at the Department of labor have been talking about will cost $20,500, so I'll have to sell an additional 102,000 cheeseburgers to pay for it.
- The proposed federal excise tax increase on alcohol to fund health care will cost $3,800, so I'll have to sell an additional 19,000 cheeseburgers to pay for it.
- The 1992 state unemployment surcharge increase in Maryland costs me $5,400, so I already have to sell an additional 28,000 cheeseburgers to pay for it.

That adds up to selling 150,000 more cheeseburgers next year. People love our cheeseburgers, but not quite that much.

I ask you to please consider the overall impact of what you are doing. I know my business has to pay some taxes, but I can't even do that if you're going to pass laws like reducing the business meal deductibility that will keep customers from coming in.

So, Mr. Chairman, **it all boils down to jobs.** If I am left with the choice of reducing labor costs or surviving as a business, which of my people am I going to fire? And why is my own government asking me to make that choice?

Simply put, if the government is going to impose yet another set of new taxes on restaurants, then maybe the government should also tell me who to fire—Susetta or Brenda?

On behalf of the National Restaurant Association, I would like to mention our support for the FICA tax on tips tax credit you passed twice last year and the permanent extension of the Targeted Jobs Tax Credit.

Thank you, Mr. Chairman.

BUSINESS MEAL DEDUCTION FACTS

The deduction for expenses associated with business meals and entertainment was reduced from 100 to 80 percent as a result of the Tax Reform Act of 1986. President Clinton has proposed cutting the deduction to 50 percent effective January 1, 1994, as part of his economic plan. The 50 percent limit would apply to all business

marketing meals, as well as to meals purchased by business travelers. *The National Restaurant Association opposes this limitation for the following reasons:*

I. The reduction would result in job, sales and tax revenue losses

In the four years following the Tax Reform Act of 1986, real sales declined almost 6 percent in establishments with per person checks of $15. In fact, the six years following the 1986 change were the worst years the foodservice industry had seen in decades. Real sales in *all* tableservice restaurants actually dropped in 1990 and 1991, and rose only a slight .1% in 1992. Recent figures on a reduction to 50 percent indicate that 165,000 jobs will be lost and that the industry will see an annual loss of $3.8 billion in sales.

Consider these facts

- *A majority of those employed in foodservice occupations are women.* Twenty percent are teens, 12 percent are African-American, and 12 percent are Hispanic—those least likely to withstand economic dislocation.
- *A majority of those purchasing business meals are small business people.* A survey commissioned by the National Restaurant Association shows that seventy percent of those purchasing business meals had income below $50,000 and 39 percent had incomes below $35,000.
- *Fully one-quarter of those purchasing business meals are self-employed.*
- A drop in business meal traffic affects far more than "fine dining" restaurants. *Low- to moderately-priced tableservice restaurants are the most popular type of restaurant for business meals.* Seventy-eight percent of business lunches and 50 percent of dinners occur at these establishments. The average amount spent on a business meal, per person, is $9.39 for lunch and $19.58 for dinner.
- Over the last decade, U.S. cities have invested millions of dollars to attract people and businesses to downtown areas. Business travelers are a significant part of this revitalization. By reducing the deduction for business and travel meals, the federal government is creating a disincentive for such activities. Federal revenues might increase—but local and state economics and treasuries would suffer.

II. Placing a limit on the deduction would take a special toll on small businesses

Many businesses, particularly small businesses, rely on restaurant meals to give them an opportunity to sell their products and services one-on-one. For many of these business people, other forms of advertising—such as radio, or newspaper ads—are either too expensive or not effective. Reducing the deduction unfairly penalizes the small business people who use it and the small foodservice businesses they frequent.

III. The business meal is a legitimate marketing tool

Like other sales-generating expenditures that are fully deductible (advertising, promotions, free samples, etc.), the business meal is an integral part of the marketing plans of many firms. It is not right for the U.S. government to inject itself into the private decisions a business makes about which marketing techniques work best.

THE IMPORTANCE OF ADDRESSING FICA TAXES ON EMPLOYEE TIPS

What are FICA taxes on tips?—

Current law requires both employers and employees to pay Social Security (FICA) taxes on all tip income earned by employees. Under the Omnibus Budget Reconciliation Act of 1987, employers are required to pay FICA taxes on all employee tip income. Under the prior law, employers paid FICA taxes on all wages they paid directly to employees. Employers paid PEA taxes only on tips used as a credit up to the minimum wage.

Why current law is contradictory and unfair—

Federal law treats all employee tip income as employer provided wages for tax purposes, while only treating 32.12 cents per hour as wages for purposes of meeting the minimum wage. It is inconsistent to treat tips one way under the Internal Revenue Code and another way under the Fair Labor Standards Act. This has cost restaurants hundreds of millions of dollars and thousands of jobs. Tipping is a private transaction between patron and server over which the employer has no control. Tip income is earned independent of the employer. Restaurateurs should not be forced to pay payroll taxes on non-payroll income in excess of meeting their minimum wage obligation.

Why this tax was enacted—

Congress enacted the FICA tax on tips provision to raise federal revenues to meet the FY 1988 Gramm-Rudman-Hollings deficit reduction targets. The increased revenues were not needed by the Social Security Trust Fund, nor do they provide any increase in retirement benefits for tipped workers. It is wrong to increase Social Security taxes to balance the federal budget.

The FICA tax on tips is costly to tipped businesses—

The FICA tax on tips has been financially devastating to the foodservice industry—particularly small restaurants. Over 70 percent of eating and drinking places have annual sales of less than 3500,000 per year—with an average pre-tax profit between 3 and 5 percent of sales. The FICA tax on tips costs many small restaurants more than $10,000 each year—a cost that is unpredictable and cannot be budgeted for. It has completely eliminated any profit for many struggling enterprises, curbing job creation and economic growth.

The law disrupts employer-employee relations—

Whereas, U.S. labor law stipulates that all tip income belongs to the employee, the FICA tax on tips now creates a direct financial interest for employers in the private tip transaction between patron and server. The provision also creates a potential tax liability for employers when employees fail to report all tip income. This has resulted in unexpected back tip assessments against employers who have been complying with tip reporting laws in complete good faith. The law has worsened employer-employee relations while imposing additional paperwork and recordkeeping burdens on small businesses.

The need for corrective legislation—

This provision of the tax code has cost 39,000 jobs due to the increased cost for employers. Legislation to modify current law has been introduced in both the House and Senate. Congressmen Mike Andrews and Don Sundquist introduced H.R. 1141, and Senator John Breaux introduced S. 573. This legislation, which passed both Houses last year as a part of the tax bill, would provide an income tax credit for FICA taxes paid on employee tips above the minimum wage. The enactment of this legislation would not only provide relief from an unfair burden on restaurants but would also create thousands of jobs and improve the profitability of restaurants.

We strongly urge that the tax credit for employer paid FICA taxes on tips be included in the Budget Reconciliation Act.

TARGETED JOBS TAX CREDIT

What is the Targeted Job Tax Credit (TJTC)?

TJTC is a federal tax credit offered to employers of individuals from nine target groups, including economically disadvantaged youth (18–22) physically or mentally handicapped persons, Vietnam-era veterans, ex-felons, ODC and general assistance recipients, and SSI recipients. The program also includes hiring of economically disadvantaged youth aged 16–18 years for the summer months. The credit was established in 1979 to encourage employers to hire workers from these groups that chronically experience high unemployment.

Employers can earn a credit of 40 percent of the first $6,000 of qualified first-year wages paid to eligible employees.

Are employers utilizing the program?

To date, close to six million disadvantaged Americans have been hired through TJTC, roughly 500,000 per year. Participants have come from each target group and every state.

Is permanent extension of the program important?

Yes. The uncertainty of benefit availability discourages even broader participation in the program. Any special recruiting program such as this one has start-up costs, and requires advance financial planning. The uncertainty of the extension process automatically disqualifies a number of operators.

Administration's Economic Package

The Administration's economic package includes a permanent extension of the TJTC. It does not, however, include 23- and 24-year-olds.

Position of the National Restaurant Association

The National Restaurant Association supports the inclusion of the permanent extension of the Targeted Jobs Tax Credit in the President's economic package and was pleased that it was made retroactive to June 30 1992.

We support this program as it is highly used by the foodservice industry to employ economically disadvantaged individuals. We would, however, recommend that a provision be added which would expand the TJTC to apply to 23- and 24-year-olds.

PREPARED STATEMENT OF SENATOR CONRAD BURNS

Mr. Chairman, I would like to thank you and the members of the Committee for holding this hearing. The proposed energy tax has been the focus of much attention, and I appreciate being able to offer my comments.

In the production of food and fiber, energy is at the very base of every level of production, process, and distribution. Energy is the lifeblood of this county. This nation runs on its ability to be mobile. No other country in the world can match our diversity and use of technology to sustain the standard of living we also enjoy. According to the Congressional Office of Technology Assessment, 30 percent of the nation's total energy is consumed is by manufacturing plants, mines, farms, and construction firms.

The president has put forth an economic blueprint that he feels will reduce the deficit as well as address areas of need. And I am pleased that the president has focused attention on the deficit, and it is incumbent on all of us to work with him. However, in my view, the package may not help to reduce the deficit, plus it would have a profound negative impact on my home state of Montana.

Our top three industries—agriculture, mining, and tourism—would be adversely affected under the president's proposal and specifically under the energy tax.

President Clinton's energy tax would raise $71.4 billion in the next five years. However, this tax is not fair to all Americans—it will hit Western states far more than another section of our country. Not only do Montanans rely on energy to keep our homes warm during the cold winter months and to drive longer distances, but our major industries rely heavily on the expenditure of energy.

For these reasons and others, I ask the Committee to consider an "Off-Road Motor Fuel Tax Exemption" amendment. Mr. Chairman, in 1991, farmers and others consumed some 1.4 billion gallons of gasoline and some 2.8 billion gallons of diesel fuel in off road uses such as farm machinery.

Farmers are price takers—they cannot pass price increases on to the ultimate consumer of food. If the price of input goes up, they,the farmers, absorb the cost. And what we have to remember is consumers of this country dictate food prices through the food processing industry. Add this tax to farmers and you run the risk of destroying the food chain of this nation.

The effects on agriculture will be great. And I could go on and address the effects the proposed tax will have on industries related to coal production, oil production, and hydroelectric power.

I would also like to emphasize my concern over the effect of applying the tax to energy consumed as part of a manufacturing production process. I am referring to manufacturing processes that utilize energy sources in one of two ways; (1) as a raw material is transformed into a product; or, (2) as a direct input to effect a chemical or physical change that turns the raw material into a finished product. In either case, we would be taxing a basic feedstock utilized in a production process that may only be able to be re-designed at great difficulty or expense, or possible not at all.

But one last area that has not been given enough consideration in this debate is how this tax will affect small businesses—which comprise 98 percent of Montana's businesses. As a state, Montana has started to take hold of export opportunities. The costs that will occur because of the energy tax will increase the vulnerability of small businesses in foreign competition. The energy tax will reduce American businesses' international competitiveness and reduce economic recovery and increase unemployment.

The energy tax is a regressive tax to western states and will result in less production and therefore less economic activity. The less there is in growth, the greater the loss of future tax revenue. We lose on both ends of the formula the president has recommended to deal with the deficit spending situation we find ourselves in.

Mr. Chairman, thank you for the opportunity to testify this morning.

PREPARED STATEMENT OF MORTIMER M. CAPLIN

My name is Mortimer M. Caplin of the Washington law firm of Caplin & Drysdale. I served as Commissioner of Internal Revenue under Presidents Kennedy and Johnson from February 1962 until July 1964.

I recommend that the Committee eliminate the proposed investment tax credits—both the two-year incremental ITC for large businesses and the permanent ITC for small businesses. The $30 billion tax savings (1994–1998) could better be used to reduce the deficit, reduce marginal rates or strengthen other aspects of the President's program.

ITCS AND ADMINISTRATIVE COMPLEXITIES

Dating back to the 1960's, I participated in the development of the ITC concept—first, as a member of President Kennedy's Taxation Task Force that proposed the ITC and, later, as the Commissioner of Internal Revenue called on to help draft regulations for its implementation and to police its use after its enactment in October 1962. The House Ways and Means Committee had rejected the incremental credit as too complex and erratic in its application, and the ITC finally emerged as an across-the-board 7% tax credit for new and, to a limited extent, used tangible personal property.

Any "building and its structural components" were excluded; but what games accountants and lawyers played in trying to get around this ban! Movable partitions inside the buildings became the fad. Many other line-drawing problems arose and, indeed, a new industry developed for making specific ITC studies so businesses could provide support for positions they took on their tax returns. IRS agents uniformly disputed these studies and countless cases ended up in IRS appeals offices and the courts.

Court calendars were crowded by ITC issues in many forms. One lengthy proceeding involved the government's injunction action against a major accounting firm for the promotion and aggressive marketing of allegedly fraudulent ITC services, and the alleged use of misleading terminology to describe items of questionable qualification to avoid IRS detection. Mislabeling examples provided to the court were:

—*Concrete block walls:* Labeled "knock-out panels"
—*Section of roof on building:* "Equipment support"
—*Fixed walls:* "Movable partitions-gypsum"
—*Doors:* "Movable partitions-wood"

Besides using traditional machinery and equipment as the base for ITC tax claims, taxpayers were in court defending ITC claims for a broad range of items: Movable ceilings, ski slopes and earthen ramps, catwalks, amusement park rides, bath houses and fixtures, egg-processing structures, drive-up teller booths, gasoline pump canopies, master film strips, "reproduction masters" of original Picasso works, book rights, baseball and football player contracts and, yes, even cattle. The government won all these cases, although IRS efforts to monitor compliance with the law became inordinately burdensome.

ECONOMISTS' VIEWPOINTS

Economists differ sharply on whether the ITC is an efficient, cost effective means of stimulating the economy and contributing to real long-term growth. Under theoretical macro-economic criteria, the ITC certainly has its charm; but, on a real-world analysis, the ITC's tax-reduction attributes are a strong brew for distorting normal decision-making and encouraging tax-motivated, noneconomic behavior. Tax avoidance and abuse are an inevitable byproduct.

The on-again off-again history of the ITC provides little proof that, by itself, it results in substantial increases in investment. Although the timing of expenditures may be affected by the ITC, much of the prior ITC was wasted on investments that would have been made in any event. Some economists have even concluded that for each dollar spent by the Treasury on ITCs considerably less than $1 of increased investment was in fact produced.

Beyond this, the principle of tax neutrality is sharply violated by the ITC's bias toward capital-intensive industries—resulting in discrimination against service businesses, distributors, wholesalers, retailers and businesses obliged to finance large inventories. If it is jobs we are after, why subsidize capital?

In a recent survey of the ITC literature, Jane G. Gravelle of the Congressional Research Service, Library of Congress, included the following among her conclusions:

—Overall, very high marks are not given to the use of ITCs "as counter-cyclical tax devices because of the long lags in responding to these incentives."
—Little economic evidence exists "to support expectation of a large effect on capital formation."
—"[T]he degree of capital formation obtained will have a modest impact on future standards of living and growth rates over the next few years."

Ms. Gravelle finds little favorable to say about the ITC's efficiency or effectiveness in spurring needed investment. Based upon my own experience as a lawyer, former tax administrator and member of a number of corporate boards of directors, I have never been impressed by the impact that the ITC had on decision-making to increase investments. Most businessmen I know make acquisitions of machinery and equipment in order to enhance production, not to receive a 7% or even a 10% ITC.

Incremental ITCs have their own severe difficulties. They are targeted at investment that would not be made absent the ITC stimulus—i.e., investment in a tax year that is in excess of a taxpayer's average historic investment made during a preceding base period. But the questions that arise here are complex and, even when answered, are hard to draft and administer:

1. What is a "fair" base period for a wide variety of businesses with differing histories?
2. What about new, loss or fast-growing businesses?
3. Businesses that recently made large investments?
4. Or those that recently made unusually low investments?
5. How do you identify and police whether some used property was acquired during the base period?
6. How do you treat multiple businesses controlled by the same taxpayer?
7. How do you treat lessors and lessees under leasing arrangements?
8. What about the acquisition or disposition of businesses during the base period? During post-base periods?
9. How do you treat the proceeds of sales of old assets when new replacement assets are then purchased?
10. And how do you treat bunching of investments to achieve incremental ITCs?

THE TAX SHELTER PROBLEM

In the past, ITCs became the prime bait to attract investment in numerous exotic tax shelters that were widely marketed right up to the Tax Reform Act of 1986. Administration of the controlling law was difficult in the extreme and the IRS was compelled to focus major portions of its resources on tax shelter examinations, appeals and fraud cases.

The wide publicity given to tax shelter fever brought public scorn, disrespect for the tax system and inevitably a weakening of voluntary compliance with our tax laws. With an annual tax gap approaching $120 billion—resulting from the faulty reporting of income from legal activities—this nation cannot accept further revenue deterioration by opening the door to the potential of a new wave of tax shelter offerings. Reenacting ITCs, even for a limited time, could well sow the seeds for such a revival.

The 1986 Revenue Act contained a number of provisions aimed at curtailing tax shelter abuses—passive loss rules, limits on investment interest deductions, accounting rules changes, lower depreciation deductions, a toughened alternative minimum tax and repeal of the investment tax credit. This was strong medicine and the tax shelter industry was left reeling under a major blow. Yet, today there is still some room left for creative packaging of tax shelters, albeit on a much more limited basis.

Since 1986, the name of the tax game is to generate sufficient passive income so as to offset a taxpayer's accumulated passive losses. Many recent shelter projects have been shaped to meat this goal and have been successfully marketed on this basis. Older investments that have turned sour can also produce sizable amounts of passive income through the recapture rules, not to mention investments that are actually sold at a profit. With pools of passive income thus made available to a broad spectrum of taxpayers, tax shelter promoters continue to have a significant constituency. If new ITCs are added to the mix, the attractiveness of these investments increases markedly.

In sum, the President's proposals taken as a whole contain enough essential ingredients to whet the appetites of hungry tax shelter promoters: Higher tax rates, tied to an already broadened and tougher tax base; capital gains preferences, with a 30% reduction in the top rate for high-bracket taxpayers, plus a 50% exclusion for targeted capital gains for "qualified small business stock;" partial repeal of the passive loss rules, for real estate professionals; introduction of new ITCs; and even enterprise zone benefits—all available to be packaged together for the right customers. In such a setting, adroit and ingenious tax planning should not be underestimated.

ITCs run completely counter to the philosophy of the 1986 Act—aimed at broadening our tax base while coupling it with a lower marginal rate structure; eliminating tax preferences and avoiding micromanagement of the economy by selecting particular activities or industries for special rates or other tax benefits; and encouraging taxpayers to make business decisions based upon sound economic criteria rather than tax inducements.

Our nation would better be served by a tax system that continues in this direction—one that is not diverted by a temporary or permanent tax incentive heralded as an imagined economic stimulant.

PREPARED STATEMENT OF ARTURO CARRION

Good morning Mr. Chairman and members of this Honorable Committee. My name is Arturo Carrión and I am here today as the spokesman for the Puerto Rico Private Sector 936 Coalition, a group of 27 organizations that have joined together to preserve our blueprint for economic development.

The organizations in this Coalition, together represent more than 30,000 businesses of all sizes and from all sectors of Puerto Rico's economy, and these businesses in turn account for more than 50% of total employment in Puerto Rico.

These private-sector organizations agree with the ongoing effort to create jobs, improve US competitiveness, and reduce the federal budget deficit. We also believe that Section 936 of the Internal Revenue Code is vital to the continuing economic development of Puerto Rico. It is in this context that I deliver this message today on behalf of the Coalition.

For the record, I am attaching a summary of the impact which the issue at hand, will have on each economic sector represented in the Coalition.

As we address this hearing on the Administration's economic program, we are conscious of President Clinton's call for sacrifice by all Americans to restore health and vitality to the US economy. However, this sacrifice must be shared equitably and fairly by all Americans. This is not the case with the Administration's proposals as they pertain to Puerto Rico.

Puerto Rico is being asked to carry a disproportionate share of the tax burden in the President's program. We are the only jurisdiction being asked to put at risk the very foundation of our economic system. The proposed changes to Section 936 are not merely an incremental adjustment in taxes, but a radical change in our economic structure. Sound policymaking requires a full understanding of the derivative effects of such a change.

The objectives being pursued by the Administration do not warrant this dangerous change in Puerto Rico's economic system, and can be achieved in more effective and less risky ways. Our understanding is that the Administration has two clear-cut objectives: One is to raise revenues. The other is to create jobs. Both are simple and clear goals; neither of them requires or justifies the sweeping changes in Puerto Rico's economic structure that are being proposed.

Aside from their far-reaching nature, the dollar value of the changes being proposed also has a dramatic impact. When differences in population and income are taken into account, we find that Puerto Rico is being asked to carry a burden six times as large as the burden on the mainland economy. Moreover, the proposed changes in Section 936 imply enormous increases in the effective tax burden on the economy of Puerto Rico that would cause irreversible harm to the entire economic development program on the Island. This is too high a sacrifice for Puerto Rico to bear.

The revenue-raising proposals in the Administration's program, totaling $246 billion, amount to slightly less than $1,000 for each American on the mainland. In contrast, the $7.5 billion being asked from Puerto Rico's economy are more

than $2,000 for each of Puerto Rico's 3.6 million American citizens. If we factor into the calculation the fact that Puerto Rico's income per person is about one-third of the income per person on the mainland, we find that the proportionate share of the tax-raising burden placed on Puerto Rico is six times higher than the corresponding burden on the mainland.

Viewed from another perspective, the $7.5 billion requested from Puerto Rico in five years, which translate into $1.5 billion per year on average, is equivalent to a 43% increase in Puerto Rico's annual tax burden. In other words, raising $1.5 billion per year in tax revenues out of Puerto Rico's developing economy is like a 43% increase in local taxes, none of which will be spent on development-oriented activities in Puerto Rico. Picture such an increase in the tax burden on any state or municipality on the mainland. Changes of such magnitude cannot take place without causing severe disruption in economic activity.

Whichever way one looks at the proposed changes in Section 936, the magnitude of the change is staggering. We have no doubt that changes like those being proposed would cause severe hardship to those in Puerto Rico who are least able to escape the negative impact of this economic dislocation.

In the four-and-a-half decades since the late 1940s, we in Puerto Rico have taken full advantage of Section 936 and its predecessors to produce a dramatic transformation of our economy and society. We have increased our GNP per person eighteen-fold, from $348 in 1950 to $6,450 today. Employment increased more than 50%, from 596,000 in 1950 to 925,000 presently. In the process, we transformed a traditional agricultural economy into a modern and dynamic manufacturing and services economy. We have also modernized all aspects of Puerto Rican life, reaching world standards in matters of education, health, life expectancy and other indicators of economic development. Section 936 and its predecessors and the active mobilization of Puerto Rico's own constructive energy have been essential to this process.

Yet, after four-and-a-half decades of impressive achievements we still face major shortcomings in our economic development. It is because of these shortcomings that Puerto Rico's economy is not strong enough today to carry the burden implied by the proposed changes in Section 936.

When Puerto Rico's modern industrial development began in the late 1940's, we had three major advantages to build upon. First, we had preferential access to the United States market under a common currency and common customs. Second, we had a low-cost labor force. Third, we had local and federal tax benefits for industrial corporations. Besides these three pillars of our industrial strategy, we also had lower energy costs due to exemption from oil import quotas.

As we leveraged on these advantages, we developed our human resources to the point where cheap labor is neither a possible nor a desirable feature of the Puerto Rican economy. Through the years, we have also lost the advantages of our preferential access to the US market, not because the market has been closed to our products, but because many other countries have gained almost equal access to the US market. The two rounds of GATT negotiations, the Caribbean Basin Initiative, and more recently, the proposed North American Free Trade Agreement, have given many other countries such easier entry into the American market that our free access is no longer so advantageous.

We have made a good deal of progress towards our goal of sustaining economic growth on the strength of our human resources, our entrepreneurial ingenuity, and our physical and technical infrastructure. However, we still need an instrument to support economic development in the foreseeable future.

We must recognize that despite all the achievements of the last four decades, Puerto Rico must still compete without natural resources, with a population density that is one of the highest in the world, and a per capita income that is still only about half that of the poorest state. We should also remember that in contrast to many countries that compete with Puerto Rico for investment capital, we are bound by some of the toughest environmental standards in the world, by US minimum wage legislation, by the cost of maritime transportation in US ships, and by higher energy costs than the mainland.

We have to continue this transformation on the basis of the partnership historically developed between the federal government and Puerto Rico in order to compensate for the challenges that Puerto Rico faces. Section 936 is part of the arrangements the United States offers for economic development in the possessions.

This tax-sparing arrangement has always been recognized by the US government since the beginning of the century, is customary practice in relations between other industrial countries and many developing countries, and has proved beneficial to both Puerto Rico and the United States.

Puerto Rico is one of the world's largest purchasers of US products, with imports of more than $10 billion annually. This places us as the single largest buyer of US products on a per capita basis and just below such a large and high-income country as France in terms of the dollar value of purchases. These purchases of US products, many of them raw materials and supplies purchased by 936 corporations, support about 200,000 jobs on the mainland. In addition, Puerto Rico's heavy use of US merchant marine services is instrumental to the survival of this strategic industry.

Creating jobs, particularly high-quality, well-paid jobs, is ultimately the main thrust of the President's economic program. We maintain that Section 936 is essential if we are to continue with our economic development and our endeavor to create jobs. That is what 936 means to our economy. It is the mechanism that creates employment in Puerto Rico. Besides generating 115,000 jobs directly in manufacturing, the activities of 936 corporations indirectly generate and support about 200,000 additional jobs in services, trade, retailing, and many other activities characterized by medium and small-size companies led by Puerto Rican entrepreneurs. These are the people represented by this Coalition.

In the banking industry, approximately 35% of total deposits are 936 funds and the financial system as a whole, including broker-dealers and thrifts, intermediates approximately $10 billion from 936 companies. This produces, due to the operation of local financial regulations, $12 to $13 billion in economically-productive, employment-generating investments and loans. Additionally, 936 companies directly hold investments of approximately $5 billion, consisting of PR government securities, various forms of residential mortgage obligations and bonds of the Puerto Rico Industrial, Medical, Education and Environmental Control Financing Authority (AFICA) and of the Caribbean Industrial Financing Authority (CARIFA). That is $18 billion employed in productive investment

assets. These "936 funds", which have permitted the emergence of modern capital markets in Puerto Rico, have provided low-cost financing essential to Puerto Rico's development. The preservation of this source of funds is essential to preserve Puerto Rico's economic growth.

In fiscal year 1992, 936 companies paid an estimated $600 million in taxes to the Puerto Rican government and its municipalities in one form or another. This is more than half of total corporate tax payments. Unemployment is high, but without 936 companies it would be substantially higher. While total employment in the manufacturing sector has remained stable over the last ten years, over 20,000 jobs have been lost through plant closings while an almost equal number have been added through new openings thanks to the industrial incentives made possible by Section 936.

Section 936 has also helped to promote economic growth and stability throughout the Caribbean Basin. Direct investments under Puerto Rico's Twin Plant Program and lending for development-oriented projects have been possible thanks to an agreement between Puerto Rico and the Congress to put 936 to work in furtherance of our economic and political goals in the Caribbean.

In addressing the objectives of the Administration's program, the Treasury has recognized the importance of Section 936 and, on that basis, has proposed a wage-based limitation on the 936 credit. However, we must state that the wage credit proposal being advanced as a replacement for the 936 system is not by itself an adequate alternative. The wage credit alone is not a sufficient incentive to maintain the mix of high-technology and labor-intensive industries that we have in Puerto Rico today; a mix that is essential to our continued economic development.

High-technology industries have become key actors in Puerto Rico's economic development. In fact, the high-technology, capital-intensive industries have been responsible for most of the manufacturing employment created in Puerto Rico during the last two decades. In contrast, the labor-intensive manufacturing industries have been losing employment and have suffered a declining trend even under the current system of an income-based credit. In the ten years from 1982 to 1992, employment in high-technology 936 firms increased by 10,688, a rate of more than 1,000 jobs per year, while other industries lost 10,386 jobs during the same period.

Even with the proposed wage credit, Puerto Rico would still find it difficult to compete with production centers like Mexico, Ireland and Singapore in light, labor-intensive industries. On the other hand, high-technology manufacturing is not likely to benefit from a wage credit alone, since these industries are not highly sensitive to labor costs, being capital-intensive operations by their very nature. Therefore, an income-based credit is essential to the preservation of our industrial mix. The government of Puerto Rico has recognized the need to keep both elements in the 936 system.

High-technology manufacturing has given Puerto Rico the dynamic benefits that come from being at the forefront of new production systems and increasingly competitive products. In addition, it has stimulated and supported the development of world-class human resources in our economy by providing stable employment in high-quality and well-paid jobs. And while it doesn't

create as many direct jobs per million dollars of production as the labor-intensive industries, high-technology manufacturing has a high employment multiplier, precisely because it pays high salaries that support internal demand for all sorts of goods and services and the jobs that depend on that demand. We should not think of dismantling this high-technology sector that is so important to our present economic well being as well as to our future economic development.

This is not to say that we want to abandon the labor-intensive industries that still account for a substantial portion of total employment in Puerto Rico. What we do need is a mechanism to balance the continued development of high-technology industries with the necessary support and strengthening of more traditional manufacturing.

In view of the need to protect the benefits which the economic system based on Section 936 represents for Puerto Rico, we submit that any modifications considered necessary to the 936 system must adhere to certain parameters that are indispensable to ensure Puerto Rico's continuous economic development in harmony with the objectives and needs of the US economy. These parameters are the following:

- Puerto Rico must answer President Clinton's call to sacrifice in proportion to its capabilities as the lowest income and highest unemployment economy within the United States.

- Puerto Rico's economic model must be capable of fostering a favorable environment for creating jobs, generating income, enhancing the cross-linkages between all the sectors of the Puerto Rico economy and supplying funds for low-cost financing of public infrastructure and private productive activities.

- Modifications to improve the 936 system must provide for the continuous stability of Puerto Rico's investment climate and its attractiveness for future investment and job creation.

- Puerto Rico must retain the ability to attract high-technology industries while strengthening labor-intensive industries.

- Modifications to the current 936 system must be implemented on a gradual basis to give the economy time to readjust its basic underpinnings.

Thank you.

ATTACHMENT 1

ECONOMIC IMPACT ON SEVERAL SECTORS OF OUR ECONOMY

Following is a summary of the estimated effects of the proposed changes in Section 936 on each economic sector represented by the Coalition. We have not included in this summary the manufacturers' position, since they will testify separately from the Coalition owing to the direct impact that these proposals have on their operations. However, the Puerto Rico Manufacturers Association is one of the members of this Coalition.

FINANCIAL SECTOR

Should the financial system in Puerto Rico suffer a significant reduction in the 936 funds, it would face a severe liquidity problem. This, in turn, would have negative repercussions on the Puerto Rican economy, to the extent that the financial intermediaries would be forced to restrict credit to the employment-generating sectors of our economy and reduce their purchases of government bonds.

The reduced liquidity would impact the economy in two ways:

- a higher cost of funds as the 936 funds in the market are reduced; and
- a reduced availability of credit as the 936 funds are reduced and the condition of the economy deteriorates as a consequence of a gradual increase of the unemployment rate.

This liquidity crunch would affect the four main intermediaries of 936 funds in similar ways. However, owing to their particular business nature and capital structure, each of the major intermediaries would be affected to varying degrees, as explained below.

Commercial Banking Sector

Even though liquidity would suffer, commercial banks, in general terms, could replace the 936 funds from external sources, but at a higher cost and, in all probability, with reduced availability. This, in turn, would affect the availability of credit to most, or all of Puerto Rico's economic sectors and would raise the cost of credit to levels much higher than at present. On the other hand, commercial banks, particularly those with concentration on the retail, commercial and mortgage markets, would probably suffer a higher delinquency and foreclosure rate as the condition of the economy deteriorates. Needless to say, the internal generation of capital would be negatively affected as profits would most probably be reduced as a function of higher loan losses. This is also true of other financial intermediaries.

Savings Banks

Savings banks, by their corporate nature, are 936 companies. As such, they do not pay US taxes but pay taxes to the Puerto Rican government (18 million dollars in 1991). Any change to Section 936 would force them to pay an equal amount in federal taxes. They would claim a tax credit in Puerto Rico, thus reducing the tax revenues for the government of Puerto Rico.

Like the commercial banking sector, but with greater severity, the savings banks would suffer a serious liquidity limitation. Any reduction in the credit granted to the 936 companies would have an immediate effect on the investment income and, consequently, on the deposits intermediated through the financial system. The savings banks would be mostly affected due to the marginal nature of their operations in this market. Without this liquidity, the mortgage origination which has been their principal line of business would be reduced. This would have a very negative impact on the housing construction industry.

Like the commercial banking sector, but again, with greater severity, the quality of assets at savings banks and the availability of credit from these institutions to the Puerto Rican borrower would be affected by the overall deterioration of the local economy.

Securities Industry

Any reduction in the tax credit would negatively affect the 936 funds intermediated through the securities industry which amount to $2.5 billion. Here again, as the tax credit is reduced, these funds would be reduced substantially and, even in the event that the exemption on investment income would prevail, the reduction in the funds would make it academic. The ultimate impact would be in the reduced availability and higher cost of the capital needed to finance projects in Puerto Rico. These funds would have to be sought externally at a higher cost, assuming they were available.

During 1991 and 1992, 936 companies invested, through the securities industry institutions in Puerto Rico, $2.663 million in the following activities with maturities of five years or more:

Activities	Amount
Puerto Rico Government Bonds	$524 million
Mortgage Securities	$809 million
AFICA Bonds	$220 million
CARIFA	$517 million
Bank Securities	$443 million
Others	$150 million

Mortgage Banking

The financing of housing and commercial property would be directly affected with the reduced liquidity of the financial sector. Mortgage bankers account for 80% of the mortgages underwritten in Puerto Rico and most of them depend on the secondary market which is made possible by 936 funds. While these funds can be replaced by external sources, they would not be readily available and undoubtedly at a higher cost. This could mean that a good portion of the low income mortgage holders that qualify for loans underwritten today, probably would not qualify, due to a higher monthly payment.

On the other hand, federal agencies participate heavily in the Puerto Rican housing market either through direct loans, guarantees, or insurance underwriting. HUD, for one, has insured dwellings for $5.8 billion and the Veterans Administration has guaranteed mortgages for 1.2 billion dollars .

The majority of these loans are placed or sold in the secondary market through the use of Mortgage Backed Securities (MBO's) either through GNMA, if they are FHA or VA, or through FNMA or FreddieMac, if they are conventional conforming mortgages.

Non-conforming mortgages are placed in Collateralized Mortgage Obligations (CMO) which are sold to 936 companies. All of these investments would suffer as it is estimated that real estate values in Puerto Rico would be reduced by about 30% as a consequence of the recession that would follow the changes in Section 936.

HEALTH CARE INDUSTRY

For years, 936 companies have contributed significantly to the availability and quality of care in Puerto Rico. By providing one hundred and fifteen thousand

direct jobs, they also provide family health insurance to an equal number of families, covering a total of more than three hundred thousand people. These figures, important as they are, do not take into consideration the indirect jobs supported by the 936 companies which also generate health insurance coverage.

Any reduction in the jobs generated by 936 companies would then have an important impact on the quality of and access to health care. Some of these people would have to move to an already overburdened public health system which would be unable to accommodate them.

Access to health care would also be affected in the private sector which now depends, to a great extent, on health care plans. It is anticipated that some of these hospitals would be forced to reduce their services substantially or close down completely, particularly in those areas with a heavy 936 concentration. The effects trickle down to physicians offices, ambulatory care and other related health care services.

Consequently, the quality of care would also be negatively affected due to lesser technological advances, instrumentation, and the like, as income generation is reduced.

AGRICULTURE

The agricultural sector has been depressed in Puerto Rico for several years. However, since the advent of Section 936, and more recently, by the increased maturity of the investments made by these companies in our financial sector, credit has been more readily available to this important sector of our economy.

Agricultural lending is a required eligible activity to receive 936 funds (as per government Regulation 3582). This, not only has caused a more abundant availability of credit, but also a lower interest rate. The 936 funds has also stimulated new investment in the agricultural industry and the development of new projects.

This industry would be severely affected by a reduction in the pool of 936 funds that would send it back a number of years in its financial and productive capacity.

WHOLESALE AND RETAIL TRADE

The wholesale sector is mainly composed of distributors of US made and locally manufactured goods which depends on the economic well-being of our citizens. Here, again, financing is of outmost importance and the lower cost and better availability of credit afforded by 936 funds has allowed them to better finance their working capital and expansion needs.

The retail sector is mainly composed of individual proprietorships and small service organizations. It employs about 125,000 people which constitute a strong force in our economy and would suffer great hardship should the Puerto Rican economy experiment a setback. This sector lacks the capital necessary to finance its operations and expansions which has been supplied mainly by credit sourced by 936 funds. As a matter of fact, 65% of the commercial loans granted by the commercial banks in Puerto Rico are for amounts less than $25,000 and 90% are for amounts less than $100,000.

Finally, the municipal license tax that both wholesalers and retailers pay to the government, have been instrumental in the financing of government activities throughout the island.

CONSTRUCTION

Puerto Rico is in great need of developing a master plan for the rehabilitation and further construction of its infrastructure. The source of financing for these projects, which include water treatment, energy generation, improvements to transportation ways, ports and airports, relies heavily on the low cost financing made possible by the 936 funds. Needless to say, the development of this infrastructure is vital to our economic development.

Private construction, like new housing, commercial and industrial buildings, would be reduced substantially should these funds not be available as readily as they are now, or at the low interest rates which they now command. The construction industry has a labor force of approximately 40,000 people, and a high employment multiplier because of its very nature. 936 companies, with their constant expansion program, have provided stability to this industry in the last decade. As a matter of fact, the industry estimates that 50% of the architects and engineers licensed in Puerto Rico depend on the 936-related construction work. With the constant menaces to Section 936, however, this activity has slowed down considerably as of late. Finally, housing construction, which is so vital for a community with a population density of 1,000 per square mile, would be greatly hindered. Many of the low income families that now are able to finance their dwellings would be driven out of the market.

The comments above reflect the importance of the 936 system to some of the sectors of our economy which are represented in this Coalition.

ATTACHMENT 1

MEMBERS OF THE PUERTO RICO PRIVATE SECTOR 936 COALITION

AIESEC - Puerto Rico
Asociación de Agencias de Cobro de Puerto Rico
Asociación de Agricultores
Asociación de Bancos de Ahorro
Asociación de Comerciantes de Materiales de Construcción
Asociación de Comerciantes del Viejo San Juan
Asociación de Compañías de Seguros
Asociación de Constructores de Hogares de PR
Asociación de Contratistas Generales
Asociación de Distribuidores de Automóviles
Asociación de Industriales de Puerto Rico
Asociación de Navieros de Puerto Rico
Asociación de Radiodifusores de Puerto Rico
Asociación Médica de Puerto Rico
Asociación MIDA
Asociación Puertorriqueña de Agencias de Viajes
Asociación Puertorriqueña de Representantes de Fábrica

Cámara de Comerciantes Mayoristas
Cámara de Comercio de Ponce y Sur de Puerto Rico
Cámara de Comercio de Puerto Rico
Cámara de Comercio del Oeste de Puerto Rico
Cámara Oficial Española de Comercio
Centro Unido de Detallistas
Colegio de Arquitectos de Puerto Rico
Colegio de Contadores Públicos Autorizados de Puerto Rico
Colegio de Ingenieros y Agrimensores
Mortgage Bankers Association
Puerto Rico Bankers Association
Puerto Rico Hotel and Tourism Association
Sales & Marketing Executives
Securities Industry Association

ATTACHMENT 2

PUERTO RICO'S FAIR CONTRIBUTION TO THE PRESIDENT'S REVENUE PROGRAM

	PUERTO RICO	UNITED STATES	RATIO PR/US
GDP PER PERSON	9,528	23,200	41.1%
REVENUE-SHARING BURDEN (1994-97)			
TOTAL IN BILLION $	4.9	213.8	
PER PERSON IN $	1,374	834	164.7%
PUERTO RICO FAIR SHARE (1994-97)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
	343	1,221	
PUERTO RICO FAIR SHARE (1994-98)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
	428	1,526	

Memorandum Item: Puerto Rico 1992 population 3.565 million.

PUERTO RICO'S FAIR CONTRIBUTION TO THE PRESIDENT'S REVENUE PROGRAM

	PUERTO RICO	UNITED STATES	RATIO PR/US
GDP PER PERSON	9,528	23,200	41.1%
GNP PER PERSON	6,625	23,243	28.5%
PERSONAL INCOME PER PERSON	6,359	19,720	32.2%
REVENUE-SHARING BURDEN			
TOTAL IN BILLION $ (1994-97)	4.9	213.8	
PER PERSON IN $ (1994-97)	1,374	834	164.7%
PUERTO RICO FAIR SHARE (1994-97)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
GDP BASIS	343	1,221	
GNP BASIS	238	847	
PERSONAL INCOME BASIS	269	959	
PUERTO RICO FAIR SHARE (1994-98)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
GDP BASIS	428	1,526	
GNP BASIS	297	1,059	
PERSONAL INCOME BASIS	336	1,198	

Memorandum Item: Puerto Rico 1992 population 3.565 million.

PUERTO RICO AT A GLANCE

PERSONAL INCOME PER PERSON

UNITED STATES	$19,720
MISSISSIPPI	$13,328
PUERTO RICO	$6,359
RATIO PR/US	32.2%
RATIO PR/MISSISSIPPI	47.7%

UNEMPLOYMENT RATE*

UNITED STATES	7.0%
PUERTO RICO	18.0%

*March 1993

FAMILIES UNDER POVERTY LINE*

UNITED STATES	10.0%
PUERTO RICO	58.9%

*1990 Census of Population

PUERTO RICO AT A GLANCE

COMPOSITION OF GROSS DOMESTIC PRODUCT
1992

AGRICULTURE	1.4%
MANUFACTURING	39.0%
HIGH-TECH	28.5%
OTHER	10.5%
TOURISM	5.2%
TRADE AND SERVICES	38.3%
TRANSPORTATION & UTILITIES	8.4%
GOVERNMENT	11.0%
OTHER	7.7%

RATIO OF FIXED DOMESTIC INVESTMENT TO GDP
1992

CONSTRUCTION	8.1%
MACHINERY & EQUIPMENT	7.1%
TOTAL	15.2%

PUERTO RICO AT A GLANCE

EMPLOYMENT IMPACT OF SECTION 936

TOTAL EMPLOYMENT	925,000
MANUFACTURING EMPLOYMENT	155,000
SECTION 936 EMPLOYMENT	
DIRECT	115,000
INDIRECT AND INDUCED	98,900 TO 209,250*
TOTAL	213,900 TO 324,250*
RATIOS:	
DIRECT 936 EMPLOYMENT TO MANUFACTURING EMPLOYMENT	74.2%
TOTAL 936 EMPLOYMENT TO TOTAL PUERTO RICO EMPLOYMENT	23.1% TO 35.1%*

*Lower and upper bounds of estimates derived with different methodologies.

PUERTO RICO AT A GLANCE

LOCAL FISCAL IMPACT OF SECTION 936
Fiscal Year 1992

COMMONWEALTH NET RECURRENT REVENUES (MILLION $)	5,900
OF WHICH, INCOME TAX REVENUES	2,348
OF WHICH, CORPORATE INCOME TAX	1,033
OF WHICH, 936 CORPORATE TAXES	513 *
RATIOS:	
936 CORPORATE TAXES TO TOTAL INCOME TAX REVENUES	21.9%
936 CORPORATE TAXES TO TOTAL CORPORATE INCOME TAXES	49.7%

* Projection to 1992 based on 1989 data and trend growth rate. Includes income and tollgate taxes.

PUERTO RICO AT A GLANCE

INVESTMENTS FINANCED WITH 936 FUNDS
1992

TOTAL 936 FUNDS IN PUERTO RICO (In Billion $)	15.0
IN COMMERCIAL BANKS	6.1
IN FEDERAL SAVINGS BANKS	1.7
IN INVESTMENT BANKS	2.1
IN DIRECT INVESTMENTS	5.2
INVESTMENTS SUPPORTED BY 936 FUNDS	18.8
COMMERCIAL FINANCE	6.7
HOUSING FINANCE	4.8
PUBLIC SECTOR FINANCE	4.1
CBI-COUNTRIES FINANCE	1.1
OTHER INVESTMENTS	2.1

PREPARED STATEMENT OF LUIS P. COSTAS ELENA

I am Luis P. Costas Elena, General Counsel and Vice President of *Puerto Ricans in Civic Action—a civic, non-partisan, grassroots movement, in Puerto Rico. We, Puerto Ricans in Civic Action, wholeheartedly support President Clinton's Proposals for Public Investment and Deficit Reduction, especially the reform of I.R.C. Section 936 into a wage credit.* We also support Senator Pryor's Bill.

Puerto Rico should receive domestic solutions and programs, not tax gimmicks that can only produce resentment in the States, because of Runaway businesses. The March 1993 CBS segment by Dan Rather on 936 Runaway plants, the 1987 Kansas Business Review study, the Pulitzer Prize and 1992 best selling book "America: What Went Wrong?" exemplify the substantial harms caused by 936 against your constituents.

At the very least I.R.C. Section 936 should have a sunset provision and strict requirements for reauthorization. Immediate reform of 936 into a wage credit and sunsetting could provide $3 billion in additional funds for the U.S. budget, above and beyond what President Clinton has proposed, funds that could be used partially to finance the uncapping of Medicaid in Puerto Rico or any future substitute National Health Program that includes the island plus the fomenting in Puerto Rico of programs for education, jobs and infrastructure.

Marcus Aurelius in his *Meditations* has stated: "The Universe is change, life is opinion." And St. Augustine *On Free Choice of the Will* affirmed: "(Y)ou shall know the truth and the truth will make you free. " Accordingly, we have for many years been pointing out that the facts belie any need for gradualism in the reform of I.R.C. Sec. 936 and that *I.R.C. Section 936 is a scandalous, ever-increasing federal tax expenditure, which in effect is a wasteful, federal welfare program basically for pharmaceutical and other Fortune 500 corporations.*

You and I should wholly agree with Professor Stanley Surrey of the Harvard Law School, former Assistant Secretary for Tax Policy of the U.S. Treasury during the Kennedy Administration:

> "(A) tax incentive does involve the expenditure of government funds."
> *"A dollar is a dollar*—both for the person who receives it and the government that pays it, *whether the dollar comes with a tax credit label or a direct expenditure label."*
> "(A) resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities."
> *"(T)ax incentives do involve expenditures—'back-door expenditures' . . . and . . . a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door. "*

(Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harvard L. Rev. 705, 717, 721–722, 732 (1970).

The Congressional Budget Office has explained:

> "(A) tax expenditure is analagous to an entitlement program on the spending side of the budget; the amount expended is not subject to any legislated limit but is dependent solely upon taxpayer response to the particular provision. In this respect, tax expenditures closely resemble spending programs that have no ceiling." (Congressional Budget Office, Five-Year Budget Projections Fiscal Years 1978–1982, April 1977)

I.R.C. Section 936 is extremely perverse, expensive and a tremendous drain on the federal budget. The annual federal tax expenditures of I.R.C. Sec. 936 have increased to $2.8 billion in 1989 from the $80 million of antecedent I.R.C. Sec. 931 in 1972. The United States General Accounting Office has calculated that *from 1993 through 1997 the United States treasury will lose $15 billion ($15,000,000,000) because of I.R.C. Section 936.* According to the Puerto Rico Planning Board the estimated number of employees in the entire chemical and analogous products group in Puerto Rico (936 and non-936 corporations) which includes pharmaceuticals, was at most 22,600 for fiscal year 1991, including temporaries; and such employees are around 2% of the total number of employed persons (925,000) by major industrial sectors in Puerto Rico; yet pharmaceutical corporations pocketed 49% of the Section 936 tax expenditures in 1989 or $1.385 billion of the $2.82 billion in total Section 936 tax expenditures of 1989. In other words, Section 936 is the worst type of welfare, welfare for the extremely rich pharmaceutical corporations, (those that least need federal subsidies and that employ relatively few persons in Puerto Rico), in the

misguided and false expectation that some of those federal subsidies will indirectly to the average Puerto Rican trickle down.

I.R.C. Section 936 is a section of the federal, Internal Revenue Code that allows United States corporations, principally the "Fortune 500" to organize United States subsidiary corporations to do business basically in Puerto Rico. The "Fortune 500" parents then shift profits from their taxable operations in the United States or elsewhere to the Puerto Rican business (that receives Fomento tax exemption in Puerto Rico) and then retrieve those profits plus the tax free investment income generated by those profits almost completely free of both federal and Puerto Rican income taxation either via the 100% intercorporate dividend deduction or a tax free liquidation. The parent companies then commence again this circle of avoidance of federal income taxes by shifting other profit to the Puerto Rican operations. The I.R.C. Section 936 subsidiaries do not pay federal income taxes because they receive a federal income tax credit for taxes that they have never paid. The credit device spares—exempts—the profits covered by the credit from federal income taxation.

In 1991 Merck received $204,375 in federal tax expenditures of 936 per employee; American Home Products $105,600 per employee; Bristol-Myers Squibb $101,904 per employee; Upjohn $133,929 per employee. Obviously, said companies did not pay those amounts in salaries to each one of their employees and not all of those employees were even in Puerto Rico. Many employees were even temporary.

Because of I.R.C. Section 936 the people of Puerto Rico suffer the capping or restriction of five very important social programs: Supplemental Security Income, Aid to Families with Dependent Children, Nutrition Assistance, Medicaid, and Medicare Reimbursement. The federal government cannot uncap or unrestrict these programs in a time of budgetary constraints, when the federal treasury is already hemorrhaging at the rate of around $3 billion every year because of Section 936. Accordingly, the aged, the needy, the blind or otherwise disabled, the dependent children and the nurses, doctors and hospitals of Puerto Rico are sacrificed for the sake of Section 936.

Section 936, moreover, constitutes unfair competition against the States of the Union and injures the workingmen and workingwomen of each of the 50 States—your constituents—by subsidizing businesses that run away to Puerto Rico. As long ago as 1952 Senator Brewster, among other Congressmen, pointed out:

> "A basic fallacy in the whole Puerto Rican industrialization program is the fantastic cost per job. In other words, the program of luring business to Puerto Rico costs millions of dollars in United States taxpayers' money and produces relatively few jobs for Puerto Rican workers."

Worse still, Section 936 is a threat to democracy. Section 936 has created powerful, vested economic interests, ever vigilant and protective of their exemption privileges, in Puerto Rico—a small island of insufficient social and political resources to overcome such great concentrations of wealth. Those vested interests cry wolf at any attempted reform or reduction of 936 and consist of the exempt persons—especially the so-called Section 936 corporations; the professionals—lawyers, accountants, consultants and executives—that serve the privileged exempt persons; Fomento; financial intermediaries such as large banks or brokers; and diverse governmental personnel that seek or expect employment, political contributions or other rewards from said exempt persons, professionals or banks.

Although the supposed justification for Section 936 is the creation of jobs in Puerto Rico, Section 936 has never been tied to such jobs. Section 936 provides the federal subsidy and the exemption on the basis of profits, irrespective of the creation of any jobs or the payment of compensation.

Section 936 and its predecessors 931 and 252 have not reduced unemployment in Puerto Rico. In 1898 unemployment was at 17%, in 1940 at 15% and the latest figures from the Puerto Rico Planning Board report that unemployment still stands at around 17%.

Recently, the Puerto Rico Senate Labor, Veterans Affairs and Human Resources Committee has held hearings on the expected changes to Section 936, and much of the testimony therein, including that of the President of the Puerto Rico Government Development Bank, supports that Puerto Rico will not only not suffer from the proposed reforms but can expect economic progress from the totality of the President's proposals and programs. In fact, concerning 936 funds in Puerto Rico the said Puerto Rico Senate Committee has already concluded:

> "At December of 1992, 93.5% of the funds were invested for a period of 90 days or less. The deposits at 30 days generated a return of 2.6%, while the deposits at 5 or 6 years offered a return of 5%. This dramatic data for a date before President Clinton's proposals arose, reflect that *almost the total-*

ity of the 936 funds available at that date were not financing activities of economic development, but were dedicated to liquid instruments for the financing of activities at very short term." (Puerto Rico Senate Committee for Federal Affairs, Economic Development, Tourism, Commerce, Industrial Development and Cooperativism, Report of April 5, 1993, at 50.)

The aforegoing is further evidence of the conclusion reached by Nobel Prize winning economist James Tobin that the 936 corporations, and their antecedent 931 corporations, do not resemble manufacturing businesses, but are like cash rich, mutual funds.

To argue that Puerto Rico and the Puerto Ricans will be hurt by the reform of I.R.C. Sec. 936 into a wage credit is utter nonsense. Such reform for the first time will actually tie 936 to real jobs and compensation for Puerto Ricans. Moreover, most of the 936 companies under the President's proposals will remain untouched and the huge profits of the capital intensive pharmaceutical corporations certainly allow room for the proposed federal taxation of their profits. After all, why should a dollar of profit in Puerto Rico of an American company be taxed any less than a dollar of profit in any State of the Union? In fact, Professor Glen Jenkins, Director of the International Tax Program at Harvard Law School has already pointed out the falsity of the multipliers propagandized in defense of I.R.C. Sec. 936:

> "When estimating the opportunity cost per job of section 936, it is misleading to use employment multipliers. To the degree that such secondary effects are created by section 936 investments, these effects will also be present if alternative measures are taken to promote investment. Furthermore, the impact of section 936 industries on the Puerto Rican economy through their use of intermediate inputs is minimal because most of these items are imported. The increase in the demand for services in Puerto Rico as a result of the purchases made by employees of section 936 companies is also reduced because the companies are so capital intensive.
>
> "The magnitude of the multipliers is also questionable. With an employment multiplier of about 1.5 as is implied by these studies, for every public sector job created a further expansion of employment of 1.5 jobs would occur. Considering only the impact of the public sector and section 936 firms on the economy, such a multiplier would have resulted in the creation of more additional jobs than there are people available in the labor force on the Island. Given the Island's observed high unemployment rates, obviously, such an employment multiplier is not realistic.

The President's package needs and counts on the $7 billion or $8 billion that the reform of I.R.C. Section 936 produces for the budget, a budget that will provide good programs for the United States and Puerto Rico. The Congress can actually advance the President's package and programs by accelerating the reform of 936 and its sunset.

At present 936 does involve the expenditure of about $3 billion in federal funds each year but is an extremely irrational subsidy.

The time to change and reform is long overdue and is now.

Prepared Statement of Harvey Coustan

INTRODUCTION

Good morning. I am Harvey Coustan, Chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants. I am privileged to be here to represent our 310,000 members. The AICPA is the national, professional organization of CPAs of whom many (if not most) advise clients on tax matters and who prepare returns for millions of taxpayers.

We are not economists or politicians; our interests are sound tax policy and administration. Nonetheless, our members have a substantial interest in, and strongly support, President Clinton's stated goals of fostering public investment and achieving deficit reduction. We also urge, however, that tax policy objectives be accomplished, where possible, through simpler, more direct law changes. We thank the committee for the opportunity to offer our suggestions. Please note that our comments this morning are based on the Treasury Department February 25, 1993, release summarizing the Administration's revenue proposals, as supplemented by Treasury on April 8, 1993.

SIMPLIFICATION

The AICPA has, for some years now, been urging the need for simplification in our tax system. Year after year, statistics indicate that approximately one-half of individual taxpayers feel it necessary to hire a professional preparer to comply with their tax return obligations. Many of our members are beneficiaries of this fact; nonetheless, we are strong believers in the need for constant attention to simplicity as an important tenet of a tax system that aims for voluntary compliance.

We recognize that we live in a time of highly complex financial transactions, and that considerations of economics and equity are also critical. Thus, we understand that there will continue to be a need for complex tax provisions. However, Congress needs to consider carefully whether we are approaching a point of diminishing returns (no pun intended) concerning respect for the tax system and for voluntary compliance.

We would also suggest that, given the limited resources of the Internal Revenue Service to audit returns, the government's interests, as well as those of taxpayers, are served by less complexity. Document matching alone cannot replace this lack of other audit resources in a tax world as complex as ours. In short, complexity carries a real cost to the tax system through lower levels of compliance by taxpayers (inadvertent and illegal) combined with the inability of the government (through lack of resources) to provide adequate monitoring.

Complexity, and lowered respect for the system, also come from "back door" approaches to tax policy. We believe our government can, and should, be more open with the American people. For example, rather than imposing a 10 percent surtax on individual taxable incomes greater than $250,000, why not put a 40 percent (or 39.6 percent) bracket in section 1 of the Code? Instead of making permanent the personal exemption phaseout and the 3 percent limitation on itemized deductions, why not recognize that this is a back door marginal tax increase on individuals at particular levels of income, and translate that into a direct rate increase which would affect that approximate group?

It is our view that a simpler tax system is one that first defines the tax base more directly, and then raises revenue through adjustments of the rates—something political and other considerations seem not to have allowed in the past number of years. We believe that should change.

Investment Tax Credit. In this regard, with respect to the Administration's proposals, you need to consider the investment tax credit, both permanent and incremental. The complexities inherent in the proposal, especially the incremental credit, are such that a disproportionate amount of IRS resources will be required to ascertain that compliance levels are cortect—and for what, to a specific taxpayer, may well be a relatively modest benefit. Thus, our suggestion is that a direct, rather than an incremental credit, should be employed if possible.

Further, in addition to the major definitional and computational complexities, the proposal seems to promise more than it is likely to deliver—to most taxpayers. First, while the nominal rate is 7 percent, the only taxpayers who will receive that rate on qualified investment are "small" businesses investing in 10-year property (barges, tugs, fruit trees, limited other items). As a practical matter, the great bulk of purchased assets will fall in the 5-year or 7-year categories, which produce a lower ITC.

For the incremental credit, there is a further limitation, to 50 percent of qualified investment. Thus, the incremental ITC for larger businesses can never exceed 3.5 percent of qualified investment. The incremental credit is then scaled down to reflect whether property is less-than-10-year property. Finally, the amount of the credit is taken back into income (at taxpayer's highest bracket) ratably in 1995–7.

Consider the acquisition of a $10,000 asset with a 7-year life:

Nominal credit at 7%		$700
Limitation: 3.5% of investment ($10,000 x 50% x 7%)		$350
Less 20% for 7-year property		(70)
Maximum credit		$280
Additional tax payable in 1995–7 ($280 x 34%)	$95	.....
Discounted for later payment		(85)
Value of ITC		$195

Thus, a presumed 7 percent credit has worked its way down to an approximate 2 percent credit—and at a cost of tremendous complexity.

We also think it worth noting for this committee that, even on an incremental basis (and before any scaleback of the credit based upon cost recovery life), the higher the level of investment. the lower will be the effective rate of the ITC. In fact, once incremental investment reaches one-half of qualified investment, the effective rate of the credit begins to decrease from 7 percent trending toward 3.5 percent. Note the following examples, all of which assume a "best case" scenario in which property has a 10-year life—most property has a 5 or 7-year life which will make the tax results even less beneficial.

	A.	B.	C.	D.
1. Qualified investment	12,000	20,000	50,000	100,000
2. Fixed base (assumed)	10,000	10,000	10,000	10,000
3. Incremental investment	2,000	10,000	40,000	90,000
4. 50% limit on qualified investment	6,000	10,000	25,000	50,000
5. Credit (7% x lesser of lines 3 or 4)	140	700	1,750	3,500
Credit as percent of qualified investment	1.2	3.5	3.5	3.5
Credit as percent of incremental investment	7.0	7.0	4.4	3.9

We commented above that the ITC proposal seems to promise more than it is likely to deliver for many taxpayers. The above examples strengthen that conclusion.

We have several other thoughts on the ITC:

- We are pleased that there is at least a partial offset against the alternative minimum tax for the investment tax credit, since to deny that would merely be to take back with one hand what Congress has given with the other. We have not had the time to conclude, through research, that a reduction of tentative minimum tax by 25 percent (as proposed by the Administration) will give substantial relief from the AMT for investment in qualified property, but if subsequent investigation indicates significant problems in this area, we will supplement these comments.
- The credit is permitted on the amount of qualifying investment in excess of a determined "fixed base" for either 1989–91 or 1987–91. However, used property purchases in the base years would increase the amount of fixed base investment, while used property purchases in 1993 or 1994 would not qualify for the credit, which seems inconsistent. Using the same type of property to build the base but not be counted for current year acquisitions, simply reduces or eliminates a taxpayer's credit in two ways. We fail to understand why there is no parallelism in the treatment of used property.
- In our general ITC comments, above, we noted the scaleback of the credit due to its inclusion in income over the recapture period, for larger taxpayers. However, even for small businesses (perhaps, especially for small businesses), the complexity of basis adjustments to offset part of the ITC's cost to the government is unwarranted and should, if revenue considerations dictate, be replaced with a lower credit rate in the first place. One wonders why it is necessary to reinstate the rules requiring that the amount of the credit reduce depreciation basis for acquired assets, in the case of the small business credit. The result is the credit given in year one is taken back (in part) over later years, thus both reducing its effective benefit and adding further complexity to our tax laws. If a 7 percent credit is too expensive, why not make it a 6 percent credit but allow it to be reflected only once on the tax return.

MODIFIED SUBSTANTIAL UNDERSTATEMENT PENALTY

We are concerned with the two proposals which raise the standard for accuracy-related and preparer penalties, and modify the tax shelter rules for purposes of the substantial understatement penalty. This area of the law was amended a few years ago after a well thought out, collegial review of penalties by the Congress, Treasury, IRS, and professional organizations that took almost three years and concluded only in 1989.

Taxpayers should have the right to take a position on a tax return without risk of penalty provided that the position is not clearly wrong and the position is disclosed. If the law were black and white, without the uncertainties and gray areas that presently exist, our view on this might be different. However, given the fact that the law is subject to much interpretation, taxpayers should not be precluded from taking positions that they believe have merit. A stated reason for the change,

in the Treasury release, is that "Taxpayers and preparers should try to comply with the tax laws in a reasonable manner." Given the nature and state of tax law today, that is an alarmingly simplistic statement. Query—is it unreasonable for a taxpayer to take a position where the law is unclear if the position is fully disclosed; i.e., shouldn't the taxpayer have the right to "a day in court" without actually paying the tax and suing for a refund? Courts actually do decide cases in favor of taxpayers, and taxpayers should not have to face a choice of giving in to an IRS interpretation or going to court to avoid paying a penalty.

The proposal with respect to the tax shelter rules is to require a taxpayer to demonstrate that the reasonably anticipated tax benefits from the shelter do not significantly exceed the reasonably anticipated pre-tax economic profit in the shelter. This requirement would be in addition to the requirement that the tax shelter item has "substantial authority" and that the taxpayer believed that the claimed treatment was "more likely than not" the proper treatment. We are also opposed to this provision. From an economic perspective, an investor should consider the tax benefits in determining whether or not an investment makes economic sense and whether the investor will obtain an adequate return on the investment. However, the fact that the Internal Revenue Code contains certain tax incentives (provided by Congress) should not result in a penalty against a taxpayer who utilizes those incentives where he believes that a position with respect to the shelter is more likely than not the proper position.

INCREASE IN ESTATE AND TRUST TAX RATES

While we have deliberately stayed away from the debate as to the "right" top rates for individuals and corporations, the AICPA believes the Administration's proposed higher tax rates on estates and trusts are unfair. The proposals sharply reduce the current 15 percent tax bracket from taxable income of $3,750 to $1,500 and the top of the 28 percent tax bracket from $11,250 currently to $3,500. The next $2,000 of taxable income would be subject to the 31 percent tax rate and everything above that would be taxed at the new 36 percent rate. And, incomprehensibly, the new 39.6 percent surtax on "high income" taxpayers would apply to estates and trusts having taxable income in excess of only $7,500. Individual taxpayers will be subject to this new surtax generally only when their taxable income exceeds $250,000.

The high tax rates proposed for estates and trusts would generally force executors and trustees to distribute income to the beneficiaries, something that may not be desirable or even permitted under state estate administration law or allowed under the provisions of the trust instrument.

There will be only slight (if any) additional revenue from this proposal, as executors and trustees will generally decide to pay out the income to beneficiaries who will likely be taxed at lower rates (certainly with respect to the surtax). In fact, it is conceivable, even probable, that these proposed rates would actually decrease revenue since most individual beneficiaries would not be subject to the 36 percent tax bracket until their taxable income exceeds, for example, $115,000 (single) and $140,000 (joint return). And, as already noted, most individuals would not be subject to the 10 percent surtax until their taxable income exceeds $250,000.

The tax law should not set traps for the unwary 50 that an inexperienced executor or trustee erroneously retains income, with a heavy tax exacted. Existing trusts that require retention of income in certain circumstances, such as until a child reaches a certain age, should not be penalized by a change in the law that cannot be avoided. In cases where an executor or trustee has discretion to distribute income and believes that the estate or trust objectives would be better served by retaining income, the fiduciary should not have to decide between compromising on these objectives or paying higher taxes. It is wrong for our tax laws to impose taxes at a penalizing level where an executor or trustee is charged with a fiduciary responsibility and may well be sued for an income-retaining decision that costs substantially more tax or for an income-distributing decision that may not be consistent with the spirit of the will or trust instrument.

There is nothing sinister or subversive about estates and trusts. An estate is created when an individual dies. The executor merely steps into the shoes of the decedent and collects income and pays expenses until disposition of the assets and liabilities of the estate. Generally, decedents do not plan the times of their deaths, and an executor wants to wind up an estate as soon as possible but may not be able to do so for various reasons. There is no reason for a discriminatory tax in this situation.

Trusts are set up for a variety of purposes, many of which are socially desirable, such as care of surviving spouses, minors, orphans, incompetents, the elderly, and

the handicapped. Again, Congress and the Administration should consider the many worthwhile purposes served by trusts and reconsider levying a harsh income tax against them.

We urge you to adjust the proposed rates downward to the same level as the individual income tax rates, or at least to the current differential between the rates for individuals and those for estates and trusts. The current rates already weigh heavily in favor of distribution of income, and discourage accumulation sufficiently to force the executor or trustee to carefully consider their fiduciary responsibilities in relation to the additional taxes.

REDUCE DEDUCTIBLE PORTION OF BUSINESS MEALS AND ENTERTAINMENT TO 50 PERCENT: AND DISALLOW DEDUCTION FOR CLUB DUES

Businesses do not run on a 9 to 5 schedule. While eating is a necessity, and while business entertaining certainly contains an element of personal consumption (not always pleasure—how many business people would rather be spending an evening at home with the family rather than participating in a required function?) the arbitrary decision that 50 percent is the "correct" amount to attribute to business, rather than the 80 percent decided upon by Congress just seven years ago; or that no part of club dues arises from anything but pleasure, makes one wonder how these particular standards for ordinary and necessary business expenses are being developed. We just don't agree with the stated reasons for implementing these changes.

Actually, Congress has already considered the personal element of meals, entertainment, and club dues, and has put in stiff limitations on their deductibility. Section 274 requires a *direct* relationship to a taxpayer's business for these types of expenses to be deductible, and then only if certain hurdles are overcome with respect to percentage of business use, documentation, etc. If the message is that section 274 is too difficult to administer and an arbitrary disallowance rate (50 percent or 100 percent) is easier, we would then ask whether such an approach is "fair" (a number of the present proposals, including these, are presented in the name of fairness). Are these proposals even an approximation of "rough justice," a legislative concept we generally support? We doubt it. While we have no statistics, we believe that for every individual enjoying an expense account lunch which otherwise meets the standards of section 274, there is at least one other individual participating in a meeting with others in the office, eating a dry sandwich and drinking a soda, while lunch hour is ignored in favor of continuing to work.

We also question the seemingly broad application of the club dues provision. The deductibility rules under section 274 already require a more than 50 percent business purpose use test. Should a club meet that criteria, only that portion of the dues that is "directly related to the active conduct of such trade or business" is deductible. Since the parameters of appropriate business use have been established, the Administration's proposal should not be so overly broad as to deny legitimate business deductions. A luncheon club, for example, is likely to be used for bona fide business purposes over 90 percent of the time; yet dues would be 100 percent disallowed under the proposal.

DISALLOW MOVING DEDUCTIONS FOR MEALS AND REAL ESTATE EXPENSES

We do not support a change to the moving expense rules with respect to meals. The deduction for moving expenses was introduced into the law in 1964 (PL 88–272). At that time, the definition of moving expense included meals while traveling from the former residence to the new residence. Over the past 28 years, several changes to section 217 have been enacted, including an expansion of the deduction to include house hunting trips and temporary quarters. From its enactment and through changes to the law, Congress has consistently recognized that travel from the old to the new home, house hunting trips, and temporary lodging all require *extraordinary* costs to the taxpayer in the form of lodging, meals, and transportation. The administration states that "moving does not generally increase the cost of meals because the taxpayer would have eaten meals at either location." We believe that is an oversimplification: there is no comparing the cost of meals while traveling to the cost of eating at home. Congress has correctly realized, when enacting and expanding the moving expense deduction, that meals are an integral part, as well as an incremental part, of traveling expense and moving.

TARGETED SMALL BUSINESS CAPITAL GAINS PROPOSAL

As with the investment credit, the targeted nature of the capital gains incentive seems likely to add new layers of substantial complexity to the law. We have reservations about the definitional language in the Treasury summary, and may articulate them as details become available.

One point we would bring to your attention now is that this proposal applies only to C corporations. However, currently 40 percent of all filing corporations are S corporations, and S corporations clearly tend to be smaller businesses. We suggest the Administration's interest in helping small business is not aided by excluding the 40 percent of the corporations most likely to be small in the first place.

EFFECTIVE DATES

A number of proposals have retroactive effective dates that we fear will create an unnecessary administrative and compliance burden for the IRS, taxpayers and tax professionals. For example, the extension of the research and experimentation credit (and a number of the other so-called expired provisions) applies to expenditures paid or incurred after June 30, 1992. Implementing this provision retroactively will require many businesses that have paid or incurred such expenses after that date to file amended income tax returns, and the IRS to process numerous refund claims. This situation should cause you to ask yourselves whether the costs of compliance with a retroactive date are an appropriate trade-off for the benefits sought; and whether there is not a more reasonable alternative, such as requiring the taxpayer to claim the credit on a 1993 return rather than having to amend 1992.

ALLOCATE R&E EXPENSE TO PLACE OF PERFORMANCE AND TREAT ROYALTIES AS PASSIVE INCOME FOR PURPOSES OF FOREIGN TAX CREDIT LIMITATION

The first part of the proposal would allocate R&E expense to the place of performance of the associated R&E for foreign tax credit limitation purposes. Thus, domestic research expense need not be allocated against foreign source income. This provision makes sense in that it is logical and easier to administer. We generally support its adoption.

The second aspect of the proposal would treat all foreign source royalty income as income in the separate foreign tax credit limitation category for passive income, whether or not royalties are derived in the active conduct of a trade or business, and whether or not they are received from a related party. No transition rules have been announced.

The provision treating royalty income as passive will increase the tax burden borne by U.S. companies and make them less competitive abroad because most foreign competitors are in countries with an exemption system or a less complicated foreign tax credit system. This provision would discourage U.S. companies from exploiting the benefit of licensing technology where it is not commercially feasible to export goods.

We do not agree with the passive treatment of foreign royalties. We believe such treatment discourages the transfer of technology abroad. It discriminates against those who receive royalty income from abroad rather than sales income, and will make many U.S. companies less competitive abroad because of the inability to fully utilize foreign tax credits on all foreign income.

REQUIRE CURRENT TAXATION OF CERTAIN EARNINGS OF CONTROLLED FOREIGN CORPORATIONS

The proposal would require U.S. shareholders owning 10 percent of certain CFCs to include in income currently their pro rata share of a specified portion of the CFC's current and accumulated earnings. The proposal would apply to a CFC (including a CFC that is a PFIC) holding passive assets representing 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includable earnings") would be the lesser of (a) total current and accumulated earnings and profits, or (b) the amount by which the value of the CFC's passive assets exceeds 25 percent of the value of its total assets. Includable earnings would be adjusted to account for amounts previously taxed. For this purpose, passive assets would be defined as under the PFIC rules (including the definition of passive income thereunder.) This would be in addition to any passive *income* generated by the passive asset which would be taxed currently under subpart F, or other anti-deferral regimes.

Example: If a CFC had $100 value of assets, $30 of which was passive, its income inclusion as a result of the proposal—when fully implemented—would be $5 (assuming that at least $5 of current and accumulated earnings and profits were available), since $30 is $5 more than (25% x $100).

Multinationals from all countries seek to do business where labor and transportation costs are lowest. By increasing the tax cost of doing business abroad, this provision makes U.S. multinationals less competitive with respect to foreign counterparts. Moreover, the provision discourages passive investment of funds while business searches for the best use of those funds. The provision therefore may result

in hasty investments which will harm U.S. multinational competitiveness. This proposal is another "chip" at the deferral regime. As the deferral benefit gets smaller and smaller, U.S. competitiveness from operating abroad is reduced.

PROVISIONS NOT YET INCLUDED IN THE CLINTON TAX PROPOSALS

Individual and Unincorporated Business Estimated Taxes

The AICPA strongly supports S. 739, introduced on April 2 which would, once again, provide a rational framework to the individual estimated tax system (including unincorporated business income reported on a Form 1040). In 1991, the Emergency Unemployment Compensation Act amended tax law to remove the "Exception 1" safe harbor (no penalty for underestimating tax if current year's estimate at least equals prior year's tax) for 1040s with current AGI (1) greater than $75,000 and (2) over $40,000 higher than prior year. This group of taxpayers (which includes a substantial number of unincorporated businesses—proprietorships, partnerships and S corporations, reporting through their individual owners) must estimate based on 90 percent of current year tax. While the old Exception 1 rule continues to apply for the April 15 installment, affected taxpayers must shoot at a moving target for the June, September and January payments. Further, for business taxpayers (particularly general partners and more-than-10-percent S corporation shareholders), allocable taxable income of the passthrough entity must also be appropriately estimated. If one of those entities is on a fiscal year (for example, August 31), the entity would have only two weeks in which to determine its taxable income for the year and allocate it to its owners, so that they could make appropriate adjustments for their next (September 15 in the example) estimated tax payment. Even for a calendar year business, the individual owner must know allocated taxable income within 15 days after year end, to make a proper January 15 estimated tax payment.

The provision sunsets after 1996 (unless extended). Until then, a lot of relatively small unincorporated businesses and middle- and upper-income individuals are faced with great complexity and uncertainty in fulfilling estimated tax requirements. Many of them will have absolutely no way of knowing (until close to April 15) whether they have complied with their estimated tax obligations, will have to pay a penalty, or have substantially overestimated their taxes in an effort to avoid a penalty. Further, this 5-year provision was enacted, not out of any concern for estimated tax policy but to pay for a six-month extension in unemployment compensation benefits.

An attempt to "fix" the 1991 rules failed in 1992. The proposed change became an outright revenue raiser in last year's H.R. 11 (vetoed by President Bush), which would have raised the Exception 1 safe harbor to 120 percent for all individuals and unincorporated business subject to the individual estimated tax rules. The AICPA, which had been urging a change in the 1991 rule and which acknowledged that some taxpayers might have to be subject to a more-than-100 percent safe harbor, withdrew its support from the proposed change once it no longer represented the solution to a problem.

There is now a proposed solution: S. 739, recently introduced by Senator Dale Bumpers and co-sponsored by Senator Orrin Hatch of this committee. This bill would restore certainty to the system by reinstating an estimated tax safe harbor based on year's tax. The safe harbor, for most, would remain at 100%, but for higher-income unincorporated businesses and upper-income individuals it would be 110 percent of prior year tax. If current year AGI exceeds $150,000, and is greater than last year's AGI by over $40,000, then next year's safe harbor would be 110 percent of this year's tax.

The above description may well sound more complicated than the reality. Consider these examples, contrasting last year's H.R. 11 approach and the proposal in S. 739:

Year	H.R. 11	S. 739		
		Example 1	Example 2	Example 3
1993	$35,000 AGI	$35,000 AGI	$100,000 AGI	$150,000 AGI
1994	75,000 AGI	75,000 AGI	160,000 AGI	185,000 AGI
	120% safe harbor	100% safe harbor	100% safe harbor	100% safe harbor
1995		100% safe harbor	110% safe harbor	100% safe harbor

We believe this is a fair solution to a problem that has caused tremendous difficulty for many small, unincorporated businesses as well as for numerous upper-middle income individuals. We hope you will add S. 739 to your committee's bill.

Pension Simplification

We are pleased with the introduction of S. 762, the "Pension Simplification Act" on April 2, 1993. This legislation is designed not only to increase access to pension plans by workers, but also to simplify the rules governing the treatment of private pension plans. We believe the issues of access and simplification are closely related.

The complexity implicit in the rules governing the taxation of private retirement plans is now at a point where it is: (1) discouraging the establishment of new plans and encouraging termination of existing plans; (2) diverting money to plan administration and away from benefits; and (3) resulting in intentional and unintentional noncompliance with the law.

We believe that it is possible to substantially reduce the complexity of current law while still achieving virtually all of the policy objectives of current law. We propose that the appropriate test in analyzing a pension proposal from a simplification point of view is whether the incremental contribution to equity made by a rule outweighs the incremental contribution to complexity of the law.

Tax Simplification

We are pleased with continuing Congressional efforts on behalf of tax simplification as exemplified by the introduction of H.R. 13 earlier this year. We hope that package of general simplification measures, as well as the important intangible improvements, will be considered by the Senate and included in this year's major tax legislation.

Once again, we appreciate the opportunity to present our views here today and we stand ready to assist you in any way.

Additional Comments of the Tax Division of the American Institute of Certified Public Accountants

Deny Deduction for Executive Pay Over One Million Dollars

The Administration proposes to deny a deduction for certain executive compensation exceeding $1 million a year, except where compensation payments are linked to "productivity." We do not support this proposal for the following reasons.

Tax policy calls for businesses to be taxed on their net income as opposed to gross income. On this basis, corporations are allowed to deduct their ordinary and necessary business expenses. To establish an arbitrary limitation on such deductions is contrary to this policy. The amount of compensation paid to an executive is more appropriately a corporate governance issue to be addressed by shareholders and boards of directors at their discretion rather than through government mandated performance-based tests.

Under section 162(a)(1) and the associated regulations, deductions are allowed for reasonable salaries and other compensation paid for personal services actually rendered. The present proposal is also inconsistent with the ability of corporations and executives to negotiate an arm's-length reasonable compensation package to be deducted under existing laws because compensation in excess of one million dollars will be, by statute, nondeductible (unless the compensation is otherwise excludable from the provision). Further, the suggested approach strikes us as a first step down a slippery slope in an area that should be driven by the marketplace rather than the government.

Additionally, if this proposal becomes law, who will really pay for the change? In very few instances will it be the executive. "Sign-up" bonuses and the amount of compensation required to attract the level of qualified managers needed to deal with decision-making in a highly complex and competitive multi-national world will, absolutely, be dictated by market forces and not the tax law. Consequently, and most properly in our view, there will continue to be compensation packages negotiated which exceed $1 million a year, and where whatever productivity standards are legislated will not be met (thus making part of the compensation nondeductible). In those situations, the additional tax burden on the corporation will be reflected in lower earnings available to the shareholders, a lower valuation of net corporate assets, or higher prices to customers.

Finally, we believe administrability of this provision is likely to prove difficult, because of the inevitable subjectivity and ambiguity of many of the concepts contained in the proposal. In our view, the likelihood appears strong for both continuous difficult negotiations with examining IRS agents and for increased litigation. There-

fore, the $360 million in increased revenues from new Code section 162(m) projected over the next five years may pale into insignificance compared to governmental costs of IRS, Treasury, and the judiciary in regulating, examining, and trying cases in the area; not to mention private sector costs in complying with the new rules and planning to minimize their impact.

WAGE CAP FOR HEALTH INSURANCE TAX

Assuming that Medicare is intended to continue as a social insurance system, we oppose the elimination of the cap on the taxable portion of wages for the purpose of the HI payroll tax. Such restructuring of the tax is inconsistent with proper design of a social insurance financing mechanism.

Social insurance systems have obtained popular support because, by design, there is a relationship between contributions and benefits. For the OASDI portion of the social security system, the benefits explicitly depend on past wages. Individuals with higher lifetime wages receive higher benefits than those with lower wages, so it is appropriate that taxes are higher for the former group.

For the Medicare program, payroll tax financing is appropriate only because the program replaces benefits typically obtained through employment. The insurance value of the benefits does not depend on past wages, however—it is constant for all beneficiaries. Thus, it is a departure from a social insurance philosophy for contributions to vary substantially by lifetime wage level. However the cap on taxable wages serves to prevent gross disparities between the amount contributed and the amount of benefits which may be received under the program.

To remove the cap on HI taxable wages would make it clear that Medicare is not a social insurance program. Individuals with high earned incomes would have HI payroll tax liabilities amounting to many multiples of the insurance value of the benefits they could receive. Since these increased taxes produce no additional insurance benefits to the payers, Medicare will have been converted into a subsidy program—a significant turn away from its original purpose.

Finally, since this proposal is put forth as one to "Improve the Fairness of the Tax System," we would ask you to review the fairness of singling out wage earners and self-employed individuals for this increase, vis-a-vis those receive their incomes from investments rather than labor.

INCREASE RECOVERY PERIOD FOR DEPRECIATION OF NONRESIDENTIAL REAL PROPERTY

The provision would extend the recovery period for nonresidential real property to thirty-seven years because, according to the Treasury Department summary of the Administration's revenue proposals, current depreciation allowances "exceed the actual decline" in property value. We do not agree that this is an appropriate standard to be applied. Since adoption of the Accelerated Cost Recovery System (ACRS) in 1981, and continuing through today with the modified ACRS system, there has been relatively little attempt to equate tax depreciation lives with anything but an approximation of economic life, or with actual decline in value of the asset. It is unclear to us why it becomes necessary to start moving back toward an "actual decline in value" concept, and apply the change to only one class of assets.

If, however, Congress believes it important to lengthen the life of business realty, we believe you should consider the following. As the building life for tax depreciation approaches its economic life, tenants and landlords paying for leasehold improvements may become more disadvantaged. Tenants with short-term leases must depreciate improvements for which they pay over the statutory life (which would now be 37 years), even though a lease may be for only 10 or 15 years.

As to landlords, improvements are usually specialized to the particular tenant's needs and do not usually have much, if any, economic value at the conclusion of the lease period. As a result of this, landlords who are already disadvantaged by the present 31.5 year recovery period would be put at an even greater disadvantage as a result of the requirement to use a 37-year life for leasehold improvements.

For example, assume a landlord agrees to invest $370,000 for tenant improvements in order to entice a tenant to sign a ten-year lease. At the end of the lease term, the landlord would have depreciated 10/37 of the cost but is not entitled to write off the remaining $270,000 of cost even though it has little or no economic value. Such cost is capitalized as a part of the building cost and cannot be written off even if the associated assets are abandoned. If at that time the landlord must make the same arrangement in order to secure a new tenant ($370,000 of additional tenant improvements) he now has an undepreciated balance of $640,000 (the remaining $270,000 plus the new $370,000) for tenant improvements that are worth $370,000.

If the cost recovery period for business real estate is extended to 37 years, we believe Congress should legislate a separate, shorter, depreciation class for leasehold improvements and for other *known* shorter-life assets, which presently are keyed to the recovery period of the overall building.

ENHANCE EARNINGS STRIPPING AND OTHER ANTI-AVOIDANCE RULES

The proposal would treat any loan from an unrelated lender that is guaranteed by a related party as related party debt for purposes of the earnings stripping rules. Except as provided in regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures (on an unconditional or contingent basis) the payment of another's obligation. For purposes of determining whether the interest paid on the guaranteed debt is exempt from U.S. tax, the fact that the lender is subject to net basis U.S. taxation (as opposed to U.S. withholding tax) on its interest income would not be taken into account. This proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993.

Guarantees by a parent corporation of its subsidiaries' debt are commonly required by lenders and often have no connection with eroding the U.S. tax base. By presuming guarantees are abusive, the provision will discourage foreign investment in the U.S. and could result in a loss of U.S. jobs. Also, by considering all guarantees abusive, the proposal does not distinguish between the acceptable commercial uses of guarantees and abusive situations. Moreover, this provision may result in retaliation against U.S. companies operating abroad through foreign subsidiaries.

In addition, we are concerned with the summary of the proposal which states, " . . . the fact that the unrelated lender is subject to net basis United States taxation on its interest income would not be taken into account." This statement is so overly broad as to encompass domestic lenders (with no foreign activity) subject only to U.S. taxation.

EARNED INCOME TAX CREDIT

The Administration initiative in the February 25 Treasury Department release is entitled: "Expansion and Simplification of Earned Income Tax Credit." However, the description of the proposal (similarly detailed in the May 4, 1993 Joint Committee report) seems to focus on "expansion" of the credit.

We trust a substantial effort will be made in this proposal to simplify the credit as well. The credit is most important to low-income taxpayers, who often ignore or miscalculate it due to difficulty in understanding and applying it.

We would be pleased to assist any efforts to give this very difficult area a badly needed overhaul.

TAX COMPLEXITY INDEX

In our oral testimony on April 30, we referred to our new Tax Complexity Index and promised to include a copy with these comments. The Index and the press release describing it are attached as an appendix.

OTHER PROPOSALS CONGRESS MAY WISH TO INCLUDE IN THIS YEAR'S TAX PACKAGE

50 Percent Excise Tax on Pension Plan Reversions

IRC section 4980 imposes a 50 percent excise tax on reversions upon termination of defined benefit pension plans. If a replacement plan is established using 25 percent of the reversion or if benefits to employees are increased, the excise tax is 20 percent instead of 50 percent.

This 50 percent excise tax produces a harsh, unintended result in the case of a small business owner who terminates a defined benefit plan at the same time the business is terminated, for example, when the business owner retires, dies or becomes disabled. When the 50 percent excise tax is added to the regular federal and state income tax, the total tax associated with the reversion can exceed 90 percent.

This problem for small business owners could be solved by amending section 4980 to state that the 20 percent, rather than the 50 percent, excise tax will apply where the plan termination takes place as a result of (or within 60 days prior to) the cessation of the employer's business. This exception could be limited to employers with less than a specified number of employees or some other definition of small business.

Estimated Tax Rules for Corporations Which are Not Large Corporations

Under present law, corporations that have any prior year tax liability, regardless of the amount, either regular or alternative minimum, may utilize this liability as

a "safe harbor" for current year estimated tax payments. However, a corporation with a net operating loss must base its estimated tax payments on its current year taxable income. This requirement can create an unnecessary burden for many small businesses.

The AICPA endorses a change in the rules to allow a corporation that is not a "large corporation" to use the prior year safe harbor when the previous year's tax returns showed a zero tax liability and that taxable year was a taxable year of 12 months.

Subchapter S Improvement

Subchapter S is available only for certain corporations that can meet sharply defined requirements such as a maximum number of shareholders, a single class of stock, and certain types of shareholders. These strictures make Subchapter S more complicated to use, foreclose certain types of financing vehicles, necessitate unnecessarily complex corporate structures to manage liability concerns, and create a number of "traps" into which business owners can unwittingly fall with serious results. These problems reduce the utility of Subchapter S for small businesses.

The AICPA, together with the American Bar Association and the U.S. Chamber of Commerce, has developed a proposal consisting of 26 separate changes to Subchapter S. The proposals are designed to:

- Make small businesses in the form of S corporations more attractive investment vehicles for venture capitalists.
- Enable owners of S corporations to more easily plan for the succession of their businesses to younger generations of employees.
- Permit S corporations to separately incorporate different portions of their businesses to control liability exposure.
- Simplify Subchapter S to remove traps that cause small business owners to shy away from using the S corporation business form or cause unproductive tax planning to avoid jeopardizing the S election.
- Place S corporations on a par with other forms of doing business and S corporate owners on a par with small business owners using other business forms.

PREPARED STATEMENT OF J.D. FOSTER

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am Chief Economist and Director of the Tax Foundation. It is an honor for me to appear before the Committee today on behalf of the Tax Foundation to discuss President Clinton's proposals, particularly those to raise the personal and corporate income tax rates.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. We have approximately 600 contributors, consisting of large and small corporate and non-corporate businesses, charitable foundations, and individuals. Our business membership covers every region of the country and every industry category. The Tax Foundation does not lobby for specific tax legislation. Our appearance today before the Committee is intended solely to promote sound fiscal policy.

I would guess there is probably no Member in the Senate, with the possible exception of the President Pro Tem, who has a better appreciation of the lessons of history than the Chairman of this Committee. I think that is important, because the proposals to raise the income tax rates are not a sudden revelation. It is very easy to be caught up in the moment in this town -- to believe that each political battle is the first, or the biggest, or even the last of its kind.

This is not the first, and it won't be the last time we seriously consider changing income tax rates. To assess these proposals reasonably demands that they be placed in historical context. And in this case, the history is very recent, and much of it took place in this very room.

It is easy to debate the rights and wrongs in tax policy over the last fifteen years or so. But the one change about which, I think, there can be no debate is the tremendous progress that was made in reducing income tax rates on individuals and corporations. Beginning in 1981, whatever its other faults, we made great progress in the Economic Recovery and Tax Act (ERTA) in cutting rates; progress that was continued dramatically in 1986.

I would guess the speeches made in the Senate Finance Committee alone during this period could number in the hundreds, possibly the thousands. And each of the ideas and sentiments expressed in each of these speeches was echoed many times over on the Senate floor.

Nor was this an exercise isolated in the United States. Nations around the world, particularly our major competitors, followed the lead of the U.S. and reduced their tax rates, some more, some less, but virtually all in the same direction. There was even talk, if you may recall, of the U.S. reaping an unfair advantage because it was cutting its income tax rates. And there was talk of a new kind of trade war, in which rate cuts in one country forced rate cuts in other countries which forced rate cuts in still others.

Unlike most trade wars, however, which are primarily defensive in nature, protecting industries at home because they cannot compete for one reason or another, the trade war in competitive tax rate cuts was essentially offensive in nature -- if the U.S. cut its rates, its industries would become too competitive and they would flood foreign markets with their products.

While talk of tax-based trade wars was certainly overstated, it was exactly correct in principle.

The basic laws of economics governing how individuals respond to incentives have not been repealed. The reasons for keeping tax rates as low as practicable have not changed in seven years. I submit that what has changed is the focus of our attention.

Higher tax rates discourage all sorts of economic activities. They create a disincentive to work, for example. At first blush, it may seem hard to believe that higher tax rates, particularly on individuals with higher incomes, could affect their behavior. To such doubters I would point to the luxury tax on boats which apparently has done so much damage to the recreational boat industry. And I would point to the arguments for raising energy taxes on the basis that it would discourage energy consumption.

There is nothing so unique about boats and oil that tax disincentives work their magic on these goods and yet are ineffectual with respect to personal service income. The fact is, upper-income individuals are the most able to respond to changes in tax disincentives. These individuals face the most freedom of all of us in choosing to work an afternoon or to play golf.

It may be crass and perhaps not very humanistic, but the fact is an individual's economic contribution to society is, to a first approximation at least, fairly well measured by his income. With a struggling economy producing slow improvements in productivity, we have before us a proposal to increase income tax rates, to increase the disincentive to work facing the most productive individuals in the country.

I suspect the Members of this Committee have read or heard about the National Bureau of Economic Research (NBER) study done by Martin Feldstein and Daniel Feenberg where they found after running the President's income tax rate and Medicare tax increases through the NBER's TAXSIM model that personal tax receipts would rise by only about a fourth of the amounts predicted by the Treasury. The difference in the estimates is due solely, as I understand them, to the fact that the NBER model takes changes in individual behavior into account in a much more comprehensive fashion. The disincentive effect I described above is much of what the TAXSIM model is taking into account.

Let me talk about another disincentive that would increase if we increase tax rates, and that is the disincentive to save and invest. No one who has spent any time with the Senate Finance Committee can be unaware of well-placed concerns over our national saving rate. While economists may dicker about the proper measure, few question that our rate of saving is low and that raising that rate is vital to our prosperity.

The decision to save or consume income is one of opportunity costs. What will I receive tomorrow if I forego consumption today? As my after-tax returns on saving decline, I have less reason to forego consumption. A great many taxpayers, particularly low and middle income taxpayers, have only limited ability to save; their basic costs of daily living absorb most of their income. What group has the most discretion? Upper-income taxpayers. By raising tax rates on upper-income taxpayers, we would be discouraging those individuals who are most capable of making discretionary saving decisions, and who, in fact, do most of the saving at the individual level. Make no mistake -- private saving will decline if tax rates rise.

No one questions the need to raise our level of investment. More investment, properly made, means more jobs, more growth, higher incomes, higher productivity, etc. The only question is how

to go about raising investment levels. Higher income tax rates will substantially reduce investment in the United States unless offset by appropriate and substantial investment incentives.

Tax rates are not the only factor determining how and to what extent a tax system distorts the way resources are allocated in an economy. It is entirely possible to adjust the tax base to offset or magnify the effects of any proposed change in tax rates. This is a lesson we seem to have missed to some extent during debate on the 1986 Tax Reform Act, for example. While statutory tax rates came tumbling down, it is now widely accepted that effective tax rates on investment rose because of the extensive base-broadening.

I understand the need for a fair tax system. But fairness must be balanced with the need to promote economic growth, jobs, and higher productivity.

It has been a great pleasure for me to have this opportunity this morning. So, as you consider the balance between fairness and economic growth, let me repeat a little bit of country wisdom I learned when I was sitting in one of the chairs behind you: You have to grow an apple before you can cut it up.

Thank you, Mr. Chairman, and I would like to request that the balance of my testimony be placed in the record.

We really have one central economic problem in this country today -- one problem that either captures the effects of other problems, or is itself the cause of the other problems: Low productivity growth.

Whether your main concern is wage growth, job growth, international competitiveness, or the futures we leave to our children, it all boils down to increasing productivity.

Productivity, measured as output per hour of all persons in the nonfarm business sector, grew at about 2.4% between 1959 and 1969, slowed to 1.3% from 1969 to 1979, and slowed further to 0.8% between 1979 and 1989. This general pattern has been repeated in most of the major industrialized nations.

Some of the slow productivity growth is demographic in nature. As the baby boomers entered the work-force it shifted the balance of skills to relatively less-skilled workers. The same occurred as the percentage of women entering the labor force increased. New entrants typically have fewer skills, and lower productivity, than more experienced workers. Eventually this surge of less-skilled workers will produce a surge of highly-skilled, experienced workers and improvements in living standards should accelerate.

There are a host of other reasons for the slower productivity growth, however, which do not appear to be self-correcting, including

- the shift to more service-oriented industries,
- the high costs of government regulation,
- the increase in the size of government at all levels, draining resources from the private sector,
- the low national savings rate,
- the enormous time our businessmen and women spend defending themselves from frivolous lawsuits,

- and the time they spend trying to understand how the latest changes or interpretations of the tax code are going to affect their next investment.

We know that we need to raise our standard of living more rapidly in the next 20 years than in the past twenty years. The question we must ask ourselves at this juncture is: Does a deficit reduction program relying on very large tax increases, defense spending cuts, and a reshuffling of domestic spending programs offer any hope of addressing our productivity problems?

Sadly, it does not.

Tax policy is just one of many influences on our economy. Even a perfect tax policy on economic efficiency grounds will not guarantee prosperity if we make enough other mistakes, any more than an all-star short-stop can take a team to the World Series if the team has no pitching.

Nevertheless, tax policy can contribute to higher productivity growth in many ways, most of which can be summed up by simply getting out of the way. Tax policy can best contribute to higher productivity by getting the tax disincentives out of saving, investing, business formation, and risk taking.

Take saving, for example. Tax-based deficit reduction may increase total national saving by reducing government dissaving, but only if the taxes raised do not reduce private saving by more than the amount of deficit reduction.

While there is much we do not know about how the President's tax proposals will affect the economy, there are a few things we do know. First, we know the tax increases will slow the economy. The only offsetting effect, a possible slight reduction in interest rates, will almost certainly be swamped by the tax increases' disincentive effects. A slower economy means reducing the savings base, as well as the tax base.

We also know that most of the private saving in the U.S. is done by upper-income individuals and corporations. If you want to increase the rate of saving, you must either let those who are likely to save keep more of their money, or you must reduce the disincentive to save facing the rest of us.

Sadly, the Clinton program has passed-up the opportunity to encourage low- and middle-income Americans to increase their saving. There is not one provision in the President's plan to help these families increase their saving.

By raising tax rates on the rich and corporations, the President's plan has specifically targeted for higher taxes those people most likely to save. The Clinton program is likely to reduce both the rate of saving per dollar of income and the rate of economic expansion, thereby assuring a reduction in private saving which may exceed the amount of actual deficit reduction.

President Clinton's budget program, like its most immediate predecessor, the 1990 Budget Deal, will further slow productivity growth, not enhance it. It will slow saving, investment, business formation, and job growth.

While the process by which the budget is enacted may be much smoother in 1993, the fact is there are a great many similarities between President Clinton's program and the 1990 Budget Deal. Both featured enormous new taxes. Both reduced defense spending below baseline projections. The 1990 Budget Deal allowed total non-

defense spending to increase by nearly 29% in its first three years. President Clinton's program is better in this regard, it holds the rate of non-defense spending increases in the first three years to only 14%. Of course, this figure for the Clinton plan assumes all projected spending cuts are made and no new spending programs are enacted.

Perhaps the most disheartening similarity between President Clinton's program and the 1990 Budget Deal is that each will have a successor of like design and size. Mr. Chairman, just as sure as Winter follows Fall, two, maybe three years from now this committee will be holding this same hearing again, the words spoken today still echoing. As Yogi Berra said: It's deja vu all over again.

This is, in fact, the 7th such effort at tax-based deficit reduction since 1982. I have always believed in the expression: If at first you don't succeed, try, try again. But there comes a point where even the most committed, most tireless advocate must ask himself, what am I doing wrong?

President Clinton ran on the basic idea that it was time for a change. He titled his February booklet "A Vision for Change For America". In this case, at least, I wish he meant it. Because history shows clearly that the program before us does not represent change. It represents business-as-usual. And, as usual, it fails to address our basic economic problems -- saving, investment, higher productivity, better international competitiveness -- putting off for tomorrow what we should have done yesterday.

Deficit reduction is important for many reasons. As a matter of tax policy, the deficit has greatly hindered efforts to reform our tax system to prepare for the competition of the 1990s and the next century. Every attempt at reform either dies on the vine or is turned into an opportunity for raising taxes further. Chairman Rostenkowski has worked hard to make a number of reforms that would simplify the tax code. Each time, the deficit makes the climb that much steeper.

As a matter of fiscal policy, the deficit diminishes our prospects for long-term prosperity. In economic terms, the deficit is a bad. And, as Federal Reserve Chairman Greenspan recently told this Committee: Taxes are not a good in themselves. They are a bad.

Family Tax Burden

President Clinton has proposed tax increases that will significantly boost the tax burden of working, middle-income families. Even without taking into account this potential increased tax burden, Federal, state, and local taxes already represent the largest item in the typical American family's budget. In 1992, the average American family spent 39.7 percent of its budget on taxes -- more than on food, clothing, and housing combined. After discharging its tax burden and purchasing the necessities of life, the typical family had only 29 cents left out of each dollar to pay for such items as health care, transportation, and insurance, and to save for the future.

Notwithstanding significant Federal individual income tax reductions in 1981 and 1986, income tax relief for the typical family has been overwhelmed by the rising toll of Social Security taxes, Federal excise taxes, and state and local taxes. The bulk of the family's tax savings from income tax reductions in the 1980s were offset by the rapid growth in Social Security taxes. Since 1980, the Social Security tax has increased six times -- from 12.2 percent to 15.3 percent. Because of these tax increases, coupled

with annual increases in the Social Security wage base, the Social Security tax took $8,260 out of a typical family's income in 1992, half directly and half through the employer's share of the FICA tax.

Business taxes and numerous excise taxes on such items as gasoline, liquor, tobacco, and telephone use also take a significant portion of the family's earnings. Business taxes result in lower wages and salaries for workers, higher prices for the products and services they consume, or reduced returns on the family's savings and investments. The median-income family paid an estimated $1,702 in total indirect Federal taxes in 1992 -- or 3.15 percent of its income.

The growth in taxes levied by state and local governments has also accounted for part of the decline in the family's after-tax income. Since 1990, states have added an additional $42 billion in new taxes. Total state and local taxes, which claimed 8.9 percent of the family's total income in 1982, take 9.8 percent (or $5,282) of the typical family's earnings today.

Tax Fairness

President Clinton's economic plan contains a number of proposals intended to assure that higher-income individuals bear a heavier tax burden. The rationale for these proposals is that higher-income taxpayers do not currently pay their fair share of income taxes.

Several facts should be considered before concluding that the Federal income tax burden in the United States is not distributed fairly. For example, based on 1990 tax return data from the IRS, the top ten percent of income earners paid 53.9 percent of all Federal individual income taxes. In 1980, this group bore 48.6 percent of total individual income tax liability. The share of the tax burden borne by the top five percent of income earners grew by 17 percent over the past decade, from 36.4 percent in 1980 to 42.9 percent in 1990.

At the lower end of the spectrum, the bottom 50 percent of income earners saw their share of income taxes decline from 7.4 percent in 1980 to 6.2 percent in 1990. The average tax rate in 1990 ranged from 4.5 percent for the bottom 25 percent of income earners to 21.1 percent for the highest five percent of income earners.

What the numbers above demonstrate is that, notwithstanding arguments that the benefits of the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 went mostly to the wealthy, tax policies during the 1980s maintained the progressivity of the Federal income tax system, as higher-income individuals continued to pay an increasing share of taxes. Broadening the tax base, reducing tax rates, and encouraging upper-income taxpayers to leave their tax shelters raised their share of the total Federal tax burden -- just as predicted.

The personal income tax is, of course, not the only source of revenue to the Federal government. The Federal government also levies various excises which are generally regressive forms of tax. However, the importance of excise taxes as a group has declined steadily from 8.1% of Federal receipts in 1970, to 4.7% in 1980, to 4.2% in 1992. The Federal government also imposes a highly progressive gift and estate tax and a corporate income tax that is probably a progressive tax. No changes in either of these taxes have been enacted recently to change their contribution to the progressivity of the overall Federal tax system.

The final remaining significant source of revenue is the payroll tax. The payroll tax, however, is part of an inter-generational tax and transfer system -- in effect, a combination of a tax and a negative tax system. Thus, even though the tax is regressive, the overall program is highly progressive because the progressivity of the transfer, or negative tax, portion of the program is greater than the regressivity of the payroll tax.

Consequently, the overall Federal tax system is highly progressive, due largely to the progressivity of the individual income tax, and has become more progressive in recent years.

International Competitiveness

One of the principal tenets of the Tax Foundation is that the U.S. tax system should provide an environment in which U.S. businesses can compete successfully with businesses of other industrialized nations. The Tax Code should not impede the free flow of goods, services, and capital. Clearly, the United States has through its tax policy frequently placed its own multinational corporations at a disadvantage by imposing more severe restraints and heavier tax burdens on foreign-source income than have several of its trading partners. Moreover, the frequent changes in, and complexity of, the tax law can be a disadvantage to our multinationals because of the high cost of tax compliance and added uncertainty.

The BTU Tax and Corporate Rate Increase

Both the proposed corporate income tax rate increase and the BTU tax as it applies to businesses are direct assaults on our international competitiveness.

It is often claimed by advocates of these taxes that businesses will simply pass them along to their customers in the form of higher prices. These claims are dubious, at best. Whether the business is domestic or foreign, competition in the global marketplace is fierce and getting more so. The economies of our major international competitors are struggling and their companies are working hard to expand market share and profit margins, particularly on export sales.

If a U.S. company were to try to raise its prices to pass along a BTU tax, for example, it would very quickly lose market share to foreign companies happy to receive the windfall. Raising prices in this environment is simply not an option for most companies.

Nor can or will most businesses reduce their payments to the owners. A funny thing about business owners, if they have an alternative to reducing their own income they will usually take it. Business owners, in fact, often have two alternatives. They can reduce capital investment and they can reduce employment and wage growth. Neither of these results advance the goal of improving our international competitiveness.

International Provisions

Over the past several years, while expressing support for the integrity of legal foreign corporate entities, the U.S. has driven the tax code further and further into the foreign operations of its multinational businesses. This ongoing effort to bring more revenues into the net of current taxation and to restrict the usefulness of the foreign tax credit represents an incremental abandonment of the fundamental principle of international taxation: avoiding double taxation.

Uncertainty is the nemesis of investment. Investors, whether private or corporate, whether investing at home or abroad, take great pains to eliminate all unnecessary risks from their investments and to gauge the remaining risks accurately to ensure that the projected return is commensurate with the degree of the project's risk.

A significant disadvantage for U.S. multinational companies has been the instability of the U.S. international taxation system. Every year or two for the past twenty years, the system has been changed in some way or changes have been threatened.

This continuous change in the tax code confounds tax professionals trying to guide business planners through the tax code both because the existing tax code and regulations are poorly understood, and because future changes, presently unpredictable, can dramatically change the financial condition of a proposed investment.

Thus, not only are U.S. multinationals effectively subjected to heavier tax burdens on foreign income than many of their competitors, but their ability to do long-term business planning also has been hampered severely, thereby raising the uncertainty surrounding their investments.

In the end, many investments simply are not made, even though they would otherwise yield a satisfactory return, because they cannot produce enough income to cover all their costs plus the premium that must be charged to tax uncertainty.

There are several proposals in President Clinton's economic plan that would affect our system of international taxation. These proposals would affect the working capital exception for foreign oil and gas shipping income, transfer pricing, research and experimentation expenditures, royalty income, earnings stripping, and deferral of income.

The repeal of deferral of tax for so-called excessive accumulated foreign earnings could have a significant impact upon the international activities of U.S. multinational firms. Many companies utilize a foreign holding company as the base for their international operations. Under present law, active income earned abroad through a subsidiary generally is not taxed until it is repatriated.

President Clinton's proposal would tax a company on so-called excessive accumulations of capital regardless of dividend payments. The definition of excessive accumulated foreign earnings would be based on a percentage of assets calculation. If more than 25 percent of a controlled foreign corporation's total assets were passive, then the amount of excessive accumulated foreign earnings would be the lesser of the amount of current year and accumulated earnings or the passive assets over the threshold of 25 percent of total assets.

For example, if a company had $100 of assets, $45 of which represented passive assets, and $15 of accumulated earnings, the excessive accumulated earnings that would be subject to current taxation would be $15. This proposal would add an additional layer of complexity to an already extremely complex area of the tax law and reduce the ability of U.S. multinationals to compete abroad.

Under present law, royalty income can be placed into the active income basket if the royalties relate to an active trade or business. Another proposal in the Clinton program that would be disadvantageous to U.S. multinationals would place all royalty income in the passive income basket for purposes of the foreign tax credit computation. This proposal could significantly affect U.S. companies that are required to establish royalty agreements with their controlled foreign corporations, under Code Section 367, for the transfer of intangible assets. While these assets normally are used to generate active earnings, the royalty income would be classified as passive. The increased taxation of earnings from licensing would adversely affect the competitiveness of U.S. multinationals. It could also result in increased imports of technology and, thus, exports of associated jobs.

The enactment of these proposals most likely would result in the increase of the overall effective tax rate for U.S. multinationals at a time when most U.S. companies are already struggling to compete globally. Accordingly, any additional revenue generated for the Federal government through these provisions could well be offset by a loss of global revenues for U.S. companies.

In contrast to the proposals discussed above, President Clinton's proposal to allocate 100 percent of research and experimentation expenses to the place of performance of the research and experimentation would simplify current law significantly and would reduce the compliance costs associated with this constantly changing area of the law. As the Treasury Department points out, enactment of this proposal also likely would encourage firms to conduct research and experimentation in the United States.

One of the most pro-competitive actions the Congress could take would be to preserve the corporate income tax rates enacted by the Tax Reform Act of 1986. Since 1986, most of our trading partners have followed the lead of the United States and have reduced their own corporate tax rates. To raise U.S. rates now would increase the tax burden of U.S. exports and the tax advantage of imports.

Conclusion

The new Administration is to be complimented for quickly producing a plan to reduce the Federal budget deficit. The economy is growing albeit slowly, inflation is low, and the ongoing adjustments to the reductions in defense spending and the deep recessions in the economies of many of our major trading partners seem to be the only significant disruptions to the normal flow of economic activity. Therefore, any disruption to the economy from reducing the deficit, per se, is not likely to disrupt the economy sufficiently to cause a recession.

Whether deficit reduction ultimately serves to improve long-run economic performance or not depends entirely on how we proceed. Yet another major tax increase, with numerous specific tax proposals that will directly inhibit the forces that could otherwise lead to higher productivity growth and improved international competitiveness, will not advance the cause of prosperity in the United States.

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Thank your Mr. Chairman: I would like to begin my remarks by stating that I do not believe fast track procedures rob Congress of the power to "regulate commerce with foreign nations" as mandated by Article I in the constitution.

I have heard comments in this body and had an opponent of mine in the last election who has indicated that fast track authority relinquished to much of the Congress's authority to the executive branch. The fact of the matter is, Mr. Chairman, Congress's role is safeguarded by provisions embodied in the 1988 Omnibus Trade and Competitiveness Act.

Among them are the following:

1. Congress spells out in the act specific objectives that the President must fulfill when he negotiates trade agreements.
2. The President must obtain special permission from Congress to negotiate any non-GATT agreement, such as the planned U.S./Mexico FTA, even if Congress has already given the President general fast track authority.
3. The President must consult constantly with Congress during trade negotiations, or the House and Senate can rescind fast track authority by a majority vote under what is known as "reverse fast track."
4. Congress ensured a public debate of trade agreements by creating private sector advisory groups made up of representatives from labor, business, agriculture, and government that consult with the President and report to Congress on the economic effect of every trade agreement that the President will negotiate under fast track, and,
5. A simple rule change in either House of Congress can cancel the President's fast track authority before, during, or after he negotiates an agreement.

Mr. Chairman, fast track authority has worked well over the course of the last two decades. I believe it is imperative that we grant President Clinton an extension of fast track authority that is about to expire to complete the negotiations in the Uruguay round. In fact, the reality is that the U.S. cannot effectively promote free trade unless the President has the authority and the credibility he needs to negotiate trade agreements.

Mr. Chairman, our goal should be to retain U.S. leadership in the international economic arena. Whether it be in the GATT, the NAFTA, or a possible Chile FTA, the expiration of fast track means losing economic opportunities for this country. Opportunities to build a better life for all of our citizens do not come often. Shakespeare once wrote, "There is a tide in the affairs of men which, taken at the flood, leads on to fortune." We are riding such a tide, and in fact, it was President John Kennedy that said, "A rising tide lifts all boats."

We are riding such a tide today with both the Uruguay Round of GATT and the North American Free Trade Agreement. 1993 is an important year for international trade . . . . one that will test the cooperation of our trading partners and our executive and legislative branches of government at home.

Coming from a State like Iowa . . . where AG exports are so important . . . I know the potential that trade has to maintain a prosperous economy. our best opportunities will come from a comprehensive GATT round and the successful completion of the North America Free Trade Agreement. I will conclude by stating a significant element to this debate that should be of concern to all AG State senators. This element deals with a little known provision which protects farmers from undue trade risks. The provision states that certain agriculture spending reductions enacted in the FY 1990 budget will be nullified if the Uruguay Round Agreement is not in effect by June 30, 1993. However, this safeguard will be revoked if Congress does not permit the extension of "fast track." In other words, marketing loans for wheat and feed grains will not be triggered if fast track is denied.

Mr. Chairman, the President has asked for a "fast track extension" without any amendments. I believe this President, or for that matter any President in the future, should be granted the authority in the manner in which he requested it. I know there are several of our colleagues who plan to offer amendments, some of which I support and have co-sponsored, but I cannot support them being offered on the extension of the President's fast track request. I feel strongly that the potential of amendments to this extension may drown the extension request and deny the President the authority to pursue avenues of opportunity.

We are all aware that the world trading system today is vastly more complex than it was when the GATT was written in 1947. The negotiating agenda runs the gamut of U.S. interest, both in opening world markets and in establishing rules of fair play in areas vital to U.S. competitiveness. Yet, an open multilateral system is the best guarantee that U.S. export opportunities will continue to expand into the next cen-

tury and the Uruguay Round is one of the most important initiatives to expand these opportunities.

Thank you Mr. Chairman.

PREPARED STATEMENT OF JANE G. GRAVELLE

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss the President's investment tax credit proposals.

The President's proposal includes a temporary, incremental tax credit for equipment purchases of large businesses, and a permanent, non-incremental credit for small businesses (with gross sales of less than $5 million). The temporary credit expires after 1994.

Over the fiscal year period 1993–1998, the estimated cost of both credits is $28 billion, according to the Administration. The permanent credit for small business, while not separated out in the latest estimates, appears to be in excess of $2.5 billion a year. This small-firm credit is the single largest permanent subsidy for business provided in the tax package.

Like pre-existing investment credits (which were repealed as part of the 1986 Tax Reform Act), the credits would apply to tangible personal property. Examples include computers, cars, trucks, aircraft, furniture and fixtures, tractors, construction equipment, and machinery used in factories.

The large-firm credit is allowed for investment in equipment in excess of a base period, reflecting the historical experience of the firm. For 1993 (and including investment made after December 3, 1992), the base is 70 percent of average investment over 1989–1991 (or, if elected, average investment in 1987–1991), indexed for growth in Gross Domestic Product (GDP). For 1994, the base is 80 percent of these averages. The base must be a minimum of 50 percent of investment.

The credit is allowed at a 7 percent rate. The full rates apply, however, only to equipment that is depreciated over periods longer than seven years. One-third of the credit is allowed for equipment depreciated over three years, two-thirds is allowed for equipment depreciated over five years, and eighty percent is allowed for equipment depreciated over seven years. The amount of the investment that can be depreciated is reduced by the amount of the credit.

The credit for small firms is determined in the same fashion, except that no base is applied (the credit is not incremental) and the credit is made permanent in the third and following years at a lower, 5-percent, level.

The temporary, large-business credit must be viewed as a short-term stimulus program; the small-business credit is presumably related to long-term growth issues as well as current stimulus. One should not, perhaps, draw these distinctions too strongly, since temporary provisions, history teaches us, have a way of becoming permanent.

I would like to discuss the temporary, incremental credit and the permanent small-business credit in order.

TEMPORARY CREDIT

The implications of a temporary credit are quite different from those of a permanent one. Since a temporary credit does not change the relative attractiveness of purchasing equipment relative to purchasing other capital or hiring workers, increases in spending are likely to be borrowed from the future. The credit increases spending in the short run, but since there is no permanent effect, spending in the future tends to be reduced an equal amount.

A temporary incremental credit should have more effect on increasing spending per dollar of revenue loss than a regular credit. Given the slow recovery and continued gap between actual and potential GNP, there may be a case for such a fiscal stimulus, although some economists may feel that such a stimulus is not needed this late in the cycle.

Some reservations can, however, be voiced about the temporary credit. First, will it be successful in stimulating increased spending? Second, is the stimulus worth the administrative complications? Finally, what are the implications for fairness of large differentials in benefits across firms that will occur in part because of their past investment histories? Despite many attempts to study the influence of tax credits on spending, evidence that the investment tax credit operates effectively as an investment stimulus is hard to come by. Indeed, many studies fail to identify any

relationship between investment and the cost of capital.[1] Thus, the power of an investment credit to stimulate investment in the short run is subject to some question.

One of the reasons typically advanced for this weak short-run relationship between investment and the price of capital is the long planning lag that firms experience. Plans for capital expenditure programs tend to be made well in advance of purchases and may not be easy to alter.

Because of these planning lags, and because the credit would be retroactive to investments made after December 3, 1992, much of the credit would inevitably accrue to investments that would have been made in any case. To the extent that this effect occurs, the credit will act largely as a windfall, and will not provide the investment stimulus intended.

While the precise magnitude of the response to the temporary credit is not easy to determine, it will clearly be modest relative to a $6 trillion economy and will not appreciably affect the course of the business cycle.

The second reservation about the temporary incremental credit is the administrative complexity that will accompany the credit. The credit has all of the complications of a regular investment credit, plus additional complications brought about through the temporary and the incremental aspects of the provision.

Among the difficulties of the old investment credit was the defining of eligible assets. The distinction between structures and equipment turns out to be somewhat fluid, as illustrated by the interest that developed in previous years in substituting movable partitions (which could arguably be classified as furniture and fixtures) for walls. Also, equipment only qualified if placed into service in the United States, which required recapture rules for property that is first used in the United States and then moved abroad, as well as complex regulations to deal with transportation property that moves between the United States and other countries. There are also complications arising from the possibility of leasing property, since some firms do not have adequate tax liability to use the credit.

The credit was presumably made incremental in order to limit the revenue cost. Making the credit incremental greatly complicates the administration of the credit, however, because the base is defined with respect to the firm's past behavior. And, firms have an incentive to get around the base. The administration of an incremental credit, even a temporary one, thus leads to some serious problems. How should the base be established for new firms, or for those involved in merger or divestiture? Should the base be applied to a partnership or to each individual partner? Each approach has its difficulties. Or, to phrase this as a more general issue, how can the law deal with ownership of multiple businesses? The stakes over whether the lessee or lessor gets the credit become higher, since some firms won't qualify or fully qualify for the credit because their base is too high or because they fall under the alternative minimum tax.

During 1992, there was discussion of a permanent incremental investment tax credit. A permanent incremental credit is very difficult—perhaps even impossible—to design, and would have certain economic drawbacks, including a built-in tendency to exacerbate business cycles and increase industry concentration.[2] Making the credit temporary avoids these problems and lessens the general administrative problems associated with an incremental credit since firms have less of an incentive to try to manipulate the base if the credit is only temporary. At the same time, however, a temporary credit adds its own set of complications. In order to prevent firms from bunching investments, and then reducing them dramatically in the years immediately after the coverage of the credit, a recapture rule applies if investment falls below the base in 1995–1997. In addition, there is a tension between limiting the credit and allowing some benefit for investments that take a very long time to construct. The proposal would allow certain "progress payments" to be eligible, further complicating the computation of the credit.

A final issue is the differential impact of the credit on different firms. Of course, an equipment credit, by its very nature, favors those firms and industries that are intensive in equipment capital. And, any tax provision that is not refundable will not benefit firms with no current tax liability, although this effect is partially alleviated for some firms by carryforward provisions. In addition, firms that are subject

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[1] Most studies find negligible relationships between investment and the cost of capital. The most recent of these statistical studies is Peter K. Clark, Tax Incentives for Equipment Investment in the United States: Lessons from the Past and Considerations for the Future, Presented to the Brookings Panel on Economic Activity, April 1–2, 1993. The existing studies are reviewed in Tax Subsidies for Investment: Issues and Proposals, Congressional Research Service Report 92–205, by Jane G. Gravelle, February 21, 1992.

[2] These problems are discussed in Jane G. Gravelle, Incremental Investment Credits, Congressional Research Service Report 93–209 S, February 10, 1993.

to the alternative minimum tax or that are pushed into the alternative minimum tax as a result of the credit may be able to make less use of the credit.

The incremental credit feature adds another dimension to this differential treatment. Firms that had larger than average investment programs in the past will have a higher base, and therefore a smaller tax benefit. Some firms might have no benefit at all, if their previous capital expenditures were large relative to planned expenditures, while others whose prior investments were quite low will obtain large benefits. These differences can occur for firms that are generally very similar and that are competitors in a given industry.

While these differences may have little impact on behavior, the perceived fairness of the tax system is an issue which might be considered in designing and evaluating the desirability of the tax credit.

PERMANENT SUBSIDIES TO SMALL-BUSINESS EQUIPMENT INVESTMENT

In assessing the economic issues surrounding the permanent small-business tax credit, there are two issues that are both separate and related. The first issue is why a subsidy should be directed to equipment investment. The second is why an equipment credit should be targeted to small business.

Turning to the first issue: conventional analysis of capital income taxation usually suggests that providing subsidies for particular types of investment is inefficient. Economic analysis suggests that capital is allocated efficiently and the economy is most productive, absent some market failure or other existing distortion, if all capital income is taxed at the same rate.[3] The notion that tax neutrality across investments contributes to economic efficiency was a fundamental philosophy behind the design of the Tax Reform Act of 1986, which repealed the investment credit in favor of lower tax rates.

Current law tends to provide fairly even treatment across different kinds of business assets within a firm, although at current inflation rates, equipment tends to be already somewhat favored relative to other forms of business investments (in structures and inventories). Several arguments have been advanced, however, for providing a special subsidy to equipment investment. Some such arguments, such as those that equipment is more "productive" or more technically advanced do not stand up well to economic scrutiny on conceptual grounds.[4]

In general, in order to make the case on economic efficiency grounds that a certain type of investment should be subsidized, one needs to identify some additional benefit to society from that investment. There are cases where this spillover effect undoubtedly occurs, as in the case of investments in certain types of research and development.

One recent claim that has attracted some attention is the argument that equipment investment contributes especially to economic growth. This argument does not propose a precise type of benefit, but is largely based on a statistical study across countries that showed a strong positive relationship between investment in equipment and growth rates.[5] This relationship was found to be true when all countries were combined, and was especially pronounced with a sub-category of "high-productivity" countries. After finding this statistical relationship, the authors subsequently argued that there were spillover effects from investment in equipment, particularly with investment that is technically advanced.

While such research is intriguing, experience suggests that one should be cautious about new statistical findings until they have been subject to scrutiny by others and replicated. The statistical relationship found, in particular, appeared to be heavily influenced by behavior of only a few countries. A recent study, using the same data, found, in fact, that the relationship disappeared when the "high-productivity" countries were restricted to OECD countries.[6] Moreover, the relationship among the non-OECD countries became statistically insignificant if one country, Botswana, was eliminated from the sample.

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[3] "Market failure" is a term of art that refers to the violation of competitive market conditions, and usually refers the failure of prices to reflect true economic costs.

[4] For example, although a new generation of equipment might be more efficient than existing capital, new technology does not mean that the existing capital stock should be discarded. Rather, it is efficient to replace older capital only if such a replacement will increase profitability. These economic decisions are made efficiently only if the return to this investment ia taxed at the same rate at other investments.

[5] See J. Bradford DeLong and Lawrence Summers, Equipment Investment and Economic Growth, Quarterly Journal of Economica, v. 106, May 1991, pp. 445–502.

[6] Alan J. Auerbach, Kevin Hassett, and Stephen D. Oliner, Reassessing the Social Returns to Equipment Investment, Board of Governors of the Federal Reserve Working Paper 129, December 1992.

Another argument that has been made in favor of an investment credit is that it benefits new investment and not the returns to existing capital, and is thus more likely to increase overall investment and savings. Note that this argument does not constitute an argument for favoring equipment, per se. More importantly, there is little evidence that private savings rates are affected by changes in taxes; the revenue devoted to subsidizing investment would probably be more likely to contribute to savings if used to reduce the deficit.

The second issue is why such a subsidy should be directed to small businesses. Small-business credits would certainly not be consistent with the argument of favoring "high tech" investment. Small-business credits tend to be concentrated in industries that don't use such investment—only 5 percent of the credits would go to manufacturing; over 60 percent would go to trade and services.[7]

Moreover, small businesses, which are largely unincorporated, are generally subject to lower taxes than are large businesses that operate in corporate form, and the credit will simply increase an existing favorable treatment. The most heavily taxed capital investment in the United States is investment in corporate equity.

In his address to the Congress on the economic program (February 17), the President indicated that small business was targeted because it had created such a high percentage of new jobs.

The perception that small businesses create most of the new jobs dates from a study done in 1981 that claimed that firms with less than 100 employees, which represented about 35 percent of the labor force, created 8 out of 10 jobs over the period 1969–1976.[8] But subsequent analysis of that issue (reviewed in Brown, Hamilton, and Medoff) found this number to be incorrect and more on the order of 50 percent.[9]

Brown and his co-authors also had some other interesting insights into the figures on job creation by small firms. Although the data suggest that small businesses in general created new jobs in excess of their share of the labor force, there were two important qualifications to this observation. First, part of the growth reflected the fact that industries that tended to be dominated by small firms had been growing. The increased jobs by new firms may not have been so much because small firms were doing better than larger ones, but rather because the industries in which small firms operated were growing, perhaps for unrelated reasons.

Secondly, these authors point out that most of the jobs were created by new firms, which tend, of course, to be small. (Firms are not usually "born" large.) The data reflect a blending of old and new small firms. According to Brown, et al., the majority of these jobs will not persist because many new firms will fail—from 60 to 80 percent of new firms fail within the first few years.

On the whole, Brown and his colleagues suggest that there is little evidence that small firms disproportionately create jobs, especially if one is concerned with permanent jobs. They also point out that jobs in small firms tend to pay lower wages, have fewer fringe benefits, have poorer working conditions, and tend to be less secure than jobs in larger firms.

In addition to the question of the factual basis for the job creation argument, two important points should be made about this argument.

First, if increasing the number of jobs created by small firms were the objective of the investment credit, the subsidy is questionable. It subsidizes not wages, but rather a competing factor—investment in equipment. It favors those firms that are capital intensive. Such a subsidy might even *reduce* employment in small businesses because it encourages the substitution of capital for labor.

More importantly, however, if more job growth has, in fact, accrued to small firms, this does not necessarily mean that subsidizing them will create more new jobs or even that such firms are more productive in some way than large firms. Economic theory suggests that there is no reason to view job creation as a long-run objective of government policies. The economy generates jobs by the natural process of growth and market adjustment. In 1961 and in 1991 the unemployment rate was the same—6.7 percent. Employment, however, rose from 66 million to 117 million. Employment tends to grow steadily; the unemployment rate fluctuates. Federal policies may, of course, be needed to smooth out short term cycles, but even in these

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[7] These calculations are presented in Jane G. Gravelle, Small Business Tax Subsidy Proposals, Congressional Research Service Report 93–316, March 15, 1993.

[8] David Birch, Who Creates Jobs? Public Interest, V. 65, Fall 1981, pp. 3–14.

[9] This and the following discussion is based on Charles Brown, James Hamilton, and James Medoff, Employers Large and Small, Cambridge: Harvard University Press, 1990.

cases it is generally the aggregate stance of fiscal policy that affects employment, and not a specific program.[10]

In sum, the validity of the job creation argument for the small-business investment credit can be questioned on three grounds: the factual basis of the argument, the association between the form of the incentive and its effect on employment, and the general use of the job creation justification for such a government program.

Some distributional issues might be raised. Despite our image of small businesses as struggling "Mom and Pop" enterprises, as a statistical average owners of small businesses are much wealthier and have higher incomes that most Americans. Owners of small businesses, according to Brown, Hamilton, and Medoff, have five times the wealth and almost twice the income of the average American.

Indeed, the smallest of small businesses will not benefit from the investment credit because current law enables them to expense up to $10,000 in equipment investment; such investment will not be eligible for the credit because it is already subject to an effective zero tax rate. The corner grocery or corner gas station is not likely to receive much, if any, benefit from the proposal.

This discussion is not meant to imply that there may not be legitimate concerns about small businesses and their role in the economy. For example, there are arguments that small businesses, and particularly new businesses, might not have appropriate access to credit markets. Providing a tax subsidy is unlikely to address this issue, however, since new businesses so frequently experience losses in their initial years and cannot use tax benefits. And, if this problem exists, there is no reason to expect that it would be confined to firms that invest largely in equipment.

Small businesses may also experience a particular burden in coping with paperwork and regulatory requirements. An investment credit is not likely to relieve that burden; indeed, it would complicate compliance with the tax law.

There are two final observations that might be made about the small-business credit. The first is that, as currently designed, there is a notch problem, since firms lose all credits when their receipts rise above the dollar limit, which will discourage growth beyond this point.

Second, there are also some administrative issues that might need attention. The small-business credit does not suffer from the problems associated with being temporary or incremental, although many generic complications of the investment credit remain.

Whenever a tax provision for business is limited by size, however, it tends to create some administrative problems. One such problem is the treatment of multiple ownership of firms. If an individual or firm can split up business interests among different entities (partnerships or corporations) then he could qualify for the small business benefit. Such qualification might also be obtained by setting up leasing firms. To prevent these types of tax sheltering activities, it is necessary to set up a series of attribution and tracing rules that will place a burden on the Internal Revenue Service, and which are unlikely to work perfectly. These provisions are particularly difficult when considering minority interests in partnerships and corporations.

Another problem associated with the investment credit, which is based on size of receipts, is that taxpayers will have an incentive to arrange the timing of receipts and investments in order to qualify. For example, a firm would try to arrange to have large purchases occur in years when receipts are lower, or to delay or speed up receipts when a large purchase is planned.

PREPARED STATEMENT OF CONGRESSMAN LUIS V. GUTIERREZ

Mister Chairman; Members of the Senate Finance Committee: Thank you for this opportunity to testify before you today.

I come before you as the Congressman of a heavily Puerto Rican district in Chicago, and as a Puerto Rican myself.

Since the beginning of the current "Hurricane 936," I have urged all interested parties in Puerto Rico to unite and speak with a single voice. I have refrained from commenting specifically on any of the different counter-proposals that have come out of Puerto Rico to President Clinton's proposals to eliminate Section 936.

I have studied, and will study all such proposals, and, as much as possible in consultation with the Governor of Puerto Rico, and with other Puerto Rican leadership,

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[10] These issues are discussed in more detail in Jane G. Gravelle, Donald W. Kiefer, and Dennis Zimmerman, Is Job Creation a Meaningful Policy Justification? Congressional Research Service Report 92–697 E, September 8, 1992. This study also suggests that the government might wish to intervene to help disadvantaged workers.

I will in the end, support that proposal or set of proposals which help Puerto Rico the most.

I know Governor Rosello has been working hard to develop such a proposal. So have other Puerto Rican leaders. I look forward, as I know you do also, to hear from them, and to be able to study their proposals.

I would like, however, to comment on some general principles that, in my opinion, should be considered seriously during this discussion.

Puerto Rico is a United States' "possession." Technically, Puerto Rico is an "unincorporated United States' territory." In reality, this means Puerto Rico is a colony of the United States.

Since Congress assumed sovereignty over the island and its inhabitants, Congress has controlled the economy of Puerto Rico. Every single important aspect of the economy, from minimum-wage laws, to foreign trade, to the extension of coastwise shipping laws to Puerto Rico; currency, immigration, they are all under the jurisdiction of Congress. The application of Section 936 to Puerto Rico is but another example of this.

It is my view that the Puerto Rican people have a right to self-determination. We, as a people have yet to exercise this inalienable right.

Perhaps the best example of the need for Puerto Rico to have self-determination is the current debate over Section 936.

Lacking from the official discussion of this issue is consideration of the Puerto Rican point of view: What impact will it have on the island economy, and, more importantly, on the future of Puerto Ricans. Did anyone consider the impact something of this magnitude will have on the lives of six million Puerto Ricans, both in the island and on every single Puerto Rican Community on the mainland, including my own in Chicago? The elimination, or substantial modification of Section 936, without an adequate substitute, or safeguards will result, no doubt, in an unprecedented economic crisis in the island, greatly increased unemployment, and heavy migration to our already overburdened cities, and communities on the mainland.

To be sure, Mr. Chairman, much may be said, and much has been said, in criticism of the way the Puerto Rican economy operates under Section 936. As you may know, Mr. Chairman, I favor Independence for Puerto Rico. And, while I agree there is much to be improved with Section 936, as it relates to the environment, to labor relations, to the use of Section 936 bank deposits, to the lack of involvement of Section 936 companies with the development of Puerto Rican communities on the mainland, and other aspects of the section, and, while not only the demise of the Section, but the way this whole affair has been handled may seem on the surface to be good for the cause of Independence; the truth is that it would be totally irresponsible for anyone to advance a cause, be it independence, commonwealth or statehood at the cost of the livelihood of tens of thousands of Puerto Rican workers and their families.

The way the current debate is unfolding is unfortunate. If there are concerns about the pharmaceutical companies, and the prices they charge for medicines, let us deal with that issue, as such. If there are problems with the so-called "runaway plants," let us deal with that issue, as such. If some companies may be abusing Section 936 by transferring, and therefore sheltering profits from continental operations which should otherwise be federally taxable, let us then work to close such loopholes.

But what I strongly object to, respectfully, Mr. Chairman, is to proceed in such a fashion as to drastically alter the current basis of the Puerto Rican economy without considering the impact this will have, not only on the economy of the island, and subsequently, on districts like mine, but just as importantly, the impact this would have on the whole status question debate on the island. And this, Mr. Chairman, would be done, really in the absence of meaningful participation by the people of Puerto Rico in the process.

Mr. Chairman, Puerto Rico is not a state of the union. Puerto Rico does not have voting representation in Congress. The only participation Puerto Ricans had in the Vietnam War situation, for example, which started our big deficit problem, was to have our young men die on the battlefield in disproportionate numbers.

Puerto Ricans did not vote to elect the President, nor the Congress which ran the huge bills for that war, and for many other matters. Puerto Rico has always received a fraction of the Federal funds it would receive if it were a state. Our Vietnam veterans, and this is a shame, do not receive in Puerto Rico, the same benefits veterans receive on the mainland.

Puerto Rican communities on the mainland, Mr. Chairman, and I know you have studied this in depth, are some of the poorest in the country.

So, I respectfully ask, how come Puerto Ricans who benefited the least from the "Spending Bonanza" that led to our huge deficit, who were not represented on the

decision-making bodies that created the deficit, who have a per-capita income of about half that of Mississippi, and a third of the national average, who last year received about half of federal outlays per person than that of the national average, and who suffer from at least twice the national unemployment rate, how, Mr. Chairman, is the economy of Puerto Rico expected to contribute more than twice per inhabitant to the President's deficit reduction initiative than those of us on the mainland are being asked to do? If you consider all of the factors cited above, you are asking the fragile Puerto Rican economy to contribute at least 12 times as much per person to the reduction of the deficit than what is being asked of the United States economy as a whole.

Mr. Chairman, I wholeheartedly agree with the March 24 *Washington Post* editorial that there is no "Puerto Rican Policy" behind this proposal to eliminate Section 936. In fact, Mr. Chairman, I am informed there is currently, not even a presidential advisor on Puerto Rican matters in the White House.

Mr. Chairman, I respectfully submit to you, and to this committee that to continue down this path will prove to be disastrous both for Puerto Rico and the United States. I, again respectfully, submit to you that the time has come to review indepth and comprehensively the relationship between the United States and Puerto Rico and to proceed decisively and constructively along a dignified path of self-determination for the people of Puerto Rico. For only in such a context does it make sense to study any proposal to significantly alter the very basis Congress itself laid out for the current economy of Puerto Rico to grow and develop. I can't think of a better investment of our taxpayer dollars than to provide for the healthy economic development of the island of Puerto Rico, regardless of the final outcome of the status question in Puerto Rico.

In closing, Mr. Chairman, I can assure you not only of my support for the President's overall plan for deficit reduction, but also, that of all Puerto Ricans. Let us, however, remain cognizant about the history and reality of Puerto Rico and Puerto Ricans so as not to create a worse problem than that we are trying to address.

Thank you.

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Thank you, Mr. Chairman. As we begin to move along speedily in examining the President's tax provisions, I am pleased that we are paying special attention to those that affect multinational corporations.

I agree with the President that we need to promote economic growth and create jobs for Americans. It is ironic, though, that the Administration is seeking to drastically cut back a provision that promotes those very objectives—the Section 936 credit. I believe that there are three basic concerns that need to be examined regarding this proposal. First, we must consider the impact of the cutback of Section 936 on Puerto Rico's economy.

I remember your outstanding support, Mr. Chairman, last year when we debated an amendment limiting the Section 936 credit for the pharmaceutical industry. At that time you provided us with an eloquent reminder that the 936 credit is essential to Puerto Rico's continued economic growth and development.

Second, we need to examine what will happen to U.S. companies currently operating in Puerto Rico. Do we want to force these businesses to relocate or expand into foreign countries because we have driven up the relative cost of doing business in Puerto Rico?

Finally, we must ask why this proposal is being advanced. Is it simply another way to raise revenue, or a penalty of the perceived abuse by one of the last healthy industries in our country?

Mr. Chairman, I have serious concerns about making any changes in this tax provision. I am particularly interested to hear what those who represent the people of Puerto Rico have to say about the impact of the proposal.

The area of taxation of multinational corporations is one fraught with complexities and misconceptions. Yet, the importance of setting solid and effective tax policy in this area cannot be overstated. The 1990s, more than any previous decade, will be one where we must effectively compete internationally to survive as a world economic power. No longer can we think of U.S. business simply in terms of the domestic market. In today's business world, practically all large American corporations, most medium sized ones, and more and more small companies are involved internationally.

We must ensure that our tax code does not impede the ability of our businesses to effectively compete overseas. Not only that, but our tax code must not discourage foreign corporations from investing and creating jobs in the United States. Unfair and poorly thought out tax laws will discourage trade, invite retaliation, and result in lost opportunities for Utahns and all Americans.

President Clinton's revenue proposal contains a number of provisions that would raise significant revenues by changing the way we tax multinational corporations. The Administration has stated that these changes will close loopholes in the current tax code and are needed to prevent abuse.

I want to urge my colleagues to take a close look at these provisions. Let us make sure that we are not, for the sake of what appears to be easy revenue, making it even more difficult for our nation to compete in an ever more competitive world.

I look forward to hearing from our witnesses.

PREPARED STATEMENT OF ROBERT E. JULIANO

On behalf of Edward T. Hanley, general president of the Hotel Employees and Restaurant Employees International Union and all the HEREIU members we are privileged to represent, it is once again a pleasure to appear before this distinguished committee as it deliberates on President Clinton's economic package.

Over the years, we have had the privilege of working with Congress, most especially with this distinguished committee, on a myriad of issues. Therefore, we know the committee will appreciate the spirit and intent of our testimony. Even though this union and its members worked tirelessly across the country on behalf of the Clinton-Gore ticket, we cannot support the Presidential package as one unit, because the package includes a proposal to reduce the deductibility of legitimate business and entertainment expenses from 80 percent to 50 percent that would create a significant loss of membership. Also it will create a disproportionate negative impact on urban America because the majority of businesses affected by this proposal are located in major urban areas.

Secretary of the Treasury Lloyd Bentsen testified recently before this committee that there will not be one single job lost or one less penny spent by consumers if this proposal is adopted. The implication was clear that there was no effect in reducing the deductibility from 100% to 80%, and that therefore there would be no effect if you reduce it from 80% to 50%. This testimony was very troubling to me because I have the utmost respect for the secretary and i have had the privilege of working with him for many years.

A study we commissioned in 1977 by federated consultants prepared by Ed Unger, its late president, was predicated on the Carter administration's proposal to reduce the deductibility of legitimate business meal expenses from 100 per cent to 50 percent. Using an elasticity curve of 2–5 percent for spending patterns, as well as sound economic principles, the experts predicted a significant loss in business expenditures should such a policy change occur. That reduction in expenditures, in turn, would lead directly to a substantial loss of jobs—anywhere from 55,000–175,000 jobs *throughout* the country, a significant portion being members of our union. That study is as valid today as it was 15 years ago.

I believe that there has already been economic dislocation within the industry. In total candor, some loss can be attributed to the reduction from 100% to 80%, but also there is no question that the sluggish economy which created some recessionary cycles between 1987 to 1993 is also responsible. As it relates to treasury's assertion that not one job was lost by reducing the deductibility from 100 percent to 80%, I have to tell you sadly, without blaming any single factor, that our union, from January 1987 to February 1993, has suffered a loss of 30,000 to 35,000 members. This loss is predicated on an average membership throughout the country of between 300,000 and 325,000 members.

To our dismay, the fact that the deductibility issue has risen once again points out the total lack of understanding of the tourism industry and the contribution it makes to the national economy or to the labor-intensiveness of the industry.

These then are the facts which you should be aware of before tinkering with what is probably the most successful domestic industry this country now has.

In 1992, $369 *billion* was spent on travel services across the country, of which *85 percent* represented domestic expenditures, 15 percent international. That spending generated nearly $44 *billion* in tax revenues for Federal, State, and local governments, of which $24 billion goes to the Federal Government. In other words, for every dollar spent, 13 cents goes to support Federal, State and local programs.

The one billion dollars a day that travelers spend pays the salaries of nearly 6 million Americans, making the travel industry the *second largest employer in the country* (exceeded only by the health services industry). Moreover, the travel industry provides a disproportionate number of jobs for the traditionally disadvantaged in this country: African-Americans (11.5 percent of total 1989 travel industry employment, compared to 10.2 percent nationally); Hispanic-Americans (10.5 percent versus 7.3 percent nationwide); and women (51.5 percent versus 45.2 percent of total U.S. employment).

When you have an industry such as tourism that generates by itself six percent of the nation's GNP without any significant government expenditure, you *encourage* growth, not discourage it. The travel and tourism industry is, after all, the third largest retail industry in terms of business receipts, following only automotive dealers and food stores.

Even international tourism is a plus in that it represents the *only* export account that shows a surplus. International tourism is the largest U.S. business services export and accounts for 11 percent of total U.S. exports of goods and services ($73 billion in 1992 and 1.3 million U.S. jobs).

Since most objective analysts agree that the drastic cut from 80% to 50% would lead to a considerable drop in consumer spending, if we put it in today's terms, we would be talking about three-and-a-half billion dollars in lost business revenue. A reduction of expenditures of this magnitude would directly translate to a job loss of between 50,000–160,000.

Our union members are extremely frustrated that somehow the perception has developed that this is an "inside-the-beltway" or "fat-cat" issue. It is not. It is strictly a jobs issue. When revenue goes down, jobs disappear. Its that simple.

In the last few months, I have talked to a number of your colleagues who are gravely concerned about base closings as prescribed by the base-closing commission and the resultant job loss that these closings would create. They were all able to enumerate immediately how many boilermakers, steelworkers, steamfitters, pipefiters and sheetmetal workers would lose their jobs because of the proposed base closings in their states. Yet, many expressed disbelief that the jobs of those who work in their State's hotels, restaurants, and tourist attractions are very much on the endangered list as well to be honest, many were not interested in our issue because of the perception that it simply deprives "fat-cats" of a fancy meal or business entertainment function.

Clearly, in the minds of many Members of Congress and the administration, it is perfectly ok for the country to pay billions of dollars to defense contractors as long as it provides jobs and it can be done under the political cover of national defense.

But if you are a waiter, waitress, busboy, bartender, bellhop, reservations clerk, etc. in this country your job is expendable. Your contribution to the nation's economy is just not as valuable. Your family and future is not as important.

However, it is apparent how this perception of tourism industry workers as an expendable commodity arises. One need only listen to the speeches of President William Jefferson Clinton or Secretary of Labor Robert Reich to find out that the goal of this administration is to be able to provide 250,000 new jobs. If that is done at the expense of those currently holding jobs, well that's tough. We'll retrain them for a position to be named later.

Try telling that to workers in the real world who need jobs to provide for their livelihood and that of their families. Before the Sheraton Chicago opened last year there were approximately 5,000 people waiting in line in freezing temperatures to be interviewed for jobs that numbered only between 500 to 1,000 jobs. This response touched a national nerve and was widely reported by most of the major media across the country. So apparently there are still a large number of people who desire to work in our industry despite the administration's contention that these are "dead end" career jobs.

The President claims that that price is not too high to pay because these new jobs will be "good" jobs. That is, they will be high-paying, high-tech, computer-related jobs.

In numerous speeches they have consistently referred to a four-year college education as everyone's goal. There is never a mention of technical or vocational schools. apparently this omission is by design—not by accident. Also, it is my understanding that the administration has told members of the black and Hispanic caucuses, among others, that the loss of these tourism jobs is not important because they are not "good" jobs. The administration believes they are jobs that "subjugate" people to "dead-end careers."

The Jesuits and the folks on the west side of Chicago where I am from would either refer to this attitude as elitism or intellectual arrogance. By whatever term, it is an attitude of incredible ignorance and condescension toward generations of Americans who have made their way up-through-the-ranks.

On behalf of general president Hanley, I want to let this committee and all the Members of Congress know how terribly proud we are to have the privilege of representing these hard-working, dedicated professionals, many of whom have raised kids that did indeed go on to attend a four-year college. I doubt that their children accord their own "good' jobs and more respect than their parents' jobs—the jobs that put them through school.

But, then again, we do not represent policy wonks, so that might explain the indifference towards those who are members of our industry and of our union.

While standing on the floor of Madison Square Garden last July, I was especially struck by the words of then candidate, William Jefferson Clinton, who said: I accept this nomination on behalf of the average American, the good decent, hardworking people who raise their families and pay their taxes and whose voices have not been heard. Candidate Clinton told the country then he was running so that these people would share in the American dream.

So, Mr. President, we say with the utmost sincerity tat we have heeded your clarion call. This union does represent such Americans, and we speak for their interests, and their voices *will* be heard. But when exactly did you decide that the millions of people employed in the tourism industry where excluded from that dream?

With the greatest of respect, I urge this committee to reject this proposal and drop it from the economic package just as you are likely to do with the investment tax credit. We hope that an amelioration can be reached on this issue with an enlightened Congress, and then we can roll up our sleeves and help get the necessary votes needed to pass an economic package that will truly help a nation which is in much disrepair and truly in need of a legitimate morale boost. You can do nothing that is more important for the tourism industry and its workers that to provide a health economy for our country.

Thank you for your time, attention, and consideration.

PREPARED STATEMENT OF RICHARD W. LEONARD

My name is Richard Leonard. I am the Special Projects Director for the Oil, Chemical and Atomic Workers Union (OCAW). The OCAW is a labor union which is affiliated with the AFL-CIO and represents over 100,000 workers in the energy and chemical industries, including about 10,000 workers in the pharmaceutical industry.

OCAW appreciates this opportunity to express its views on the President's proposal for capping Section 936 tax credits by the equivalent of a 60 percent credit on wages paid in U.S. territories.

Let me begin by stating that we are in complete support of President Clinton's program for reforming Section 936. This program will raise between $7.0 and $8.3 billion over the next five years that can be employed to reduce the deficit, or strengthen desperately-needed social programs. The best news is that these new revenues will not come at the expense of important social programs or of the poor, the disadvantaged, our nation's children or others who lack the strength to exercise the levers of power. Instead, this new revenue will come from the simple act of asking a narrow group of immensely wealthy special interests to turn in their keys to the Federal Treasury.

Section 936, otherwise known as the Possessions Tax Credit, was originally designed to encourage economic development and job creation in the Philippines. Today, virtually all of the total Possessions Tax Credit is claimed by companies doing business in Puerto Rico.

Of the 105,500 manufacturing jobs directly promoted by Section 936 in Puerto Rico, 50,500 of these jobs are subsidized at an annual cost of about $384 million. While this amounts to an average annual federal subsidy of about $6,564 per job per year, this may not be unreasonable considering the economic conditions that have existed there. Section 936 companies in this category are typically involved in the manufacture of apparel, food products, plastics, leather, and other labor-intensive industries.

However, a few industries, including pharmaceuticals, electronics and instruments, along with two beverage companies, have mangled the intent of Section 936 by extracting for themselves an enormous federal subsidy while providing relatively few jobs. In particular, 57 pharmaceutical companies employing no more than 17 percent of the entire Section 936 manufacturing workforce in Puerto Rico, have captured nearly 55 percent of the Section 936 tax credit. These 57 companies take 936 tax credits equivalent to $85,316 per year for each worker employed in Puerto Rico at an annual cost to the U.S. Treasury of $66,140 per worker.

These companies have reshaped the Possessions Tax Credit to allow businesses to transfer valuable intellectual property rights and other intangibles into Puerto Rico shelters without an arm's length transfer of value. In this way, high profits normally earned on such intangibles become super profits beneath a territorial tax shelter. And because these super-profitable rights and patents are largely owned by the pharmaceutical industry, it is this industry that has been the largest beneficiary of Section 936 tax credits. Thus, a tax law that was originally designed to reward job creation has been distorted by a few special interests to reward profit creation.

Section 936 proponents reverently refer to the "high technology" industries that have been established in Puerto Rico. Terms are

used that would have one believe that these plants were temples to the gods of science and medicine. Accepting such as an article of faith would be difficult for the staunchest Branch Davidian. In the first place, the "high tech" end of this industry is all on the mainland. We know of no pharmaceutical company that has located its research and development operations in Puerto Rico in spite of the enormously favorable tax consequences of doing so. Furthermore, most of the operations that this industry has located on the Island, are at the low-tech end of the business. The typical pharmaceutical company ships in drums of ready-made powders which are mixed, compressed into pills and packaged. The only alchemy in this process is that performed by accountants who try to minimize the amount of this work that is performed on the Island while maximizing 936 benefits.

One of the largest 936 welfare clients is Coca-Cola that produces much of its world-wide supply of secret formula in Cidra. In 1991, Coke enjoyed a $137 million 936 subsidy while employing just 371 workers--a staggering $371,350 per employee.(1) For the 371 workers at Cidra, this represents a wage credit of approximately 1,100 percent. Brewing up the proprietary Coke formula does not evoke an image of 21st century technology, but one of imaginative accounting that has divined a means of sheltering an enormously valuable intangible asset at the expense of middle class taxpayers. Pepsico, has a similar facility in Cidra and, according to a study commissioned by Barron's in 1990, saved $52 million in federal taxes while employing only 151 workers.(2)

Companies like Coke and Pepsi, and many of the pharmaceuticals are neither "high tech" nor "capital intensive", but are more properly characterized as "intangible intensive".

Not to overlook the pharmaceutical industry, the Merck & Co. reported 1992 Section 936 tax savings of $181 million while employing 1200 on the island. For Merck, their artful use of 936 produced tax savings of $151,000 per Puerto Rico employee; the equivalent of a 480 percent wage credit. In the case of Merck, the implications of a $181 million tax savings are enormous. Merck, is a "profit splitter". This means that the $181 million (after Puerto Rico taxes, but before federal income taxes) is equivalent to about 34 percent of one-half of the Puerto Rico subsidiary's income before taxes. This computes to about $1.2 BILLION in before-tax income. After subtracting for federal taxes, we estimate after tax profits attributable to Puerto Rico at about $970 million; or about 40 percent of the company's 1992 worldwide net income. Thus, in the case of Merck, the company has managed to rig itself so that 40 percent of their net income producing activity is carried out by about 3 percent of the company's employees.

Merck, like the 35 or so other 936 companies that soak up around 90 percent of the 936 tax savings, has basically bundled those products that embody the most valuable intangibles and the lowest costs of production and have centered components of this production in 936-sheltered plants. As a tax policy, or as an economic development policy, the whole process is indefensible.

Is it any wonder why Senator Pryor has termed the Possessions Tax Credit, the "Mother of All Tax Shelters"?

From a revenue standpoint, the President's 60 percent wage cap on Section 936 benefits would recapture approximately 40 percent of the $18.7 billion that would be lost to the U.S. Treasury over the 1994-1998 time period. It is targeted directly at those relatively few companies which have acquired enormous wealth at the expense of mainland taxpayers, while contributing comparatively little to the

economy of Puerto Rico. At the same time, it effectively exempts the bulk of 936 companies who have contributed the most to Puerto Rico's economy. Clearly, the Administration's 60 percent wage credit does not do away with Section 936, but seeks to reestablish this tax incentive in the spirit in which it was originally created.

It is important to note that even in the complete absence of any wage or tax credit, the cost of wages paid is deductible against earnings. At the current statutory rate, most Section 936 companies already receive the equivalent of a 34 percent wage credit. Thus, the Administration's proposal, in this sense, comes close to creating a 100 percent subsidy for wages paid by 936 companies.

Under these, or any other circumstances, the President's proposal for Section 936 is extremely generous. With the growing federal deficit and pressing social matters throughout society, it would seem foolhardy, if not extraordinarily dangerous, to expect mainland taxpayers to pick up more than 100 percent of a Section 936 company's payroll costs.

The Administration's program recaptures enormous lost revenues while at the same time giving generous consideration to the special circumstances in Puerto Rico, which, for years, has experienced unemployment in excess of 15 percent and a standard of living that is less than one-half of that enjoyed by citizens on the mainland.

For these reasons, we strongly encourage Congress to resist any attempt to dilute the President's wage credit formula. To ask the American taxpayer to subsidize more than 60 percent of the wage bill for these companies would be unconscionable. Given the enormous economic and political resources of the few but very muscular special interests vested in the status quo, President Clinton's proposal is courageous and gutsy. And it is the right thing to do. It is our hope that the members of this Committee and this Congress will follow the President's example and his leadership.

President Clinton is also to be commended for his recognition that Section 936 has had a destructive effect on jobs and the welfare of working people on the mainland. While campaigning last Fall, President Clinton and Vice President Gore were quick in their expressions of outrage and in their promises to end the practice of using tax dollars to subsidize the destruction of jobs belonging to taxpayers.

During his State of the Union message, President Clinton directly addressed this issue. He declared on February 17, 1993: "Our plan seeks to attack tax subsidies that actually reward companies more for shutting their operations down here and moving them overseas than for staying here and reinvesting in America...the tax code should not express a preference to American companies for moving somewhere else, and it does in particular cases today." The President followed up this statement with a proposal to sharply curtail Section 936.

President Clinton's remarks illuminate the cruel irony involved in Section 936. The very group of middle Americans who are financing Section 936 with their tax dollars are unwittingly buying into a lottery where the winning entries are pink slips.

At this very moment, 480 workers at the Acme Boot plant in Clarksville, Tennessee, are being thrown into area unemployment lines, while their employer transfers machinery, raw materials and jobs to Section 936 facilities in Toa Alta, Puerto Rico.

At this very moment, the Syntex Corporation is undertaking the closure of its only mainland pharmaceutical plant in Palo Alto, California. The company has announced that it intends to transfer all pharmaceutical operations to facilities in Puerto Rico, thereby displacing 281 Bay Area workers.

At this very moment, the Sundstrand Corporation is laying off 200 workers as it transfers jobs from its Brea, California facility to a location in Santa Isabel, Puerto Rico.

And, at this very moment, the Colgate-Palmolive Corporation has issued notice that it intends to dislocate nearly 200 workers at its Kansas City, Kansas plant. This plant has manufactured Colgate toothpaste, as well as various liquid cleansers, which are now manufactured in a new plant staffed by 150 workers in Guayama, Puerto Rico.

The inducement created by Section 936 to destroy mainland factories and jobs is best illustrated by citing the example of the American Home Products Corporation.(3)

American Home Products (AHP), is one of the nation's leading pharmaceutical manufacturers earning $1.4 billion in profits on sales of $7.1 billion in 1991. In 1985, AHP commenced production of pharmaceuticals in Puerto Rico. Seven years later, AHP had established the largest single pharmaceutical operation in Puerto Rico and had racked up over $550 million in 936 tax savings. AHP saw its effective tax rate fall from 44 percent in 1984 to 34 percent after tax reform in 1986; then to 27 percent after its acquisition of the A.H. Robins Company (and $2 billion in net operating losses), and, finally, to 22 percent as a result of 936 tax credits on its earnings in Puerto Rico.

In 1991, AHP earned $580 million in after-tax profits in Puerto Rico, including $106 million in 936 tax savings. <u>It had, in the short span of seven years, relocated 42 percent of its worldwide income-producing capacity beneath this tax shelter</u>. With approximately 1400 employees in Guayama, Puerto Rico, and 120 employees in a 936-subsidized complementary plant in the Dominican Republic, the 936 tax credit represents a tax-financed subsidy of $68,387 per job. During this seven-year period, U.S. employment at AHP fell from 27,000 to 25,300. Pharmaceutical manufacturing plants in Elkhart, Indiana, and Great Valley, Pennsylvania, were closed or phased down, and over 1,300 mainland workers displaced.

In 1991, OCAW asked the Midwest Labor Center for Labor Research (MCLR) to examine the possibility that the situation with American Home Products was not an isolated case. This inquiry revealed 25 examples where Section 936 tax credits were a motivating factor in mainland plant closures or mass layoffs.(4) These 25 cases involved a total of 11,008 jobs. Of the 11,008 jobs identified in these 25 cases, 7,306 were directly shifted to Puerto Rico; 995 were transferred to other locations, and 2,707 were transferred to various locations, but where Puerto Rico was listed as receiving an unspecified number of these jobs. Sixteen of the 25 cases involved the pharmaceutical or medical products industry, and most of the cases dated from 1985 or later.

This report by no means resembles an exhaustive search for all such runaways but simply catalogues those situations where relocation to Puerto Rico was noted by corporate officials, the media or the labor union involved. In the vast majority of cases, it is our impression that companies have taken some care to conceal the magnitude of their relocation plans. Most relocations are not difficult to conceal. In large part, the companies taking advantage of Section 936 are <u>Fortune 500</u> companies, with many

mainland facilities. Typically, when establishing itself in Puerto Rico, or in any other tax shelter for that matter, a large company will cream off those products from its various mainland locations that offer the highest rate of return. In this way, many mainland facilities may only be slightly impacted. Once the Puerto Rico facility is well-established, the company will undertake a "review" of its mainland facilities and issue a finding that it has "excess capacity" on the mainland, and, in order to remain competitive, the company must "consolidate." A mainland plant is targeted for closure and its work is farmed out to other mainland facilities. In this way, workers and communities who are impacted are often completely unaware of the underlying causal effect of Section 936.

The majority of companies mentioned in the MCLR report have taken the position that mainland plant closures and layoffs were a result of necessary "restructuring and consolidation," without noting that such restructuring always results in an enlargement of Puerto Rico operations and diminished operations on the mainland.

It is our belief that many more examples of this complex process of relocation exist and that the locations represented in the MCLR study represent but the tip of the iceberg.

PRUSA has, on a number of occasions, represented that Section 936 has created tens of thousands of direct and indirect jobs in Puerto Rico. These assertions, however, overlook and ignore the economic impact of direct and indirect job losses on the mainland that have resulted from the tax-driven export of mainland jobs to Puerto Rico.

In the study referenced above, MCLR estimated that the ripple effects of 7,306 direct job losses account for at least 14,600 to 21,900 indirect jobs lost, as well. When the figures for direct job losses and estimated indirect job losses are added together, we derive a conservative figure for total job loss due to transfers of work to Puerto Rico of between 21,900 and 29,200 jobs.(5)

Additional evidence of job shifting in the pharmaceutical industry is provided in the table (appended to this statement) which compares the growth in production worker employment on the mainland with that of Puerto Rico. As the table demonstrates, production employment in the Puerto Rico pharmaceutical industry has increased by 88 percent during the past decade, rising by 6,600 workers between 1980 and 1991. During the same time period, mainland production employment declined by 6.9 percent or 6,100 jobs.

The pharmaceutical industry, as well as responsible Commonwealth officials, have turned a deaf ear to our concerns over the export of mainland jobs. At the present time, these parties are in a complete state of denial. They refuse to admit that there is any problem whatsoever, and, in fact, continue to maintain that 936 has had the opposite effect of actually creating new jobs on the mainland.

In a March 1993 study, PRUSA maintains that Section 936 companies in Puerto Rico have actually created 46,000 indirect jobs on the mainland as a result of their purchases of goods and services. This logic is spurious for a number of reasons. Clearly, 936 companies would have had an even greater impact on mainland employment had they stayed on the mainland, or at least a similar effect if they had gone to Mexico or Ireland or Canada.

The pharmaceutical industry and its friends have not yet admitted to the tax-driven dislocation of a single mainland worker. This is a monument to their arrogance, if not their fear of yet another lawsuit. This total and complete state of denial is utterly

contradicted by their predictions that the imposition of the Clinton wage credit would cause them to bolt Puerto Rico for sunnier tax climes, summarily dumping "tens of thousands" of Puerto Ricans into the unemployment line.

The very companies that said that they have never dislocated a single mainland worker to take advantage of what amounts to a 246 percent wage credit presently offered in Puerto Rico, are now saying that they would dump "tens of thousands" Puerto Rican workers in a heartbeat to find something better than the 60 percent wage credit.

Because of the special tax status of Puerto Rico, an anti-runaway policy has been reflected within the Puerto Rico tax code for approximately 40 years. Understanding that Section 936-type credits would be without value in the absence of corresponding exemptions provided by Puerto Rico within its own tax jurisdiction, it was recognized that similar non-relocation declarations would be necessary to blunt the threat of "runaways" and preserve this special status as well as the underpinnings of Operation Bootstrap. And, it has since been recognized that such restrictions on 936-type corporations are necessary to bring Puerto Rico policy into line with Federal policy on tax-financed industrial incentives.

For example, where federal tax receipts are used by states to offer direct incentives to a company, it has been the policy of the federal government to require the recipient to certify under oath that the subsidized project will not adversely affect employment in other regions of the country. This is true of Job Training Partnership Act grants offered by the Labor Department, Economic Development Administration grants offered by the Commerce Department, and Urban Development Action grants of the Department of Housing and Urban Development.

Sadly, in its zeal to expand the package of promotions and giveaways to business, the past administration in Puerto Rico discarded this history and its expression in policy. In our opinion, they encouraged companies to falsify non-relocation declarations required under the Puerto Rico Tax Incentives Act,as well as by the U.S. statutes governing Labor and Commerce Department training and development grants. In this way, "Operation Bootstrap" evolved into "Operation Booted Out." The fact is, a uniform federal tax policy, coupled with non-relocation restrictions, are presently the law of the land for everyone but Puerto Rico when it comes to the collection and expenditure of federal tax dollars.

Puerto Rico has also been the subject of so much attention because of the sheer enormity of the subsidy. Whereas a mainland corporation faces a 34 percent U.S. corporate income tax on earnings in any state, it is offered a free ride in the Commonwealth of Puerto Rico. The size of this break is so enormous that it dwarfs any that could be conceivably be provided by state-level tax breaks on corporate income.

We, along with the entire AFL-CIO, support the cause of Puerto Rico workers seeking more jobs and better wages. It is obscene that the astronomically high unemployment rate, and other mean levels of economic desperation are tolerated in any region, be it a state or a territory of the United States. As long as Puerto Rico is tied to the U.S., either as a territory or a state, residents on the mainland have, in our view, an enormous responsibility to see that the people of Puerto Rico enjoy to the fullest measure the fruits of U.S. citizenship.

In a January 14, 1993, San Juan Star editorial, Mr. A.W. Maldonado, a public relations consultant to Fomento, characterized Puerto Rico's non-relocation policy as "adopted for essentially public relations reasons" and "impossible to enforce." We agree. This is why the AFL-CIO has supported legislative action to amend Section 936 to allow the Treasury Department or the Courts to police the 936 companies.

All of these facts and figures don't begin to tell the real story. The real story here is told by the workers at Acme Boot and thousands like them who have been abandoned in this corporate migration to 936 tax shelters. In all too many cases, the tax code has allowed employers the added advantage of ridding themselves of older workers and replacing them with a workforce of 20-year olds. In the case of American Home Products, the average age of the workforce was 45. In the case of Acme Boot, the average age was 48. In our economy, factory workers at this age are almost unemployable. And the high cost of private health insurance is prohibitive.

In view of the generosity of the Administration proposal, we are concerned that Section 936 will continue to attract mainland businesses and, unfortunately, continue to finance the export of mainland plants and the destruction of mainland jobs. Clearly, such an outcome is not intended by this Administration, nor by anyone concerned about the use of public monies to destroy the jobs of the very taxpayers who are paying for this tax break.

For all of these reasons, our union, along with the entire AFL-CIO, continues to advocate the passage of law to prevent these substantial subsidies from causing mainland unemployment. At this time, examples of legislative approaches to the problem of 936-inspired plant closures are before several committees in the House of Representatives. I refer the members of this panel to H.R. 1207, H.R. 1210 and H.R. 1630. These legislative approaches, would by various means, have the effect of withholding or revoking Section 936 tax credits from runaway plants.

Because Section 936, even with the imposition of the 60 percent wage credit, represents a continuing threat to mainland jobs, workers in towns like Clarksville, Tennessee, Elkhart, Indiana, and Brea and Palo Alto, California, are looking to this Committee to stop the destruction of jobs and communities caused by the Possessions Tax Credit.

The members of this Committee have the opportunity to perform a great service to workers and communities by holding firm on the President's program to place a 60 percent cap on the Section 936 tax credit, and by drafting legislation to withhold the tax credits from companies who would use this tax-financed subsidy to destroy mainland jobs.

PHARMACEUTICAL PRODUCTION WORKERS - U.S. Mainland and Puerto Rico

Year	U.S. Excluding Puerto Rico	Puerto Rico	U.S. and Puerto Rico	Puerto Rico as % of U.S. Mainland	Puerto Rico as % of U.S. and Mainland
1980	88.7	7.5	96.2	8.5	7.8
1981	86.1	7.9	94.0	9.2	8.4
1982	84.1	8.0	92.1	9.5	8.7
1983	84.2	8.4	92.6	10.0	9.1
1984	81.8	8.6	90.4	10.5	9.5
1985	78.8	9.4	88.2	11.9	10.7
1986	78.4	10.3	88.7	13.1	11.6
1987	79.6	10.1	89.7	12.7	11.3
1988	81.0	10.5	91.5	13.0	11.5
1989	82.7	12.2	94.9	14.8	12.9
1990	81.3	13.3	94.6	16.4	14.1
1991	82.6	14.1	96.7	17.1	14.6
1992		14.9			

All data are in thousands
Sources: For the U.S.: U.S. Department of Commerce, Bureau of the Census

FOOTNOTES

(1) Caribbean Business, April 8, 1993; pp. 34-5.

(2) Barron's, September 3, 1990.

(3) In 1991, OCAW brought a civil racketeering suit against AHP, alleging fraud in connection with the closure of an Indiana pharmaceutical plant and the opening of a similar facility in Puerto Rico. The suit alleged that AHP defrauded OCAW by falsifying applications for Puerto Rico local tax exemptions. Applicants are required to certify that their tax-exempted projects are not intended to have an adverse effect on mainland employment. The suit also named Puerto Rico officials for conspiring in this fraud. In 1992, a related action was filed on behalf of a class of over 1,000 former AHP workers in Indiana, New York, Pennsylvania and New Jersey who had been displaced under similar circumstances. On July 29, five days before trial in Federal Court, the parties agreed to a $24 million out-of-court settlement. The court action enabled OCAW to review discovery documents, including the firm's tax returns for the last ten years, and was useful to OCAW in gaining valuable insight on the practical application of Section 936.

(4) Impact of Internal Revenue Code Section 936 on Manufacturing Jobs in the U.S., Midwest Center for Labor Research, June 1991. It must be noted that these 25 cases cited in the MCLR study were assembled using trade press, company statements, and other easily acquired material. MCLR believes that a more in-depth investigation of business records and local press sources would significantly enlarge the list of Section 936 mainland-U.S. closures.

(5) In reviewing dozens of plant closings during the past decade, MCLR has developed a method for estimating the social costs associated with the loss of manufacturing jobs in the form of increased costs to the local, state and federal governments.

These social costs account for the decreased taxes that workers pay after they lose their jobs, and for the increased social welfare benefits that they receive, in the form of unemployment compensation, welfare and food stamps.

While it is not possible to arrive at precise estimates of social costs for the 25 cases in the study, MCLR has found that for each manufacturing job lost, the combined costs to all levels of government can range from $30,000 to $40,000 per worker in the first two years following a layoff or plant closing.

PREPARED STATEMENT OF ROBERT S. MCINTYRE

I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The issue before the Committee today is not a difficult one from the point of view of sound tax and budget policy. The threshold question is whether the current 80% write-off for business meals and entertainment is a legitimate deduction in computing net business income. If so, that would end the discussion. But the answer rather clearly is no. The second question is whether a $10 billion a year government subsidy for business people's meals and entertainment makes sense. Here the answer is even more obvious: No.

Therefore, we strongly recommend that the current tax deduction for meals and entertainment be eliminated entirely. We support President Clinton's proposal to reduce the write-off to 500% as a modest step in the right direction.

1. CAN A WRITE-OFF FOR MEALS AND ENTERTAINMENT BE JUSTIFIED AS A LEGITIMATE DEDUCTION IN COMPUTING NET BUSINESS TAXABLE INCOME? (NO.)

It's a fundamental (and usually honored) income tax principle that personal outlays, whether for a family car, a house, food or entertainment, should *not* be deductible in computing net income.[1] On the contrary, these are precisely the things that net income is used to buy. If the income tax laws generally allowed people to deduct their personal expenses, there would be little or nothing left to tax (except savings).[2]

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[1] Section 262 of the Internal Revenue Code states this principle explicitly. See appendix.

[2] A few personal outlays, most notably mortgage interest, are allowed as itemized deductions in computing individual taxable income. But the mortgage interest deduction is not defended on tax policy grounds as a proper deduction in computing net income (or ability to pay taxes), but rather as a government subsidy for housing. (The case for this subsidy is generally considered to be weak by most analysts, but the transitional, regional and political problems of eliminating this subsidy are large.) A quite reasonable case on ability-to-pay grounds can be made for most other itemized deductions, such as those for state and local taxes, cash charitable contributions and extraordinary medical expenses.

To be sure, when taxpayers assert that some of their apparently personal outlays also have a business purpose, the issues are not always clear cut. Although the tax code ostensibly allows deductions only for "necessary" business expenses, this rule is liberally interpreted when a business purpose clearly predominates. The law does not limit deductions for office furnishings, for example, to the cheapest available.

But when the personal element of an outlay dominates, the tax code should not (and usually does not) allow a deduction. For example, although someone could reasonably say that he or she *needs* a place to live in order to survive (and be able to work), normal housing costs have no particular linkage to earning income, and are thus not deductible as business expenses. Likewise, commuting costs may make it possible to get to work, but they are properly treated as stemming from personal decisions about where to live, rather than being primarily business-related, and are thus not deductible.

It's hard to imagine any outlays that are more quintessentially personal than those for meals and entertainment. Everyone has to eat, no matter what their profession or trade (if any). Entertainment, by definition, is designed to provide personal satisfaction and enjoyment.

Current law recognizes that meals and entertainment expenses are primarily personal when a taxpayer makes such outlays solely on his or her own behalf. The fact that someone may read a business journal over lunch or think about marketing strategies during a football game does not transform those meals and entertainment outlays into deductible business expenses. Strangely, however, when a meal or recreational activity is shared with a business associate or a potential client or customer, the tax law generally allows 80% of the amounts spent to be written off.

Specifically, meals that bear a "reasonable and proximate relationship to a trade or business" are 80% deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during or after the meal (nor would there be any way for the IRS to drove that such a discussion actually did not take place). Entertainment outlays are 80% deductible if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity, or more liberally, if the entertainment is directly preceded or followed by a substantial and bona fide business discussion (such as a business meal). Such a discussion does not have to occur on the same day as the entertainment, nor does it have to last as long.

The problem is not merely that these rules are hopelessly open to abuse, although of course they are. For example, as an occasional freelance writer, I discuss virtually everything I write with my wife (and editor), often over dinner. Indeed, most of our meals together are "conducive to a business discussion" about my writing projects. Should we be deducting the cost of those meals? If we go to a play or a sporting event after one of our "business meals," should our entertainment costs also be deductible? Would we be on firmer ground if we talked at an expensive restaurant about my wife's small-business projects (art), on which I often give constructive and useful advice?[3]

> "The taxpayer is permitted to deduct the whole price [of a 'business meal'], provided the expense is 'different from or in excess of that which would have been made for the taxpayer's personal purposes.' . . . [T]he Internal Revenue Service has every right to insist that the meal be shown to be a real business necessity. This condition is most easily satisfied when a client or customer or supplier or other outsider to the business is a guest . . . . But it is different when all the participants in the meal are coworkers . . . . They know each other well already; they don't need the social lubrication that a meal with an outsider provides-at least don't need it daily . . . . It is all a matter of degree and circumstance . . . . Daily-for a full year-is too often, perhaps even for entertainment of clients . . . . The case might be different if the location of the courts required the firm's members to eat each day either in a disagreeable restaurant, so that they derived less value from the meal than it cost them

[3] My personal view is that none of these "business meals" and related entertainment should be deductible even under existing law, but the current rules are sufficiently vague that the answer is not certain. Ironically, our case would improve if we ate at more expensive restaurants than we would normally frequent. Our chances also would improve if we kept our excursions to a "reasonable" number per year. It might also help if we were willing to claim that we didn't really like the meals we ate. And it would clearly assist our claim if we brought a potential art purchaser (albeit a friend) to dinner with us. As the Court of Appeals for the Seventh Circuit put it in *Moss* v. *Commissioner* (7th Circuit, 1985):

to buy it or in a restaurant too expensive for their personal taste . . . . But so far as appears, they picked the restaurant they liked most."

The fundamental problem is that no matter what the technical rules, the deduction for meals and entertainment is itself an abuse of good tax policy. Personal outlays of this sort simply should not be deductible in computing net income.

Who should be taxable?

Analytically, the proper taxpayer in the case of meals and entertainment benefits should be the person who is fed or entertained. Thus, the theoretically correct treatment of such benefits would be to tax the recipients on the value of the benefits they receive. Denying deductions to payers, however, would produce roughly the same result, and would be considerably easier to administer.

Of course, in the case of self-employed people, denying a deduction for meals and entertainment personally enjoyed gives exactly the same answer as taxing the benefits. For employees, the issue is only slightly more complicated. Businesses can, of course, deduct the wages they pay their employees, whether paid in cash or in noncash compensation. But the employees are supposed to report those wages, cash or in-kind, as income on their personal tax returns. Thus, theoretically, employer payments to employees in the form of meals and entertainment could be deductible by employers and taxable to the employees. But a more workable solution is simply to deny the deductions to the employer. Because the relevant marginal tax rates on individuals and businesses are roughly the same, this approach gives about the same result as taxing the benefits to the employees.[4]

Customers of a business who receive meals and entertainment are in a similar position to employees. That is, the customers also receive in-kind income. Denying business deductions to the payer for those in-kind payments is a good, workable alter native to taxing those benefits directly to the recipients.

Valuation issues

A perusal of recent testimony on the Clinton tax program before the House Ways and Means Committee shows little effort by the proponents of the business meals and entertainment deduction to defend it on tax policy grounds. (Instead, they primarily talked about the need of their industries for government subsidies, a topic discussed below). But when a tax policy defense is raised for meals and entertainment write-offs, it usually comes down to arguing about the proper valuation of the benefits to the recipients.

In particular, defenders of the write-offs have asserted that the value of meals and entertainment received by self-employed people, employees, customers, spouses, etc. in a business context is often much less than the dollars spent. A salesman might not like fancy meals very much. Or a customer might not really be a hockey fan. Or a businessman might actually detest golf. They engage in these allegedly somewhat disagreeable activities, it is argued, only because of business necessity.[5]

This argument is terribly weak. After all, the point of feeding and entertaining customers is to make them happy. Dragging customers to restaurants or stadiums that they abhor would hardly be a sound business practice. Likewise, the providers of the meals and entertainment (or their employees) have substantial discretion in choosing where they eat or play.

In our view, the current 80% write-off for business meals and entertainment overwhelmingly fails the test of sound tax policy. While a case might be made for allowing a small portion of such outlays to be deducted on valuation grounds, we believe that the soundest policy would be to disallow such write-offs entirely. The Clinton plan, to limit the deductions to 50% of their cost, is at least a step in the right direction.

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[4] The lowest marginal federal income and payroll tax rate on wages is 30.3 percent (15% income tax; 15.3% Social Security payroll tax). Because the cross-over points for hitting the 28% bracket and exceeding the wage cap on the OASDI tax are about the same (for one-earner married couples), the marginal rate generally remains just over 30% at higher income levels. On the highest earners, the rate on wages is currently 31.9% (31% plus the effects of the itemized deductions disallowance). Under the Clinton program, the top individual rate on wages would be 43.7% (the 36% top rate, the 10% surtax, the itemized deduction disallowance and the 2.9% HI tax). The corporate marginal tax rate is generally 34%, and would be 36% under the Clinton plan. Thus, tax rates for payers and recipients are roughly the same.

[5] *See, e.g.*, "Statement of Marvin Leffler, Chairman of the Board, Nat'l Council of Salesmen's Organizations," before the Ways and Means Comm., March 31, 1993 ("When [a salesman] entertains a customer, he naturally eats a more expensive meal, but not for self-gratification—he would rather be home.")

2. DOES A $10 BILLION A YEAR GOVERNMENT SUBSIDY FOR BUSINESS PEOPLE'S MEALS AND ENTERTAINMENT MAKE ANY SENSE AT ALL? (NO.)

As noted above, defenders of the current 80% write-off for business meals and entertainment generally do not focus on tax policy issues. Instead, they attempt to defend the $10 billion annual cost of these deductions as a needed government subsidy to the restaurant, resort and entertainment industries.

Now if one were to make a list of government spending priorities, a subsidy for business men and women's eating, drinking and entertainment would seem to be very near, if not at, the bottom of the list. (Perhaps buying business people jewelry or furs would rank even lower.) How can we possibly justify higher taxes on the general public or bigger budget deficits to fund such a peculiar entitlement program?

Therefore, as already stated, we believe that the current tax subsidy for meals and entertainment should be eliminated entirely.

The bogus "jobs" issue

Proponents of a federal subsidy for meals and entertainment maintain that it is a "jobs issue."[6] But from a national perspective, the argument that cutting the government subsidy for meals and entertainment would cost jobs is wholly without merit.[7]

Essentially, there are two possible economic results that could occur if the subsidy for meals and entertainment is reduced or eliminated. Either:

a. Not much will change. Business people will continue to eat, attend sporting events, and so forth at about the same rate as they do now. This may seem the most likely outcome, particularly in the case of meals, since eating will remain a human necessity and eating well, a pleasure. The historical record since 1986 confirms that curbing write-offs is likely to have little impact on dining and recreation.[8]

b. Or alternatively, some of the money that now goes to buy meals and entertainment will be shifted to other purchases.

The important point from a national jobs perspective is that it doesn't matter which of these two results occurs. If less money is spent on meals and entertainment, then more money will be spent on other things, creating jobs in other areas.[9] Thus, there is no reason to expect any net effect on total American jobs from reduction or elimination of the subsidy for business meals and entertainment.

Transition considerations

To be sure, whenever the government shifts or reduces spending—whether on defense, meals and entertainment subsidies or whatever—policymakers should be sensitive to important transition issues and their impact on real human beings. Jobs lost in one area may not be instantly recreated in another. That's why, for example, President Clinton has emphasized retraining as a key part of his deficit reduction program. But if the government can never end an ill-considered or outmoded subsidy program because of transition issues, then it has lost its ability to govern.

Should the Committee accept our recommendation that the meals and entertainment subsidy be eliminated entirely, it might be prudent to phase it out gradually, say by 20% a year over the next four years. On the other hand, the modest reduction proposed by the President (less in total than the 1986 change[10]) probably needs no transition period.

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[6] See, e.g., "Statement of George A. Wachtel, Director, Research and Government Relations, The League of American Theatres and Producers," before the House Ways and Means Committee, March 31, 1993 ("Theatre and performing arts budgets are extremely labor intensive . . . . We should be promoting policies that ensure the further development of the arts in America . . . "); "Statement of Darryl Hartley-Leonard on behalf of the American Hotel & Motel Association," before the House Ways and Means Committee, March 31, 1993 ("In the final analysis, what really matters is how many working Americans you will displace from their jobs . . . ."); "Statement of Chip Berman on behalf of the National Restaurant Association," before the House Ways and Means Committee, March 31, 1993 ("it all boils down to jobs.").

[7] One could, of course, in some circumstances argue against deficit reduction itself on the ground that it can cost jobs, but defenders of the business meals deduction profess to favor cutting the deficit.

[8] The 1986 Tax Reform Act cut the meals and entertainment write-off by 20%, the corporate tax rate by 26% and the top personal tax rate by 44%. Yet despite this combined 40% reduction in the meals and entertainment subsidy, there was no noticeable reduction in business eating or entertaining. (Nor, by the way, did sports stars see a decline in their earnings as a result of the withdrawal of a substantial portion of the government subsidy for entertainment.)

[9] There is one other possible outcome: that people would actually save more. Since the goal of deficit reduction is to increase national savings, however, that rather unlikely result is not to be greatly feared.

[10] See note 8 above.

CONCLUSION

The current 80% tax write-off for business meals and entertainment fails the test of sound tax policy, and cannot be justified as a prudent or fair government spending program. We strongly recommend that the meals and entertainment write-off be eliminated entirely. We support President Clinton's proposal to reduce the write-off to 50% as a useful step in the right direction.

Appendix: current law (in general) on meals and entertainment:

IRC §162:

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

IRC §274:

(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION.—

(1) IN GENERAL.—No deduction . . . shall be allowed for any item—

(A) ACTIVITY.—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer established that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business . . . .

Gloss: Entertainment activities are considered to be "directly related" if the taxpayer has more than a general expectation of deriving income or a specific trade or business benefit (other than goodwill) from the activity. The alternative, more liberal rule, "directly associated with," is satisfied if the entertainment is directly preceded or followed by a substantial and bona fide business discussion. Such a discussion does not have to occur on the same day as the entertainment, nor does it have to take as long as the entertainment.

(k) BUSINESS MEALS.—

(1) IN GENERAL.—No deduction shall be allowed . . . for the expense of any food or beverages unless–

(A) such expense is not lavish or extravagant under the circumstances. . . .

Gloss: Besides the above rule, any meals that bear a "reasonable and proximate relationship to a trade or business" are deductible if they occur under circumstances that are "conducive to a business discussion." There is no requirement that business actually be discussed, either before, during or after the meal (nor would there be any way for the IRS to prove that such a discussion actually did not take place).

(n) ONLY 80 PERCENT OF MEAL AND ENTERTAINMENT EXPENSES ALLOWED AS DEDUCTION.—

(1) IN GENERAL.—The amount allowable as a deduction . . . for—

(A) any expense for food or beverages, and

(B) any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation . . . ,

shall not exceed 80 percent of the amount of such expense or item . . . .

IRC §262:

(a) GENERAL RULE.—Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

PREPARED STATEMENT OF PETER MCNEISH

On behalf of the Small Business Legislative Council (SBLC), I wish to thank you for the opportunity to testify today on the subject of the President's proposal to reinstate an investment tax credit (ITC).

As you know, the SBLC is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, profes-

sional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. For your information, a list of our members is attached.

To set the stage for our observations and recommendations, let me begin by noting that the Chairman of our Board of Directors, H. Ted Olson, issued this statement on February 19, 1993, following the President's State of the Union: "We commend President Clinton for offering the nation and small business a vision, and displaying a willingness to make the hard decisions to 'unmortgage' our children's future. As one might expect, there are items in the package we like, and others we do not like. We are confident that the legislative process can refine and smooth out these rough spots. The central point is we are willing to work within the concept defined by the President."

The second noteworthy, stage-setting fact is the SBLC, since 1991, has been vigorously and unrelentingly pursuing a four point strategy for economic recovery. We were among the first to sound the alarm regarding the recession and remain among those who believe action is still necessary to ensure we do not slip back into the economic trough. Our four point plan includes incentives to restore consumer confidence, to restore business confidence, to increase affordable credit to business, and to eliminate unnecessary regulations. A copy is attached to this testimony.

For our purposes today, the most important aspect of our economic recovery plan is our call for incentives to restore business confidence.

Throughout our history (SBLC was founded in 1976), one of our guiding principles has been that the tax code should be used to direct economic activity to encourage the growth of small businesses. This principle has led us to participate in debates ranging from restoration of a capital gains rate differential to the establishment of a direct expensing provision and it most certainly has included any debate on the merits of an ITC, an incentive which we have consistently supported.

In fact, among several reasons, the elimination of the ITC was the most prominent for our opposition to the Tax Reform Act of 1986. We believed then, and still believe now, small corporations paid a high price for someone else's rate relief in 1986, with little to show in return.

One SBLC member, the National Tooling and Machining Association (NTMA), sums up the need for an ITC in these terms:

> "The rate at which tooling and machining companies have been able to invest since the 1986 repeal of the ITC has dropped sharply. A study by the John F. Kennedy School of Government at Harvard concluded that a mere '11 percent of smaller manufacturers are using advanced technology at this time.' Reducing capital costs is most important to small tooling and machining industry business owners, most of whose profit margins are under 5 percent of sales. An ITC would represent a down payment on a machine tool. A permanent ITC is considerably less burdensome in terms of administration than the incremental credit for big business, and would help the majority (67 percent) of NTMA member companies to increase their investment regularly, thereby maintaining a steady pace with advances in technology."

Moving specifically to the President's ITC proposal, I would like to offer a series of observations.

First, we have no position on the temporary, incremental ITC for firms with more than $5 million in receipts. Like everyone in this room, we can offer plenty of suggestions for what to do with the money "saved" by not enacting it. More than a few of our members believe not spending it and toting it up as another contribution to deficit reduction would be a boost to the economy, but we will defer to those at risk for its loss to make their case.

Second, the permanent credit for firms under $5 million appears to us to be close to hitting the mark in terms of potential constituency. If you use IRS statistics, there are around 19 million business returns in the tax-reporting universe. It is our understanding that almost 98 percent of those businesses would be eligible for the credit based on receipt size of the business. However, for these purposes, a more conservative estimate of the actual active business universe based on the number of businesses with employees may be more appropriate. Based on that definition, the small business community is somewhat smaller, probably numbering in the 5–6 million range. Finally, utilizing statistics for corporate filers provides a more accurate picture of the small businesses likely to use the credit. While this is not to say sole proprietors and partners do not operate thriving businesses, we think choosing corporate status is a better measure for the purposes of measuring the value of an capital asset investment stimulus. Among the universe of the more than three and

half million corporate entities, we believe 95.5 percent of them would be eligible for the credit.

These two points lead us to our first recommendation. As the temporary credit might be lost to companies with more than $5 million in receipts, and as the statistics suggest we do have some firms that might be considered small businesses but that sit on the margin of the President's size definition, it may be appropriate to consider raising the $5 million cap. If there is one thing that can be said about a company doing slightly more than million, it probably is that the company is one of the job creators we speak of most frequently. It would be a shame to lose the opportunity to help this productive job creator.

Given the fact most of the small business universe would be eligible for the credit, based on size, the logical question is: "Why isn't the small business community jumping for joy?" I must confirm the enthusiasm is not overwhelming, and keep in mind this is coming from a group that has said it will work with the President on his overall proposal, not torpedo it, and an organization that has been a long-time supporter of the ITC.

We do believe an ITC will help restore business confidence, but the proposed credit must be modified to achieve this goal. We see three reasons why the small business ITC needs to be modified. One relates to the structure of the proposed small business ITC; the second relates to the economic state of most small businesses; and the third relates to the impact of the President's entire proposal.

First, the small business ITC, while structured as a nominal rate of 7 percent for the first two years and 5 percent thereafter, in fact yields a much lower effective rate. The proposed ITC simply has too many restrictions attached to it. The two principal restrictions are the graduated ITC rate structure based on the recovery class life of the asset and the required basis adjustment.

As you know, for example, the ITC would be applied at a 1/3 rate for three-year property (such as tractors and special tools), 2/3 for five-year property (other vehicles, computers), and 4/5 for seven-year property (fixtures, furniture, office equipment). Some previous versions of the ITC have also had restrictions, but, in our opinion, these requirements were not as stringent as the restrictions in this proposal.

When it is all said and done, and the permanent nominal 5 percent rate is implemented, depending on the assets involved and the taxable income bracket of the taxpayer, we are looking at effective rates for small corporations ranging from slightly more than 1 percent up to just under 4 percent in 1995 and thereafter. The ITC should apply to both new and used equipment.

Second, depending on the assets involved and the tax status of the business, expansion of the direct expensing provision of the tax code, Section 179, may provide more opportunities for small business to invest in capital purchases. Currently, Section 179 allows small businesses to write off the first $10,000 of such purchases in the first year. SBLC was among the most prominent private sector advocates of Section 179 when it was considered and enacted by Congress in 1981. At the current time, in the absence of an ITC, it allows small businesses to weather the strains of most capital asset acquisitions by allowing immediate write-offs.

In 1980, the 1,800 small business delegates to the White House Conference on Small Business made enactment of a direct expensing provision their second priority. In 1986, the delegates to the second White House Conference on Small Business called for its expansion *and* reinstatement of the ITC.

For some small businesses, increasing the Section 179 deduction to $25,000 may be a preferable option to an ITC, particularly an ITC with as many restrictions as the one on the table now. We would imagine that it would have to be structured as a choice between the ITC or the direct expensing provision. In the absence of an ITC, we would be rather fanatical supporters of a direct expensing provision. However, we do believe the wisest course is to have a direct expensing provision that augments the ITC. Both serve a valuable purpose, but in slightly different ways. It will increase the number of small businesses able to avail themselves of some immediate capital cost recovery.

If one looks at the body of literature produced after the enactment of the 1981 Economic Recovery Tax Act and the 1982 Tax Equity and Fiscal Responsibility Act, you will find many articles illustrating the need for careful tax planning when a taxpayer is faced with a choice between expensing and an ITC. Such factors as the income bracket of the taxpayer and recovery class of the asset can determine the benefits of one over the other.

Finally, the enthusiasm of the small business community is tempered by the rest of the President's package. It almost goes without saying small business would much rather we achieve deficit reduction through spending cuts than through reve-

nue increases. Any revenue raising provision, even those that do not directly affect us, are more likely to have a negative impact on the economy than a spending cut.

Of critical concern, however, is the balance between small business incentives and those revenue raising provisions which hit closer to home. As a practical matter, for the vast majority of small businesses, the ITC is the principal item in the "plus" column. On the negative side, the vast majority of small business owners, whether they are sole proprietors, partners, or S Corporation shareholders, are most directly affected by personal rate changes. The President's proposal, through the personal rate increase, surtax, and limitations on a number of deductions such as the meal deduction or the lobbying deduction will affect many small businesses. While, as a percentage of all taxpayers, those likely to be affected by his personal tax proposals are few in number, the reality is a disproportionate number of them are likely to be business owners.

The problem is both personal wealth and business earnings are taxed through the personal rate structure. Only two million corporate taxpayers pay taxes based on corporate rates; all other businesses use the personal rate structure. Although it may appear on the personal return, income of a small business owner is also the retained earnings of a company poised to create jobs and make capital investments.

In this regard, we are particularly concerned about the impact on family-owned businesses operating as S Corporations. With the proposed personal rate increase and the 10 percent surtax on incomes over $250,000, many of these S Corporation shareholders will be paying taxes based on a marginal tax rate of 39.6 percent. For a successful small business S Corporation, with say, receipts of $5 million, it is quite plausible this will be the tax rate on the profits of this company. On the other hand, the proposed marginal rate for corporations with taxable income in excess of $10 million will be only 36 percent. Certainly, a competitive advantage. While one might argue this is not a likely scenario, there is a situation that is likely to be more common and is a cause for concern.

There are approximately 1.4 million S Corporations; most, we believe, are what anyone would describe as a family-owned business. We believe you will find more than a few closely held, family-owned companies, faced with a marginal tax rate of 39.6 percent on income of an amount above $250,000 (not an outrageously profitable or big company by any means) competing against a C Corporation with income up to $10 million that has a marginal rate of 34 percent. The marginal rate of 34 percent for C Corporations begins at $75,000.

While it may be true that fewer than one percent of all taxpayers report income in excess of $250,000, we would submit to you a significant number of these approximately 800,000 taxpayers are S Corporation shareholders, partners, or sole proprietors. Over 3 million partners and S Corporation shareholders reported net income in 1990, in addition to the 11 million taxpayers who reported net business or professional income.

The point is, you can help small business on one hand with an ITC, and take it away on the other with personal income tax rate increases or limitations on specific business related deductions.

In the end, SBLC believes something must be done to help the economy. We believe the President has struck a positive note and placed small business at the center of a forward-looking vision for America. We want to help get us there. We hope these comments have provided some basis for working with Congress and the President to achieve our shared goals. Thank you.

Attachment.

Members of the Small Business Legislative Council

Air Conditioning Contractors of America
Alliance for Affordable Health Care
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Nurserymen
American Bus Association
American Consulting Engineers Council
American Council of Independent Laboratories
American Floorcovering Association
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Travel Agents, Inc.
American Sod Producers Association
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
American Warehouse Association
American Wholesale Marketers Association
AMT-The Association for Manufacturing Technology
Architectural Precast Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated Landscape Contractors of America
Association of Small Business Development Centers
Automotive Service Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Council of Fleet Specialists
Electronics Representatives Association
Florists' Transworld Delivery Association
Helicopter Association International
Independent Bakers Association
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Communications Industries Association
International Formalwear Association
International Franchise Association
International Television Association
Machinery Dealers National Association
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Mechanical Contractors Association of America, Inc.
Menswear Retailers of America
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Catalog Showroom Merchandisers
National Association of Home Builders
National Association of Investment Companies
National Association of Plumbing-Heating-Cooling Contractors
National Association of Private Enterprise
National Association of Realtors®
National Association of Retail Druggists
National Association of RV Parks and Campgrounds
National Association of Small Business Investment Companies
National Association of the Remodeling Industry
National Association of Truck Stop Operators
National Chimney Sweep Guild
National Coffee Service Association
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Fastener Distributors Association
National Food Brokers Association
National Grocers Association
National Independent Flag Dealers Association
National Knitwear & Sportswear Association
National Limousine Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Ornamental & Miscellaneous Metals Association
National Paperbox Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Organization for the Protection and Advancement of Small Telephone Companies
Passenger Vessel Association
Petroleum Marketers Association of America
Power Transmission Representatives Association
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
Small Business Council of America, Inc.
SMC/Pennsylvania Small Business
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

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The Economy – A Small Business Perspective

The American public has spoken and clearly change is the order of the day. As early and outspoken advocates of an economic recovery initiative, SBLC welcomes the opportunity for aggressively pursing an economic recovery package. To be a small business owner is to be optimistic by nature. Pessimists do not become successful entrepreneurs. Therefore, we wish to offer this perspective on how we should proceed from here. We are convinced that with proper direction from government, small business can, and will, lead us back to the high road of growth, innovation, and job creation.

At this juncture, we believe there is no need for us to continue to fill the page with why an investment in small business is critical to the economy. We are persuaded the new Administration's commitment to such a course is self-evident.

As to what must be done, we recall the words of an SBLC Board member, representing home builders, who over a year ago expressed a common view among many of SBLC's diverse industries. He stated:

"It's obvious that some special fiscal stimulus is needed to ensure an economic upswing next year. The economy needs a quick and temporary stimulus to a component of private demand that will generate domestic spending and domestic employment."

Our greatest concern is the perception of a recession has become an ingrained reality. Said an SBLC Board member representing campground owners:

"The low level of consumer confidence is causing people to stay at home. Either they are afraid for their own future, or don't 'feel right' traveling when so many of their friends and relatives are out of work or on the brink."

Unfortunately, we are all too familiar with the stages of a recession. Individuals fearful of losing their jobs do not spend; businesses losing sales become reluctant to take risks; and, as money is not spent, jobs are cut. That self-perpetuating cycle remains in place today. While recent economic signs are promising, unless the cycle is firmly broken through targeted government action, the economy will lapse back into the doldrums. One SBLC Board member observed about the impact of the recessionary cycle in his industry:

"A substantial number of the small firms in the video, computer, audio-visual, multimedia, teleconferencing, and high definition businesses filed for bankruptcy or closed their doors this year. Reverberations from these events affect every company in the association suppliers have become extremely cautious about offering credit, making shipments, and providing dealer support. Dealers have quit carrying inventory, relying on suppliers to ship immediately after a sale has occurred. By now, most suppliers have been stung with losses because of a failure by one or more of their dealers and they are taking every precaution to avoid being caught in another. For the next few months, some of the top supplier executives will spend more time on creditor committees than they will spend out 'in the field' selling their products. Some suppliers have merged. Others have quit manufacturing and are just selling off inventory at major discounts."

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In our view, the cycle can be broken in several places:

Business Confidence Must Be Restored *Business must be coaxed into risk-taking, job creation, and expansion*

We were among a very small group that did not find the 1986 Tax Reform Act, at that time, to be an attractive alternative. Our feeling was the tax code should be utilized to encourage certain kinds of economic activity. We believed then, and do now, small business paid too high a price in the loss of items such as the investment tax credit (ITC), for reductions in somebody else's tax rates. Parenthetically, we might note, in the mid 1970s we were in the forefront of the fight to establish a graduated, progressive corporate rate structure.

We support the re-establishment of an ITC. We do, however, offer the observation that a targeted ITC will have only limited appeal to the small business community, and if we truly want to pull the small business sector back into the job creating mode, we need to augment the ITC in two ways. We need to provide direct efforts to encourage the creation of jobs and we need to encourage capital asset investment by all small businesses. We believe you can fashion a program that offers small businesses a choice based on their needs.

Taking the latter concern first, we can augment the targeted ITC by increasing another capital asset investment incentive which already exists in the code and is specifically targeted to small business. Current law allows small business to "direct expense" capital assets. This provision, enacted in 1981, allows businesses under a certain size to write off up to $10,000 of the cost of assets in the year in which the assets are purchased.

We might observe, the champions of the provision in 1981 were a number of leading Congressional Democrats including the current Chairman of the Committee on Ways and Means, Representative Dan Rostenkowski. (SBLC led the fight for it in the private sector.) In 1981, the original proposal would have permitted a first year write-off of up to $25,000. Given the years that have passed, we suggest making it $50,000, but continue to limit it to businesses under a certain size to limit revenue losses. The small business would choose either the ITC or the direct expensing provision. In 1981, the Democrats listed these reasons for the small business direct expensing provision:

"It is simple because it eliminates the need for complicated accounting procedures and depreciation formulas;

"It is fair because it treats all facets of the business community equally; and,

"It is unaffected by inflation because, when it is fully operative, the full deduction is taken in the year in which the investment is made."

While we find the argument for an ITC compelling as we need to continue to push the edge of the envelope on technology, the fact is, small business remains a sector built on human capital. While we must invest in the long-term job growth potential within small business, if the election is a mandate, it is a signal that we need to address the "here and now." *Offering a New Jobs Tax Credit (NJTC) as an alternative choice to the ITC can help tip the scales in favor of new hiring. Payroll is the link between risk-taking and reality.* It is also the common bond of successful small businesses. The ITC and other risk-taking incentives can open up the door to the future, but payroll responsibilities come with the step through that door.

As part of the Tax Reduction and Simplification Act of 1977, Congress enacted a ***new*** jobs tax credit equivalent to 50 percent of the increase in each employer's wage base. Create a job, get a credit. After only one year, Congress killed the credit and replaced it with the more familiar targeted jobs tax credit which was and is limited to the hiring of individuals from certain target groups. In truth, the NJTC was enacted by Congress over the objection of the Treasury Department and was never given a fair shot.

In fact, most of the post-mortems conducted on the NJTC do agree on two crucial points. First, they agree the primary reason the NJTC did not work was that most employers did not know about the credit. Virtually nothing was done to promote the credit. Ironically, the little statistical data on the NJTC does suggest a trend was in place, the credit was assisting the job creation process, but the NJTC was snuffed out before the trend could become a reality. See, for example, The New Jobs Tax Credit: An Evaluation of the 1977-1978 Wage Subsidy Program, 69 American Economy Association, 173.

The other fact which the post-mortems reveal is the credit was misplaced as an "income" tax credit. A new jobs tax credit should be a ***payroll*** tax credit. After all, this is why we need more than an ITC. Scratch almost any small business and what do you find underneath? Payroll taxes. The NJTC is a good way to make contact with a touchstone for all small business' - payroll taxes. For most small businesses, labor is the name of the game. Furthermore, like it or not, the service sector is and will remain an important part of our overall economy. The service sector is small business and the service sector means jobs. *The*

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important message here is, economic recovery must address human capital concerns of small business as well. And, in every day terms that translates into payroll burdens.

Indeed, the history of the 1977 economic debate can offer clues as how to combine the ITC with a new jobs tax credit, the direct expensing and a fourth component, worker training, to provide business with choices within the framework, that work best for them. The overall incentive would be limited to a specific amount, but the small business could choose the specific alternative that allows the small business to grow and create jobs.

Finally, we do believe an injection of government spending on restoring the nation's infrastructure will produce short-term job creation benefits and long-term productivity dividends.

While our focus today is on what we *can* do, we do offer one observation about what we *should not* do. To understand the heart and soul of the small business community today, it is necessary to understand the significance of the words "family owned." If there is one issue that can galvanize and unite the small business community, it is any attempt to change estate tax laws. The 91st Congress learned that lesson the hard way with respect to Internal Revenue Code Section 2036(c). The subject transcends the statistics, it is a matter of emotion. For many small business owners, the business is everything. It is their legacy, it is their retirement, it is their way of life. As an SBLC Board member who represents retail grocers, observed:

> "Family owned business are not short-term concerns. A real family sees itself as a closely bound, dynamic entity yesterday, today and tomorrow. The realistic potential of meaningful passage of business from one generation to another is often the principal motivation for the ongoing prosperity. For the present generation, the prospect of future appreciation, represents a great legacy to his or her children. It also frequently represents a personal guarantee of retirement security. In both instances, again and again, we must acknowledge that it often partially or totally sustains the actual day to day business operation."

Consumer Confidence Must Be Restored *The consumer must be convinced to make an investment in new products*

In our opinion, across-the-board cuts in individual tax rates will not restore consumer confidence. While the numbers in aggregate sound impressive, to the individual it is not sufficient to encourage the consumer to reenter the market. Many polls indicate the consumer will reduce debt. In normal times, encouraging saving is a worthwhile goal; in a recession built on a foundation of pessimistic perceptions, it is of little or no help.

Rather, we believe the tax code can be utilized to encourage economic activity. In truth, our economy is still driven by "big ticket" items such as homes and cars. While we are not recommending a specific agenda, it is a housing purchase tax credit, consumer interest deductibility, a tax credit for trading in an old car for a new one, a tax credit for the purchase of certain significant consumer goods or services which can not only save the taxpayer money, but also stimulate the economy.

Adequate Credit Must Be Readily Available *Banks, other financial institutions and investors must be ready and willing to lend and/or invest in the potential of our economy*

Finally, we remain convinced our credit and financing systems remain skewed against small business. Whether it is venture capital or working capital, we continue to hear a steady drum beat from small business that credit is not available.

What are the problems? Is it a too cautious banking community? Is there still too much regulation? Why is it so difficult for mature, stable businesses to maintain a line of credit?

We believe we can put our banking and small business financing systems back on track and we can begin the process by appointing bank regulators that have evidenced an understanding and appreciation for the credit concerns of small business. We need to examine bank capital requirements and lending guidelines. Finally, we support community development banks developed in such a fashion that there would be access for small business in urban areas.

Do we have a national policy to promote a steady flow of risk capital for entrepreneurial activity? The tax code, through appropriate treatment of capital gains, can stimulate activity. Since 1986, we have put serious holes in the venture capital pipeline. An SBLC Board member, representing the venture capital industry, observed:

> "The venture capital industry is undergoing the toughest economic time since 1974. Money raised by venture funds is down 75 percent since the high-water mark in 1987. There has been a corresponding falloff of investments in new and emerging small businesses by the venture industry."

SBLC supports a small business targeted capital gains exclusion as proposed by Senator Bumpers.

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Arbitrary, Government-imposed Additions to the Cost of Doing Business Must Be Controlled *External factors, such as the cumulative impact of government regulations, should not contribute to the inflation of the price of goods and services*

Paramount among our concerns is the unending upward spiral of health care costs and its impact on small employers and employees. In that regard, SBLC has been a long-time supporter of comprehensive health care reform.

Throughout this debate we must be mindful not to impose counterproductive burdens on the small business community. In that regard, we believe the economic package must remain narrow in focus on *providing positive incentives to the economy*. The government has added an extraordinary amount to the cost of goods and services. When a printing firm must cope with 40 different environmental laws, or a tooling and machining shop with 800 Defense Department procurement-related laws, common sense suggests there is something wrong with the equation.

One of the fundamental problems with the way Congress develops public policy which produces regulatory costs for small business is it fails to assess the cumulative impact of all related regulatory initiatives. Perhaps an increase in the minimum wage in and of itself is modest, the cost of mandated parental leave does not appear overwhelming, or the cost of health care, while significant, is not back-breaking, but add them together and the costs are indeed counterproductive. Likewise, take an underground storage tank law, a hazardous waste disposal program, clean air rules, and a dozen more environmental rules and it is no wonder that the small petroleum marketer is caught in a spiral of increasing costs. Said an SBLC Board member who represents that industry:

> "Extensive environmental requirements being imposed by Federal, state, and local officials have added enormous new costs to not only the construction of new service stations, but also to the maintenance of existing ones. The costs are so substantial that some marketers have had to close numerous outlets."

The government should not be in the business of pricing goods and services out of the range of affordability for consumers. The regulatory burden today is greater than it was during the late 1970s. The implications are quite apparent.

SUMMARY

In conclusion, we are not so naive as to believe we can wave a magic wand. To accomplish some of these tasks involves trade-offs. How we pay for these efforts must be resolved. Adjustments in our spending priorities and adjustments in our progressive tax rate structure are two options.

We do favor linking the short-term economic stimulus package with a long-term deficit reduction measure. In this paper we have focused on the short-term but, in no way should this be interpreted as a signal of change in our opinions regarding the Federal deficit. We simply cannot hope to sustain an economic recovery without substantial reductions in the deficit. Although the task will be painful for all, we cannot shrug off the task. In that regard, we do applaud two recent initiatives for their candor. While we have not had an opportunity to work through all of the specifics of their recommendations, we are favorably inclined to agree with the basic approaches of the "Strengthening America Commission" and the "Concord Coalition" to addressing the deficit problem.

We understand the trade-offs in both the short-term for the an economic recovery package and in the long-term for deficit reduction and are prepared to help make the hard choices.

We see this moment as an opportunity for small business growth. We are prepared to make it work as a partnership for the benefit of the nation and small business.

Finally, some say nothing we do today can help before the recession ends of its own accord. We disagree. Immediate targeted government action is necessary, or it will not end. The consumer and business owner will respond to economic encouragement. The perception/reality cycle must be firmly broken.

We look forward to working with the Administration and the Congress in the months ahead. We stand ready to assist during the transition period and beyond.

The SBLC is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. While our policies are developed through consensus among our membership, we respect the right of individual associations to express their own views. For your information, a list of our members follows.

PREPARED STATEMENT OF VICTORIA MUÑOZ

PUERTO RICO: A STRATEGY FOR INVESTMENT AND EMPLOYMENT

Only half a century ago Puerto Rico remained one of the poorest countries of the Western Hemisphere, described as the "Stricken Land of the Caribbean," with a per capital income of $140 per year, life expectancy at birth of 45 years, and about 56% of school-age children had no schooling. Starting in the late 1940's, under the leadership of Luis Muñoz-Marín and the Popular Democratic Party, Puerto Rico pursued an economic development strategy based on attracting private offshore investment in manufacturing to generate thousands of jobs for one of the most overpopulated areas of the world, with scant natural resources. Combining free access to the U.S. market, U.S. constitutional protections and low effective tax rates, our industrial plan, led by former U.S. Ambassador Teodoro Moscoso and known as Operation Bootstrap, transformed Puerto Rico. Employment increased more than 50%, from 596,000 in 1950 to more than 900,000; GNP escalated from $3.7 billion to over $34 billion presently; exports today exceed $21 billion, more than the rest of the Caribbean combined. A rural, agricultural backward society was transformed into an industrial, urban and modern society.

This export-oriented strategy of economic development based on free markets, private investment, and increasing labor productivity is today the model of development pursued worldwide, from Ireland to Singapore, from Poland to Chile. With limited arable land, ample competition in tourism throughout the Caribbean Basin, the manufacturing sector has become the principal component of Puerto Rico's economy. Manufacturing generates 40% of the Puerto Rico's Gross Domestic Product. With a population density of over 1,000 persons per square mile, higher than India, Pakistan, Japan and China, an official unemployment rate of 18%, and more than half the population living under the U.S. poverty line, Puerto Rico remains a developing economy, critically dependent on outside investment for its growth and employment. In competing for investment worldwide, Puerto Rico's comprehensive tax incentives program plays a key and fundamental role.

Manufacturing employment in Puerto Rico has evolved over the years toward higher value added, more technology and capital intensive industries, as the more labor intensive employment has migrated to areas offering lower paying jobs throughout the Caribbean Basin and the Far East. In the last twenty years, high-tech industries employing better educated, skilled workers for the manufacture of pharmaceutical, precision instruments, computers, medical devices, and electrical/electronic components have proliferated in Puerto Rico. Year after year, Puerto Rico's world class industrial work force maintains exceptional quality standards in the manufacture of products shipped worldwide.

Our future growth will necessarily come from accelerating the development of the more technology and capital-intensive sectors, focusing on emerging industries with leadership in technological development. This strategy will permit us to continue to upgrade our Island's human capital, achieve stability in employment and assure Puerto Rico's participation as an important location for global production in the 21st century. This outward-looking strategy is the only policy choice available to us if we want to continue our economic development. As American citizens, Puerto Ricans expect to narrow the gap between the average per capita income in the U.S. and that in Puerto Rico. This can be accomplished over time by implementing economic policies for growth and employment, rather than greater dependence in federal transfer funds.

Puerto Rico's development story evidences the fruits of effort, initiative, investment—the same prescription President Clinton has eloquently proposed to the American people. His vision is ours. As U.S. citizens, Puerto Ricans wish to share in the collective effort to move America forward. Even though it is the poorest jurisdiction in the United States, Puerto Rico should and can contribute, but in ways consistent with our development strategy. Such contribution must be based on what is fair for our economy relative to the sacrifice that the U.S. as a whole is being asked to make. President Clinton's proposal represents annual revenue increases of approximately 1.3% of U.S. GNP. In contrast, the $2.2 billion which the U.S. Treasury proposes be taken out of Puerto Rico's economic system in 1998 represents 6.4% of Puerto Rico's GNP, a burden five times greater. This disproportionate contribution is not fair.

President Clinton's objective to reduce the deficit can be achieved in ways that avoid adverse effects on Puerto Rico while maintaining the effectiveness of incentives for economic growth. With appropriate adjustments to Section 936 provisions allocating intangible income between Puerto Rico and the United States, additional revenues would be generated for the U.S. Treasury, while Puerto Rico protects its

investment climate with a predictable and stable pattern of policies that will result in incremental employment for our people. It is important to provide stability to this program, so that all who participate in the 936 system, from investors to employees, from local municipal governments to Caribbean nations, can rely on its continuity.

Section 936: An Essential Economic Development Tool

Section 936 of the Internal Revenue Code, and its predecessors dating from 1921, complemented by the industrial tax incentives laws of the Commonwealth of Puerto Rico, has been the critical element in the modernization of the Island. Section 936 has effectively implemented the long-standing federal tax exemption on income locally generated in the Commonwealth of Puerto Rico.

Section 936 works. It permits the Government of the Commonwealth of Puerto Rico to forego some tax on income earned in Puerto Rico so as to successfully compete for manufacturing investment with other developing economies, offering effective tax rates ranging from 7 to 12%. This investment means jobs, increased productivity and a higher degree of self-sufficiency for all Puerto Ricans. Section 936 accounts directly and indirectly for over 300,000 jobs, more than one third of all jobs, and generates over 35% of the funds on deposit in banks in Puerto Rico. These deposits provide the liquidity so that banks can support investments in the commercial, industrial and tourism sectors. In fact, 936 is a system that connects all the components of our economy to make it viable.

Once the poorhouse of the Caribbean, Puerto Rico today enjoys the highest standard of living in Latin America. Our annual per capita GNP of $6,753, although still only a third that of the United States, is nevertheless seventeen times greater than it was in 1950, and more than twice that of countries such as Brazil and Venezuela, which are rich in natural resources and not as densely populated as Puerto Rico.

Section 936 is not a mere tax provision; it is a system that provides the basis and foundation of the transformation of Puerto Rico from extreme poverty to a developing economy, from hopelessness to increasing self-sufficiency.

Curtailing Section 936 Will Destroy Growth

The Treasury Department has proposed a cap to the Section 936 credit equal to 60 percent of the total wages paid to employees (as defined by the Federal Unemployment Tax Act (FUTA)). Those Section 936 labor intensive industries whose labor costs are high, relative to total output, will continue to enjoy exemption from federal tax. Due to increased competition from low wage Caribbean and Pacific Rim nations, Puerto Rico has lost 11,000 jobs during the past decade. With Section 936 we have replaced these jobs with high-skilled, better paying employment in capital intensive industries. But for each labor-intensive plant we lose to a low-wage area we have to establish 10 to 15 new capital intensive plants, with fewer jobs per plant, but with higher wages. Unfortunately, these highly productive manufacturers would, in effect, become subject to federal taxation on income derived from Puerto Rico under the proposed wage-based cap, at a rate proportional to the productivity of labor employed—the higher the value added per unit of labor, the higher the effective federal tax. In general, manufacturing income generated in Puerto Rico would become subject to an effective federal tax rate of approximately 24%,[1] ranging from a zero rate for apparel, textiles and leather products, to a 16% effective rate for electronics, 17% effective rate for instruments and related products, and 28% effective rate for chemicals and related products.

Investment decisions are made, however, on marginal, not average returns. For corporations subject to the wage cap, incremental decisions, whether to expand or contract operations at the margin, will likely face the effective tax rate applicable on its U.S. operations.[2] Clearly, imposing federal taxes of this magnitude will have devastating effects on the viability of Puerto Rico as a production location. When combined with our own local taxes of 7 to 12%, which are only deductible but not creditable against U.S. tax liability, the combined federal and Puerto Rico tax burden *at the margin* will exceed the tax imposed in the United States, and, more significantly, far exceed the effective tax rates of Puerto Rico's manufacturing competitors, such as Ireland, Singapore and Taiwan. The industrial sectors most adversely affected will paradoxically be those the United States most desires to promote—those generating skilled jobs, at high wages, but requiring substantial capital investment and a world class work force.

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[1] Estimate based on IRS, *U.S. Possessions Corporation Return, 1989* (assuming a 36% corporate tax rate).

[2] To the extent labor is not a fully variable input, the marginal tax rate approaches the statutory rate.

Increasing taxes on returns to capital will necessarily result in reduced investment in new plants, machinery and equipment in Puerto Rico, slow the pace of economic growth, estimated at 16 to 26 percent,[3] and stymie job creation. A study conducted for the Associated General Contractors of America on the proposed 65% way-based cap concluded that the growth of the Puerto Rican economy would decline from 3% to—.03% per year, with the manufacturing sector contracting 7% in real terms annually, resulting in a total job loss of between 85,803 and 101,237. This is equivalent to a loss of 10 million jobs in the U.S. economy. How is Puerto Rico expected to offset these dramatic adverse effects on investment and employment growth? Significant increases in federal social spending would be necessary. The Congressional Budget Office conducted the most comprehensive and objective study on the consequences to Puerto Rico of eliminating the tax incentives under Section 936, substituting it with the full range of social programs not now available and with additional federal outlays exceeding $2 billion per year.[4] CBO generated a macro-economic model of the Puerto Rican economy to simulate the effects of such fiscal changes. CBO found that investment would be reduced by 62 to 73%, exports drop 33 to 43%, with a loss of 50,000 to 100,000 jobs, nearly one out of six private sector jobs, a drop of 25% in wages and a reduction of 10 to 15% in GNP.

Curtailing Section 936 as proposed by the U.S. Treasury Department will impose comparable costs to Puerto Rico. While the proposed curtailment only approximates outright elimination for some firms, the CBO analysis illustrates the likely consequences for affected firms.

Higher taxes in a developing economy, particularly where, as here, the taxes collected would not be reinvested in Puerto Rico is no economic strategy. The inevitable result of this unprecedented taxation of Puerto Rico operations will be a severe contraction of the Puerto Rican economy. The resulting job loss and economic decline will hit the poorest jurisdiction in the United States. While Puerto Rico is prepared to contribute, it is being asked to withstand a severe blow to its long-term economic viability, because it will be forced to abandon a development strategy for investment and employment that has served it well and is today the only hope for economic growth.

Curtailing Section 936 Will Limit Investment in Puerto Rico and Throughout the Caribbean Region

In addition to providing tax incentives for Puerto Rico business operations, Section 936 operates to exempt from federal tax investment income earned in Puerto Rico from re-investing profits in local financial institutions and designated activities. This feature of Section 936, adopted in 1976 to encourage investment in Puerto Rico and facilitate repatriation to the United States, was amended in 1986 to encourage investment projects throughout the Caribbean Basin.

Section 936 funds amount to nearly $18 billion, invested in productive activity in Puerto Rico and the Caribbean Basin. Section 936 funds account for nearly 35% of our local bank deposits. The proposed curtailment of Section 936 funds to 80% of active assets would cut back available investment capital by nearly two-thirds. The effect of the curtailment of the 936 credit will be to substantially cut back the 936 market and cap its future growth resulting in immediate repatriation of a substantial amount of funds. Neither result is beneficial to the economic development of Puerto Rico or the Caribbean Basin. Since 1986, Puerto Rico's Caribbean Development Program has achieved impressive results complementing U.S. policy toward the region. To date, 101 projects have been promoted in 12 Caribbean countries. These projects have created more than 29,000 direct jobs in the Caribbean. Over $950 million of this investment is being funded by Section 936 funds. These funds are today the largest source of concessionary financing for the region, exceeding the amounts invested in eligible CBI countries by multilateral international institutions.

During the 1992 Miami Conference on the Caribbean, President Clinton said: "Improved economic growth in the Caribbean Basin is in the direct interest of the United States. It helps to create jobs and exports for the U.S. It helps to promote the ideals of democracy, which are important for us not only in our own nation, but throughout this Hemisphere." Curtailment of 936 jeopardizes this proposal for the Caribbean. Many countries in the region have entered into to Tax Information Exchange Agreements with the U.S. in order to qualify for the use of 936 funds. These agreements are valuable to the United States in its war against drugs and tax evasion. Many Caribbean and Central American countries took painful measures to

[3] *The Impact of Section 936 on Puerto Rico's Economy and Construction Sector,* Associated General Contractors of America (April 1993).

[4] *Potential Economic Impacts of Changes in Puerto Rico's Status Under S. 712,* Congressional Budget Office (April, 1990).

enact and ratify these agreements, expecting the U.S. to uphold its regional commitment. A significant reduction of 936 tax credits, and the additional limitation on exempt passive income, as proposed, will significantly limit the amount of funds available for development projects in the Caribbean.

Proper Allocation of Intangible Income Achievable Without Curtailing Section 936

The rationale underlying the proposed curtailment of Section 936 is the alleged disproportion between tax exemption and wage compensation. This disproportion is also found in other exemptions and exclusions, including the foreign tax credit and deferral provisions. To some extent this variance responds to the high profitability of capital intensive production. The proper inter-company allocation of intangible income is a world-wide concern that can be properly addressed in an integrated fashion without singling out Puerto Rico. The current allocation of intangible income between the U.S. and other jurisdictions should be re-examined as part of the President's recovery package so as to more correctly reflect the origin of the income. With respect to Section 936 the current profit-split formula could be revised for U.S. tax purposes only in order to achieve revenues commensurate with Puerto Rico's fair contribution to the President's economic plan. This can be achieved in a manner consistent with the unique and special relationship between Puerto Rico and the United States.

Summary and Conclusion

By adjusting the formula for the allocation of intangible income, the U.S. Treasury will raise its fair share of revenues without causing significant damage to Puerto Rico's economic system and its development strategy for investment and employment.

Puerto Rico finds itself at perhaps the most critical stage for industrial growth, as it seeks to chart the course of future economic development to improve the standard of living of the 3.6 million American citizens on this Island. Already twice as poor as the poorest state of the Union, Puerto Rico must spur economic growth. It no longer enjoys a comparative advantage in labor-intensive industries. As the world moves toward the elimination of restrictions on trade and investment, like NAFTA proposes to do with Canada and Mexico, Puerto Rico must find niches that will permit it to stay competitive in today's global markets. In manufacturing, Puerto Rico emphasizes capital intensive, high technology industries that produce higher value-added products that can best utilize our abundant skilled work force. Puerto Rico is breaking into the field of scientific research, engineering design, and computer software. It is the direction that the high-technology manufacturing strategy has taken, supported by highly sophisticated services, such Puerto Rico having become the financial center of Central America and the Caribbean.

The proposed wage cap is inconsistent with this strategy. It is detrimental to Puerto Rico and will set back the implementation of our development strategy. It is in the best interest of both the United States and Puerto Rico that an agreement be reached on this matter without curtailing the capacity of the people of Puerto Rico to be a productive society that makes a real contribution to the well-being of the Island, the Caribbean Basin and the United States of America. President Clinton has said that for the U.S., his proposal "should result in a higher rate of economic growth, improved productivity, higher wages, more high quality jobs and an improved economic competitive position in the Global Economy." Ironically, for Puerto Rico this proposal means stagnation, diminished productivity, lower wages, lower quality jobs, and a greatly deteriorated competitive position.

Attachment.

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The Realities

On the one hand is the apparent reality that the economic activity generated by the 936 companies provides jobs for 109,000 workers in Puerto Rico, who enjoy comparatively high salaries within the framework of the high level of unemployment in Puerto Rico. We say apparently, because the testimony heard in the Senate from the mayor and former mayor of Comerío indicates that despite the fact that the Planning Board certified that there were more than 500 manufacturing jobs in that town as of December 31, 1992, the reality is that there are only 77 jobs, 8 of them derived from 936 companies. If this situation is repeated in other towns, contrary to all the official statistics, there is a real possibility that the 936 companies currently generate less than 100,000 direct jobs. Furthermore, the employment of a minimum of another 100,000 Puerto Ricans is derived indirectly from the economic activity generated by the 936 companies. While the estimates of indirect jobs generated by the 936 companies vary according to the source providing the data, there

is a consensus that the total stated above represents the minimum number of indirect jobs. Consequently, the economic welfare of some 200,000 Puerto Ricans is intimately tied to the 936 companies.

From Puerto Rico's perspective, the 936 companies contain elements that are both positive and negative for our aspirations for progress. On the negative side, they represent a fragile economic model that depends on a variable we do not control and that can be eliminated at any time. They also represent a dangerous dependency on a single instrument of development. In the past, the fact that Puerto Rico does not pay federal taxes has been used as an excuse by many members of Congress to deny Puerto Rico parity in certain federal social welfare and economic development programs, such as Medicaid and Supplementary Social Security (SSI).

But on the positive side of the equation, from the federal perspective the 936 companies contribute to the economies of the States and help further U.S. foreign policy objectives in the Caribbean.

The Myths

The unconditional defenders of the current scheme of federal tax benefits enjoyed by the 936 companies have had to exaggerate the magnitude of the repercussions any change in the existing scheme would have on our economy, in order to justify and magnify its importance to the Puerto Rican economy. Those who oppose to the death the existing system of benefits of the 936 companies tend to obviate the reality of the impact that the immediate elimination or substantial modification of those benefits would have on Puerto Rico's economy. Both factions, the unconditional defenders and opponents, structure their arguments with slanted focuses on selected information that supports their respective positions.

Fortunately for the island, the proposals of Senator David Pryor and President Bill Clinton do not call for the immediate elimination or substantial modification of the tax benefits, but rather a redefinition to be implemented gradually, that should not occasion economic dislocation.

The Purpose of this Report

The evaluation contained in this report is an effort to go beyond the partisan schemes or special interests, with an indestructible faith that we can transform the tone of a lack of solidarity now prevailing in Puerto Rico. We have focused on this subject with frankness, impartiality, scientific analysis and in a creative spirit.

The 936 companies have been an instrument that in their day were beneficial to the economic growth of Puerto Rico and that can continue to provide such benefits even if the existing form of the tax code is altered. In the past, the 936 corporations have reacted with complacency and inaction to petitions for reform made by the IRS and other public policy sectors. In many cases, they have confused constructive criticism for censure. The Federal Affairs and Socioeconomic Development, Tourism, Commerce, Industrial Development and Cooperativism committees wanted to take advantage of the current juncture to carry out a carefully considered exercise of broad reexamination of the whole matter of the 936 corporations.

In this report, we defend those aspects of the 936 corporations that can be defended. We suggest amendment of that which fair and impartial analysis shows to be obstructive of the Puerto Rican people's legitimate aspirations for economic and social progress. We recognize that the current situation represents an opportunity to test our creative ability in finding solutions and mobilizing our force of spirit to overcome obstacles to economic and social progress. The leaders of our people must prepare themselves now to draft alternative strategies to the 936 tax benefits to face the coming century; this has already begun to be seen in the proposals of the Governor of Puerto Rico and other officials.

Facing the 21st Century

The new century will be filled with new challenges and opportunities that will require an evaluation of traditional patterns. We are on the threshold of an era of the formation of economic blocs, transformations in systems of production, where technology and information will predominate. This trend toward the globalization of the economy has an impact on all systems and is a source of uncertainty. There is greater competition within the United States and elsewhere to attract and hold manufacturing enterprises. Puerto Rico must be in the vanguard in the search for a new pattern of economic development. This report is an effort to establish the bases for the search for that pattern, as well as to offer short-term alternatives that take into consideration the interests of Puerto Rico and those of the federal government, at a time when the United States is facing one of the worst budgetary deficits in its history.

II. SUMMARY OF THE PROBLEM

What is Section 936?

It is a provision of the U.S. Internal Revenue Code that establishes the rules under which U.S. corporations operating outside the 50 states, in U.S. territories and possessions, will be exempt from federal taxes on earnings from operations in those territories and possessions. Under these rules, they also are exempt from taxes on passive income generated by passive investments in the territories, such as bonds, mortgages and other investment in the development of the territories.

It has been estimated that tax benefits under Section 936 represent an annual cost of more than $2.3 billion to the U.S. Treasury in revenue that is not received.

How does a Corporation Qualify?

A corporation must meet two criteria. First, that 80 percent of the corporation's gross income must be from sources with the territory. Second, that 75 percent of all income must result from active participation in trade or a business in the territory. . . .

IV. CURRENT FRAME OF REFERENCE TO DEAL WITH THE PROBLEM

Employment History

During recent years, employment in manufacturing has remained relatively stable. The maximum level of employment in the 1970s was 147,000 jobs in 1974, increasing to some 150,000 in 1991. Puerto Rico's unemployment rate has always been high. There is data that puts unemployment in 1898 at 17 percent, and nearly 100 years later, in 1992, it is still at 17 percent. The unemployment rate has never dropped below 10 percent in the past century. In 1969, in the administration of Governor Luis A. Ferré, unemployment dropped to 10.2 percent. In 1940, it stood at 15 percent, which means that today we are at the same place we were in 1940 when our industrial development pattern was put into place.

As can be seen, the increase in jobs has not been significant, although it should be recognized that today's jobs not only are better paid, but more stable than those initially created under Operation Bootstrap. Today's jobs are better because of the technology and massive investment made by the 936 corporations in their industrial complexes in Puerto Rico. Total investment of 936 corporations in physical facilities in Puerto Rico is estimated at around $6 billion. Furthermore, these corporations have made investments in the development of our human resources, complemented by federal wage incentive programs for the training of their employees, in order to carry our highly complex manufacturing processes using sophisticated equipment.

The Boom in Corporate Earnings

The earnings of these high-technology, capital-intensive industries increased enormously to the point where the cost of the tax exemption under Section 936 was notable. It is more notable, particularly when the IRS compares the cost versus benefit of the program on the basis of the federal tax credit for each job created by these companies that, because they are capital- and technology-intensive, do not create a high ratio of jobs to earnings.

The Situation from the Perspective of the Treasury

The U.S. Treasury Department views the situation of jobs created versus tax incentives in the 936 corporations somewhat differently from the picture presented in the paragraph above. In the most recent report available, 1989, the net earnings that year for 936 corporations operating in Puerto Rico totalled $7.730 billion. According to the IRS, these companies saved $2.274 billion. This tax saving represented $22.373 per employee while the average salary was $20,550 per employee. When the situation is analyzed specifically for the pharmaceutical industry, the average tax saving was more than $66,000 per employee while the average salary was $30,000 per employee. Currently, earnings are estimated at around $10 billion and the tax saving at about $3 billion.

After analyzing these figures, the federal government's concern about Section 936 is understandable. While the earnings of these corporations have increased significantly in recent years, there has not been a significant increase in the number of jobs.

The Question of the Intangibles

Another area of complaint and discontent for the IRS and the Congress is the handling by 936 corporations of patent rights and other intangibles. These companies spend millions of dollars on research and development.

The research and development for these products takes place in the States. The parent company makes deductions for this research and development in its federal tax returns and saves taxes with these deductions. In some cases, the federal government has incurred the development expenses because the research was conducted in government laboratories.

The parent company obtains patents on the products, which gives it exclusive rights to produce the product for periods of up to 17 years. The parent company transfers these patents to 936 subsidiaries in Puerto Rico, exempt from local taxes in Puerto Rico and exempt from federal taxes. This transfer makes a company's research and development aspect a highly lucrative business, since the monopoly granted for the sale of new products allows the subsidiary to set extremely high prices.

The Situation of the Pharmaceuticals

IRS statistics show that in 1989, the pharmaceuticals received 49 percent ($1.4 billion) of the tax credits while employing only 17 percent (18,000) of the total employees in 936 corporations in Puerto Rico. The remainder of the 936 corporations received only 51 percent ($1.4 billion) of the tax credits while employing 83 percent (87,500) of the total employees in 936 corporations.

The following are some dramatic cases. According to IRS figures, in 1991 a pharmaceutical company reported $204,375 in tax credits for every job created, which represented an increase of 200 percent over the tax credits in 1989.

According to 1987–1989 IRS statistics, the Section 936 pharmaceutical companies showed a reduction of 383 jobs. Employment in the pharmaceuticals dropped from 18,384 in 1987 to 18,001 in 1989.

The Situation of the Other 936 Corporations

The hypothesis could be put forward that for most of the 936 corporations in Puerto Rico, a change in the rules to a wage-based tax credit would not represent great changes in the payment of federal taxes. According to IRS figures for 1989, 57 pharmaceutical companies received $837 million in tax credits in excess of the wages paid to their workers, while another 460 companies received $184 million less in tax credits than wages paid. For those 460 companies, the changes would not have a substantial impact.

What's Different This Time?

The only difference from the challenges of the past to the tax incentives under Section 936 is that this time, at the federal level, the same party controls the White House and the Congress, and President Clinton's economic plan includes tax increases and a level of national sacrifice for all sectors of the economy. Furthermore, President Clinton's priorities have placed the cost of health services in first place, and, as a result, put the tax-free earnings of the pharmaceutical companies pursuant to Section 936 under Congressional scrutiny.

The Impact of the QPSII Provisions (Qualified Possessions Source Investment Income)

Passive income in the form of interest from 936 corporation earnings deposited in Puerto Rican financial institutions is known as QPSII (qualified possessions source investment income).

The funds of 936 corporations deposited in local financial institutions as of December 1992 totalled $9.9 billion. Of that total, 42.3 percent was deposited in domestic banks, 25.6 percent with stock brokerages, 23.9 percent in foreign banks and the remainder in savings and loan institutions.

As a percentage of the total funds deposited in Puerto Rican domestic banks, the 936 funds represented only 17.4 percent. For U.S. banks, the total was 48.8 percent, for Canadian banks 47.5 percent and for Spanish banks, 31.3 percent.

If the QPSII deposits of the Section 936 corporations were eliminated, Puerto Rican domestic banks would be the least affected.

According to data supplied to the committees by the Government Development Bank, activities eligible for 936 financing have decreased during the period 1988 to 1992, which indicates that the local economy has not generated much additional capacity to absorb 936 funds as a means of financing projects under existing regulations. It may be that sufficient emphasis has not been given to the use of these resources in the financing of projects or that sufficient emphasis has not been given to the promotion of projects.

As of December 1992, 93.5 percent of the funds were invested for periods of 90 days or less. The yield for 30-day deposits was 2.6 percent, while the yield for 5 or 6 years was 5 percent.

This dramatic data for a date prior to the proposals of President Clinton shows that nearly all of the 936 funds available as of that date were not invested in economic development but rather in liquid instruments for the financing of very short-term activities.

Will the 936 Corporations Leave Puerto Rico?

The 936 corporations have facilities in Puerto Rico that have cost them more than $6 billion and that are their most modern and efficient factories in the world. They have astronomical tax-free earnings and enjoy high productivity and all the competitive advantages that Puerto Rico offers vis-a-vis other parts of the world and that we have described above.

Puerto Rico offers them the "Made in USA" label along with direct, free access to the U.S. market, political stability, a skilled work force, state and federal industrial incentives, a democratic tradition, infrastructure, communications, water supply and many other tangible and intangible benefits not easily matched by other areas. These companies are not in a position to pull out nor do they have a need to dismantle such successful factories. Changes in the viewpoint of the 936 corporations themselves in recent weeks confirm this conclusion.

Alternatives at the Local Level

The Puerto Rican government should not depend exclusively on what it can attain at the federal level for a healthy climate for industrial development. It should begin to consider Puerto Rican initiatives, such as the following:

Repeal the law that levies a withholding tax of 29 percent on interest earned from external capital financial resources that provide financing for projects in Puerto Rico

In 1976, a law was enacted to impose a withholding tax on the interest earned on external capital sources used in Puerto Rico's economic development.

In order to attract capital from the large financial centers to Puerto Rico as an alternative to 936 funds, it will be necessary to repeal the law that imposes this withholding tax on external capital sources used in Puerto Rico's economic development.

The economic reasoning behind this tax, which puts an unnecessary brake on the import of capital for economic development, is highly questionable. It can only be justified in terms of protecting the local capital market. But our economy needs to import capital, precisely because there is insufficient local capital for economic development. The other reason to establish this tax could have been to eliminate competition from investment funds in national and world markets with the incipient 936 capital market expected to arise. Nevertheless, 936 funds are kept on 30- and 90-day deposit, and are not invested in sufficient amount in economic development projects.

Deregulation of Permits and Incorporation on the Fast-Track Concept in Construction Projects

The move toward new alternatives complementary to the 936 corporations for economic development requires affirmative action on the part of the government as a facilitator of private enterprise. The Puerto Rican government has become an obstacle to economic development. Puerto Rico cries out for reform of the system of regulations and permits for the development of projects. Development of a project in Puerto Rico needs the endorsement of about twenty-five (25) local agencies, including the Institute of Puerto Rican Culture in cases of approval of the names of the projects.

The delays caused by this process set back the development of projects by several years, involving additional costs that affect the feasibility of many projects. A new Regulations and Permits Act is needed that would facilitate economic development without affecting public policy of preserving the environment. This reform should consider inclusion of the fast-track process of permit approval to accelerate project development. The Legislature should act quickly to enact legislation to implement this reform, including time limits for granting endorsements or permits.

Establish a Tax Moratorium for Repatriation of Puerto Rican Capital Abroad

According to information provided to these committees, it is estimated that a large amount of Puerto Rican capital is invested outside Puerto Rico as a means of avoiding the prevailing high tax rates. Part of this capital has not been taxed. It is necessary to incorporate these capital resources into the productive stream of our economy. To that end, it would be useful to evaluate what possible mechanisms of legislation could be used to provide incentives for Puerto Rican capital that left the coun-

try during the past eight years to return and by used in the financing of economic development projects.

It is estimated that from 1981 to 1990, taxes were evaded on approximately $25 billion in income generated in Puerto Rico. Of that total, $445 million, or 1.8 percent, was uncovered in the most recent tax amnesty, which produced $134.8 million, including $53.8 million in cases already handled and subject to payment plans, $50.0 million in cases under audit at the time the amnesty began, $16.8 million in unaudited cases where voluntary payment was made and $14.2 million in the payment by employers of withholding taxes that had been deducted and not sent in to the Treasury Department.

This amnesty, which produced only $16.8 million in voluntary payments, demonstrated the ineffectiveness of this mechanism as an instrument to reduce the underground economy.

The proposed moratorium, unlike the amnesties of the past, would not generate immediate income for the treasury but would generate future annual revenues of more than $25 million for every billion dollars in native capital repatriated.

Create a Special Joint Legislative Committee for the Economic Development of Puerto Rico

Governmental stimulus of long-term economic development based on models other than 936 corporations requires a deeper and more complete analysis than the one conducted by these committees in the time period granted to submit this report and the one conducted by the U.S. Treasury Department in the drafting of President Clinton's proposal.

New trends toward the globalization of financial markets and the production of goods require a new vision on the part of those forging public policy for the economic development of Puerto Rico; a vision of a broad-based economic development policy to face the challenge of the globalization of markets and the new changes in the benefits provided under Section 936 of the U.S. Internal Revenue Code.

The Special Committee we propose should submit a report with recommendations for legislative action within one (1) year of its creation.

The report to be submitted by the committee should depart from the following essential elements for an economic development policy for the next decade (1995–2005):

—Clearly establish the objectives of the new policy
—Specify the factors that could limit that policy
—List specific measures to be implemented. The objectives of the economic policy to be drafted should include, among other things, the following:
—Diversification of the contribution of manufacturing within the growing framework of competition at the world level Intensify the inter- and intra-industrial ties of the various sectors within manufacturing
—Promote the nest use of our trained human resources stimulating better pay and higher quality jobs
—Attain a development that is compatible with improving the quality of the environment

Among the elements of strategy that could be evaluated in the drafting of a new policy for economic development, the committee should consider the following:

—Promoting the development of personnel trained in new manufacturing concepts, such as "Just in Time," among others, considering that in Puerto Rico the human resource must be a key factor in economic development, both as worker and as entrepreneur
—Promoting the development of micro-enterprises in the areas of services, trade, artisanry for export and light manufacturing of intermediate processes under subcontract with larger enterprises. This type of promotion would propitiate a greenhouse of future entrepreneurs with the purpose of stimulating a Puerto Rican entrepreneurial class.
—Reduce the current geographic imbalance in the economic development of Puerto Rico.
—Preservation of the physical investment, the investment in technology and the investment in human resources already made, as a base for future development
—Preservation of the existing high-technology industry in Puerto Rico and the use of the highly trained human resources as a source for the export of goods and services to the global economy
—Expansion of the communications base in Puerto Rico
—Systematic promotion of the expansion of the inter-industrial ties of manufacturing with other economic sectors as a source of solid economic development that is not dependent on a single development pole.

—Transformation of the Economic Development Administration's promotional efforts into a broader vision where emphasis is given to inter-industrial blocs with strong ties inside and outside of manufacturing, as Japan has done.
—Modification of the Economic Development Administration's duties to include promotion of enterprises financed by Puerto Rican capital, with emphasis on a selective promotion that integrates the various incentives currently provided through different means, such as federally funded training programs, tax incentives, physical plant, financing, infrastructure and the other miscellaneous incentives currently offered.
—Establishment of a university-level managerial development curriculum for Puerto Ricans interested in starting small businesses in the areas of manufacturing, tourism and highly technical services such as computerized information systems, accounting and managerial consulting services, industrial processes and quality control systems, among others.
—Promotion of research and analysis groups that would keep up to date on the course of world events having an impact on Puerto Rico's economic development.
—Establishment of liaison groups between managers and high ranking officers in the various industrial sectors and government officials in charge of economic development matters so that the government is kept informed of the decision-making processes of the established enterprises with regard to plans for the expansion or reduction of their operations in Puerto Rico.
—Promotion of greater research and development efforts for processes and technology among enterprises financed by Puerto Rican capital.
—Provide greater emphasis to the question of promoting the retention, expansion and modification of operations of 936 corporations already established in Puerto Rico with the objective of keeping their operations at a competitive level even in the absence of existing benefits under Section 936, should this be modified.
—Promote diversification of the geographic destination of industrial exports, directing them toward international economic blocs such as the European Community and others closer to home.
—Establishment of a research and analysis consortium that includes the government, universities, industry and labor unions to explore solutions to the problems limiting the industrial competitiveness of enterprises in Puerto Rico, including: the sense of responsibility in the enterprise, better public services, occupational improvement and retraining of workers, purchases on the local market of the materials needed by companies operating in Puerto Rico and stimulation of the subcontracting of operations by large companies to small companies.
—Revision of a series of labor laws that currently do not allow employers and workers to benefit from such concepts as "flexitime." For example, Act 379 of May 15, 1948, as amended, makes it impossible for an employee to opt for a four-day week, working 10 hours a day, which would give them a 3-day weekend rather than a 2-day weekend. This and other laws, enacted 3 or 4 decades ago with the laudable intention of protecting workers, should be reviewed in order to amend those that limit workers' options of choosing a working schedule more beneficial than the traditional one.
—Revise Act 17 of April 17, 1931, in order to allow payment by check or electronic fund transfer (EFT), and clarify existing provisions regarding deductions, salary advances and other things. Revise safety and health laws to reduce conflicts that currently exist between federal provisions and those of Puerto Rican law.
—Evaluate the feasibility of creating a Local Capital Investment Trust of the mutual fund type for aggressive growth investment that would stimulate participation by the Puerto Rican middle class in the development of local sources of capital.

PREPARED STATEMENT OF ERIK G. NELSON

Mr. Chairman and Members of the Committee:

My name is Erik G. Nelson. I am Vice President of Financial Operations for The Procter & Gamble Company ("Procter & Gamble"). I am pleased to testify on behalf of the Committee on Royalty Taxation ("CORT") regarding the Administration's proposal to treat all foreign source royalty income as passive income for foreign tax credit purposes.

Background.

The Committee on Royalty Taxation ("CORT") is a broad-based coalition of 15 U.S. multinational companies engaged in various businesses including the industrial gas, information technology and services, consumer products, food, electronics, chemical, construction and building products, restaurants and aerospace industries. See list of CORT members on pg. 10. The members of CORT each derive significant revenues from foreign source royalty income earned in the conduct of their active businesses. The members of CORT would be adversely affected by the proposal. In fact, two members of CORT have estimated that, had the Administration's proposal been in effect for 1992, it would have increased their effective tax rates on foreign source income by as much as 20 percentage points. Obviously, a rate increase of this magnitude goes well beyond prudent action and could seriously hurt U.S. companies in their efforts to compete on a worldwide basis. CORT believes that the proposal embodies unsound tax policy and potentially would reduce U.S. based R&D, domestic jobs and investment.

Economic Impact of the Administration's Proposal.

1. The Administration's proposal would represent a sharp reversal of longstanding U.S. tax policy

Existing law has encouraged U.S. multinational companies to increase their royalty income from their affiliates without reducing their U.S. research and experimentation efforts. These companies have planned the structure of their businesses on a long term basis on the legitimate assumption as to the continuance of the existing law treatment of royalty income both from affiliates and unrelated parties. The Administration's proposal represents an unwarranted and short-sighted reversal of this policy.

Indeed, in connection with the Tax Reform Act of 1986 it was determined that the payment of royalties actually may enhance the U.S. tax base. Royalties, unlike dividends, generally are deductible in computing foreign tax liability and, thus, may "reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends." H.R. Rep. No. 426, 99th Cong., 1st Sess. 341 (1985) (hereinafter "House Report"); see also Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 866 (1987) (hereinafter "1986 Act Bluebook").

In a briefing paper dated April 14, 1993, the Treasury staff points to dramatic increases in royalty payments since the 1986 Tax Act as indicative of tax planning that has worked to the detriment of the United States. As discussed above, tax savings from royalty payments more likely come at the expense of foreign governments than of the United States. Thus, to the extent increases in royalties are attributed to tax planning, it should be of concern largely to foreign governments, not to the United States.

More importantly, increases in royalties after 1986 are attributable to many factors that are unrelated to any tax considerations. For example, Procter & Gamble's foreign royalty income has grown almost 300% since 1986. Foreign sales, to which royalties are tied, have increased by about 225% over the same period. A weaker dollar and the lifting of restrictions on royalty payments by some countries are other major factors in the increase. Obviously, this increase was not driven by tax planning. It relates directly to the growth in our international business. A strong international business should be encouraged. It strengthens our U.S. business, producing jobs and economic growth.

Evidence from other members of CORT indicates that franchise fees and the like have increased dramatically. It is well recognized that there has been a substantial Americanization of service industries in the international arena. This source of royalties from service businesses is an important export of the United States and should not be subjected to adverse tax treatment without careful consideration.

I urge the Committee to examine the attached article which explains this growth in service exports and the concomitant growth in royalties. Wall Street Journal, April 21, 1993 at 1, col. 6.

Software royalties also have experienced tremendous growth since 1986. In addition, anecdotal evidence from CORT members suggests that international cooperation agreements involving technology transfers have become much more widespread over the last seven or eight years. This also has generated increased royalties.[1/]

Finally, U.S. companies cannot arbitrarily increase foreign royalty payments to secure a U.S. tax benefit. Foreign governments actively police and limit the amount of royalties that companies may pay.

2. The Administration's proposal singles out a narrow group of U.S. multinational companies for a substantial income tax increase and would have an adverse impact on U.S. based R&D and domestic jobs.

If enacted, the Administration's proposal would single out U.S. multinational companies that use licensing arrangements in the conduct of their active businesses for harsh tax treatment. The Administration's revenue estimate fails to disclose the heavy burden which would be placed on U.S. multinational companies since it combines increased revenues from the royalty proposal with decreased revenues from the Administration's proposal to allocate 100 percent of all U.S. research and experimentation ("R&E) to the U.S.. CORT believes that the tax increase resulting from the royalty proposal may be as great as ten times the benefit resulting from the R&E allocation rule. Moreover, many taxpayers that will be adversely affected by the royalty proposal will receive little or no benefit from the 100 percent R&E allocation rule. For example, companies which license trademarks abroad would be subjected to a tax increase as a result of the royalty proposal while receiving a de minimis benefit from the proposed R&E allocation rule.

1/ Another area where there may have been growth in royalties is the entertainment industry -- films, recordings, etc.

U.S. multinational companies affected by the proposal are an important source of high-wage, high-skill domestic jobs. See Department of Commerce, U.S. Direct Investment Abroad, Preliminary 1990 Estimates at Table II.K.1. (In 1990, U.S. multinationals paid their 18.5 million employees an average wage of over $37,000.) These companies also are an important source of U.S. based research and development ("R&D") activity and the high-quality jobs this activity supports. Moreover, royalties and license fees provide a significant revenue offset to the U.S. trade deficit. E.g., Department of Commerce, Survey of Current Business 46 (December 1992). (With royalties and license fees, the 1991 U.S. trade deficit was $11.7 billion. Without royalties and license fees, the 1991 U.S. trade deficit would have been $25.5 billion.) It seems inconsistent with the Administration's stated goals of reducing the deficit, promoting high quality domestic jobs and promoting U.S. based R&D to single out for a massive tax increase those corporations that provide such jobs and conduct significant levels of R&D in the United States. For example, according to Business Week, three members of CORT -- The Dow Chemical Company, Eastman Kodak Company and International Business Machines Corporation -- were among the top ten biggest research and development spenders for 1990. See Robert Buderi, et. al., The Brakes Go On In R&D, Bus. Wk., July 1, 1991 at 24, 26. The royalty tax proposal would make the United States less competitive in keeping and attracting such R&D activity.

Moreover, U.S. multinational companies could not pass on the royalty tax through higher prices because the tax does not apply to foreign competitors. U.S. multinational companies could lose market share if they increased their prices but their foreign competitors did not. U.S. multinationals operating in foreign jurisdictions also could be subject to higher effective tax rates than subsidiaries of companies headquartered in other jurisdictions.

3. The Administration's proposal would force U.S. multinationals to reexamine their business practices.

The Administration's proposal would raise revenue by arbitrarily forcing U.S. multinational companies into an excess foreign tax credit position. U.S. companies would be compelled to ameliorate the harsh tax consequences of the new regime, where practicable, through rearrangements of their business affairs. For example, to the extent the proposal reduces the worldwide after-tax rate of return on U.S. R&D investment, it could lead to a reduction in the level of U.S. R&D activity. U.S. parent companies also may tend to allow foreign subsidiaries to retain ownership of intangibles which they develop. Over time, these types of decisions would lead to an erosion of the U.S. technology base. Moreover, the proposal would raise the effective tax rate on repatriated dividends, thereby encouraging the retention of earnings and foreign reinvestment by foreign affiliates.

U.S. companies in economically significant excess credit positions also may seek other ways to generate low-taxed, active income, such as establishing a manufacturing facility in a low-tax jurisdiction. Thus, ironically, the royalty proposal actually may create incentives for moving manufacturing facilities offshore. This is not to suggest, however, that the decision to establish overseas operations is largely tax driven. Some U.S. companies also may choose to conduct overseas operations through branches or enter into joint venture arrangements with their foreign subsidiaries.

After U.S. companies restructure their businesses to mitigate the effects of the proposal, it is likely that these companies will pay relatively less U.S. tax and more foreign tax. At best, achieving this result will absorb resources and time of U.S. companies better spent in active business operations. At worst, the proposal will potentially reduce U.S. based R&D, domestic jobs and investment.

Tax Policy Considerations.

1. **The Administration's proposal would create an artificial distinction between earnings of an integrated enterprise repatriated as royalties and earnings repatriated as dividends.**

The look-through rule of Section 904(d)(3) recognizes that earnings of a corporate group should retain the same character when repatriated to the United States, regardless of whether the earnings are repatriated as royalties, interest, dividends or otherwise. This represents sound tax policy; the character of income moving through an affiliated group should not change based on the form in which it is repatriated to the United States. As concluded by the American Law Institute:

> "[i]nterest, rents, and royalties passing from one member of an affiliated group to another have the same character; they fundamentally represent earnings and income moving through the constituent parts of an integrated enterprise."
>
> American Law Institute, International Aspects of United States Income Taxation 247 (May 14, 1986) (hereinafter "ALI Report").

Recently proposed regulations under Section 482 take the view that royalties should be considered as another way of repatriating foreign earnings from an integrated business. See Prop. Treas. Reg. § 1.482-1T(f)(2)(v) Examples 1 and 2 (royalties will not be considered blocked income if, effectively, they can be paid out in the form of dividends).

In expanding the look-through rules under Section 904(d)(3) in connection with the Tax Reform Act of 1986, it was recognized that interest, rents and royalties represent alternatives to dividends as a means of removing earnings from a foreign affiliate. House Report at 341; 1986 Act Bluebook at 866. As discussed above, a measured effort also was made to treat royalties at least as favorably as dividends so that royalty payments (which tend to preserve the U.S. tax base) would not be discouraged. Id.

The different treatment that would be afforded income repatriated by branches and subsidiaries of U.S. multinational companies aptly illustrates the inappropriateness of trying to split active income from a foreign subsidiary into passive and active income baskets based on the form in which it is repatriated. Branches of U.S. companies can acquire intangibles as tax-free capital contributions. Any income generated by the intangibles would constitute general limitation income. There is no policy reason to change this result merely because the branch is incorporated in a foreign jurisdiction and a royalty is paid to the U.S. parent.

2. **Existing law appropriately classifies royalties from unrelated parties as active or passive depending on whether they are an integral part of an active business.**

Existing law recognizes that royalties received from unrelated persons may be active or passive, depending on the facts and circumstances. See Treas. Reg. §§ 1.954-2T(b)(5), 1.954-2T(d) and former Treas. Reg. § 1.954A-2(d)(1)(i) and (iii). Thus, if an affiliated group develops or actively markets an intangible, the royalty income from that intangible generally will be active. The Administration's proposal would characterize all foreign source royalty income as passive without regard to the efforts of the taxpayer to generate that income as an integral part of its business.

3. **The Administration's proposal attempts artificially and unrealistically to separate the active income of an integrated business into different foreign tax credit baskets.**

U.S. multinationals, like the members of CORT, develop and license intangibles as part of their worldwide businesses. The income received from the licensing of intangibles is integrally tied to income from other operations. Active royalty income is simply a part of the income stream generated from the conduct of an active business. Active royalty income earned by the members of CORT is no more or less active than other business income.

The foreign tax credit has not been applied by examining the foreign tax rate on each dollar of income of an integrated business on a transactional or even on a high-tax/low-tax basis. Rather, an overall limitation generally has been deemed appropriate. In connection with the Tax Reform Act of 1986, the Joint Committee Staff reported that Congress believed, in general, that "the overall limitation was consistent with the integrated nature of U.S. multinational operations abroad." 1986 Act Bluebook at 862.

Active royalty income does not possess the characteristics which compel separate application of the foreign tax credit limitation to passive income. Separate basketing of passive income is required because taxpayers can readily choose to invest liquid funds overseas in passive investments, thereby eroding the U.S. income tax base. See House Report at 333; see also 1986 Act Bluebook at 862. Active royalty income cannot be easily generated through investment nor have its source manipulated like passive income.

Under the look-through rule for royalties from related parties, the active character of royalty earnings follows income to which it relates as it moves from a controlled foreign corporation to the U.S. parent. Thus, any royalty income that is active under the look-through rules arises out of foreign business operations that are not readily moveable or liquid. Similarly, active royalty income from third party royalties cannot be acquired through passive investments. It can only be acquired by actively developing or marketing an intangible as part of an active business. Moreover, royalty income is sourced where the underlying intangible asset is used. See Rev. Rul. 80-362, 1980-2 C.B. 208. Thus, once a U.S. company decides to market an intangible or a product incorporating an intangible in a given country, the source of the royalty income cannot be manipulated. See ALI Study at 342.

Certain Reported Rationales for the Administration's Proposal.

1. **The Administration's proposal is not justifiable as a means to prevent "cross-crediting".**

Cross-crediting occurs when foreign taxes on one item of foreign income offset U.S. taxes on another item of foreign

income. Cross-crediting of taxes on active business income is an inherent part of the U.S. foreign tax credit system. Even if it were possible to break the income of an integrated business into various baskets so that each item of income could be considered on a transactional basis, a system that did so would exacerbate the double tax problems inherent in the mismatch between U.S. and foreign tax accounting rules. Moreover, the near infinite number of baskets and the huge number of calculations and expense allocations that would result from a transactional approach would be impossible to administer.

Thus, cross-crediting of taxes on active income is the rule -- not the exception. Active income from high tax jurisdictions is averaged with active income from low tax jurisdictions and with active income subject to lower rates as a result of foreign tax incentives. The pejorative use of the term "cross-crediting" merely ducks the true policy issue -- namely, is there some reason why active royalty income should be treated differently from other active income and therefore excluded from the overall basket that admittedly is a hodgepodge of high-tax and low-tax bits of income.

Further, it has not been explained why cross-crediting involving active royalties is bad, yet other cross crediting is acceptable. This raises substantial issues of horizontal fairness among multinational companies that each are subject to the same effective tax rate on their foreign source income. Some of the companies may have royalty income subject to low foreign tax rates from subsidiaries. Others may receive other payments that are subject to a low rate of tax. There is no grounds to treat these companies differently.

2. The Administration's proposal is not justifiable as a response to "run-away" plants.

U.S. multinationals with royalty arrangements invest overseas to expand into and service new foreign markets, not to replace U.S. jobs. U.S. multinationals that provide certain products or services often must choose between producing products or providing services locally, or foregoing that market and its associated revenues entirely. With few exceptions, sales by foreign affiliates come at the expense of foreign competitors rather than U.S. exporters. Moreover, CORT members establish overseas operations mostly in high-tax jurisdictions (Germany, France, Japan, etc.).

Procter & Gamble, for example, produces certain consumer products which are impractical to ship long distances and must be produced locally. Two such products -- disposable diapers and synthetic detergents -- illustrate this. If these products were manufactured in the United States and exported to markets in Europe and the Far East, the total delivered cost for these low-margin goods would increase an average of 20 percent. The company could not competitively price its products to recover these increased costs.

Foreign direct investment also is an important strategy to promote U.S. exports and U.S. jobs. For example, Dow Chemical Company ("Dow"), another CORT member, has found that after it has entered a foreign market by setting up a manufacturing facility, its exports to that foreign country go up. This is because the foreign facility purchases some of its raw materials from Dow in the United States. Also, the foreign facility enables Dow to more effectively market its entire product line to the foreign market.

3. **The Administration's proposal cannot be justified as an offset to improperly allocated research and experimentation deductions.**

It has been suggested that the change to the treatment of active royalties is required to "recapture" deductions allocated to domestic income. This suggestion is flawed. In 1988, the Treasury, Congress and the business community concerned about the proper allocation of domestic research and experimentation (R&E) expenses reached a solution which generally allocated 64 percent of U.S. based R&E to the United States. The 64 percent allocation rule already represents the best efforts of many people over numerous years and after lengthy debate to formulate the extent that U.S. based R&E gives rise to foreign source income. Accordingly, no compensatory "recapture" of R&E deductions is required. Moreover, if the Treasury wishes to reopen the R&E allocation debate, it should do so independently of the characterization of royalty income for foreign tax credit purposes.

If it is the proposed increase from a 64 percent domestic allocation of R&E to an 100 percent domestic allocation of R&E that is cited as the justification to change the treatment of active royalties, as discussed above, the remedy is out of proportion to the incentive purportedly given.

4. **The Administration's proposal fails to address the proper sourcing of royalty income.**

Some Treasury officials reportedly believe that royalties should be sourced where the underlying intangibles are created, not where they are used. Such a change would represent a radical shift in U.S. international tax policy and would create havoc with our treaty partners. Rather than confronting the place-of-use rule directly, and engaging in a debate on the merits, the Treasury may have chosen to ask Congress to enact the royalty proposal to achieve this result indirectly. If Treasury truly believes that royalties should be sourced where the intangibles are developed, it should repeal the 30 percent withholding tax for the use of intangibles developed in other taxing jurisdictions. Since it has not proposed to do so, this rationale sounds more like an afterthought than a consistently applied view of proper tax policy.

* * *

It is antithetical to the Administration's stated economic goals to single out U.S. multinational companies with royalty arrangements for a substantial tax increase. U.S. multinational companies, like the members of CORT, are an important source of high-wage, high-skill domestic jobs -- the kinds of jobs the Administration wants to create. U.S. multinational companies also conduct significant levels of research and development in the United States -- the kind of business activity the Administration wants to encourage. Further, royalties and license fees derived from U.S. technology

and intangible assets licensed abroad provide a significant and positive revenue offset to the U.S. trade deficit.

Conclusion.

Mr. Chairman, the royalty tax proposal represents an unwarranted and short-sighted reversal of existing law. Thank you for giving me this opportunity to present the view of the Committee on Royalty Taxation. At this time, I would be pleased to answer any questions that you may have.

The Committee's counsel is Covington & Burling. Representatives of that firm also are available to consult with your staffs. In this regard, please do not hesitate to contact Ronald A. Pearlman at (202) 662-5577 or Roderick A. DeArment at (202) 662-5900.

COMMITTEE ON ROYALTY TAXATION

Member Companies

AIR PRODUCTS AND CHEMICALS, INCORPORATED

ALLIED-SIGNAL, INC.

CPC INTERNATIONAL INC.

THE DOW CHEMICAL COMPANY

EASTMAN KODAK COMPANY

ELECTRONIC DATA SYSTEMS CORPORATION

INTEL CORPORATION

INTERNATIONAL BUSINESS MACHINES CORPORATION

KELLOGG COMPANY

MC DONALD'S CORPORATION

PHILIP MORRIS COMPANIES INC.

THE PROCTER & GAMBLE COMPANY

TEXAS INSTRUMENTS, INCORPORATED

UNITED TECHNOLOGIES CORPORATION

WM. WRIGLEY JR. COMPANY

The Wall Street Journal
April 21, 1993

Quiet Boom

U.S. Service Exports Are Growing Rapidly, But Almost Unnoticed

They Rack Up Big Surpluses, Partly Offsetting Deficits In Merchandise Trading

Information Is a Key Product

By Ralph T. King Jr.
Staff Reporter of The Wall Street Journal

American companies that don't make a thing are turning the U.S. into an export powerhouse.

The country's merchandise deficit, at $96 billion last year and topping $100 billion in seven of the past nine years, provokes repeated outbursts against America's trading partners. But almost unnoticed, U.S. companies that sell services, rather than raw materials or manufactured goods, racked up a $59 billion trade surplus last year, a nearly fivefold increase from 1986. If goods and services trade data are lumped together – they aren't, because of an outdated Commerce Department convention – it becomes clear that the U.S. has an ace-in-the-hole in world trade.

U.S. companies are sparking "a hidden boom in services exports," says Allen Sinai, a Boston Co. economist. That boom not only enriches the companies and their shareholders but also creates a significant number of high-paying jobs in the U.S. – though fewer jobs than a boom in manufactured exports would bring.

A Variety of Suppliers

World-class suppliers of services include brand-name giants such as American Express Co., McDonald's Corp. and Walt Disney Co. Also among them are thousands of smaller companies such as Monitor Co., a management-consulting firm in Cambridge, Mass., that gets half of its $60 million in annual revenue from abroad. What all these companies are exporting so successfully is information, know-how, creativity and technology, things the rest of the world badly wants.

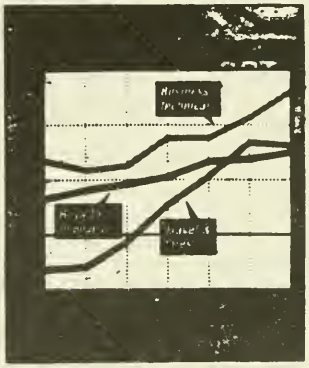
"Information is as much a product as an automobile. . . . But this is not the way people look at it. We are conditioned by the goods economy of yesteryear," Mr. Sinai says.

The misconception arises in part from the onslaught of consumer imports such as Japanese cars and stereos, which don't blend into the woodwork the way intangible U.S. services do abroad. Few people know that last year the U.S. ran a surplus in services with Japan totaling $14 billion, equal to 28% of America's $50 billion merchandise deficit with that country.

Statistical Problems

Moreover, the Commerce Department reports merchandise-trade data monthly – prompting gloomy headlines every time – and releases services-trade figures quarterly with a three-month lag. The reason: Widgets are more easily tracked and counted than services such as waste management or data processing. The government doesn't include most financial services because electronic money flows are so hard to categorize. Some experts believe that the recently reported $167 billion in services exports for 1992 may be understated by at least 20%.

But as the nation's private services sector has eclipsed manufacturing in output, its importance in foreign trade has surged, to 29% of total exports from 17% in



1988. And as the wealth of U.S. trading partners grows – and if trade barriers continue to fall – foreign demand for U.S. services is bound to increase. Mr. Sinai says it is "very easy to see" the services trade surplus "doubling or tripling by the end of the decade," to nearly $200 billion.

Some of the services responsible for the "hidden boom" don't seem like exports at all. For example, spending by foreign visitors to the U.S. – on hotel rooms, restaurant meals, air fares, vacation attractions and the like – generated about one-third of the $59 billion private services surplus last year. Foreign enrollment in U.S. universities, totaling more than 400,000 students, added $5 billion or so.

All the rest is generated by business and technical services such as engineering, accounting, computing and legal services and by entertainment and new technologies that earn royalties and license fees. Companies offering services of these types have achieved the fastest growth abroad. At Disney, Chairman Michael Eisner says foreign sales, which already account for 19% of total sales up from 10% in 1987, should continue to grow faster than its domestic business. At Texas Instruments Inc., royalties paid by foreigners for use of its computer-chip-making patents have quadrupled since 1987 to nearly $400

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Quiet Boom: U.S. Service Exports Grow Rapidly, Almost Unnoticed

Continued From First Page

million. And at Waste Management Inc., foreign sales surged more than 15-fold in the past six years, to $1.5 billion in 1992.

In addition to profits from exports, U.S. companies earned about $20 billion last year on sales by their foreign-based service operations, such as travel offices operated by American Express in New Delhi and Cairo. That figure is also expected to rise sharply. U.S. capital investment in such operations doubled between 1986 and 1991 to a cumulative $216 billion, exceeding that of U.S. manufacturers abroad.

Services exports have been aided by the plunge in the dollar since 1985. In addition, U.S. service companies, helped by superior universities and honed by an intensely competitive economy, are far more productive than their foreign rivals. McKinsey & Co. calculates that American companies are about 50% more efficient than Japanese retailers and German telecommunications concerns. These and other nations limit U.S. companies' access to key service markets, partly in hopes of catching up.

Nevertheless, the wider U.S. economy, and especially its work force, won't reap all or even most of the benefits from this boom because services are very different from manufactured goods. Although U.S. goods sold abroad create mostly U.S. jobs, the sale of U.S.-generated services often involves lots of foreign employees because many services are, by necessity, provided locally. At American International Group Inc., most of the huge insurance company's policies are devised by experts at its New York headquarters. But AIG has 16,000 foreign employees, amounting to half its total work force, selling and processing policies in 130 countries.

Moreover, much American service capability can be easily transplanted. One of the world's largest and most advanced aircraft-maintenance facilities is expected to siphon plenty of jobs and work away from U.S.-based shops when it opens at year end in Tijuana, Mexico. The owner, Matrix Aeronautica, says that Americans will provide training and supervision but that the majority of employees will be lower-wage Mexican technicians.

GE's Job Moves

Similarly, General Electric Co. eliminated hundreds of essentially service jobs at plants in the Midwest by shifting technical drafting to computer-aided designers in India and Eastern Europe, says James Sommerhauser of the International Federation of Professional and Technical Engineers. To head off such developments at American Telephone & Telegraph Co., the Communications Workers of America union is working closely with the company in strategic planning. "We want to make sure service jobs aren't exported the way manufacturing jobs have been," says Jeff Miller, a CWA spokesman.

Some American companies dominate service markets abroad because they treat customers better than foreign rivals do. Thus, American Express, which first made it easier for Americans to go abroad, now also caters to foreigners in their own countries. Within Germany, 80% of all American Express card usage is by Germans, up from 50% five years ago. Germans, and cardholders in 30 countries, now get their bills denominated in the local currency. The company's foreign revenue has nearly tripled since 1982 to an estimated $5.5 billion last year, some 20% of its total revenue.

Even when technology transfer is the primary objective, customer focus comes into play. In 1989, a consortium including a unit of Pacific Telesis Group, the San Francisco Baby Bell, won the right to build and partly own a $2 billion cellular-phone network in Germany. Other bidders had the technical expertise, but the Pactel unit offered support systems critical to building the business and making it user-friendly, things such as accounting software, management information systems and customer-service procedures.

"In the U.S., we expect good service," says Jan Neels, president of the unit, Pacific Telesis International. "That has taught U.S. companies to cater to it, and that is why we bring value" to projects in Europe where until recently the attitude was, "Shut up, you should be glad you have [phone] service." After just four years, foreigners account for 15% of the unit's 800,000 cellular customers world-wide.

Some opportunities arise from Americans' long experience with problems that other countries are just beginning to face. U.S. environmental regulation, for example, spawned a giant waste-handling industry, an industry that is primitive or nonexistent in much of the world. Into this void waded Waste Management. It collects trash, cleans streets and constructs sanitary landfills in 20 countries, including Argentina and New Zealand. It also has a 15-year contract to run a hazardous-waste treatment plant that will process all of Hong Kong's industrial waste.

Complicated legal and tax systems in the U.S. have provided a similar advantage to law and accounting firms. At Chicago-based Baker & McKenzie, the world's largest law firm, more than half its 1,651 attorneys work outside the U.S. Its chairman, John McGuigan, is Australian, and many partners are eligible to practice law in several countries. Like American Express, it expanded with the aim of serving U.S. multinationals wherever they operated, and now it advises many foreign clients at home and abroad. Besides the major capitals, the firm has offices in cities such as Valencia, Venezuela.

As big and vibrant as it is, the U.S. economy is a breeding ground for state-of-the-art thinking on many fronts. Monitor Co., for example, provides a pipeline for management ideas from the best U.S. business schools through seven overseas offices, including ones in Madrid, Milan and Seoul. Co-founded in 1984 by Michael Porter, a Harvard professor, the firm conceives business strategies to help clients exploit their competitive strengths.

Big companies such as Texas Instruments aren't the only ones tapping demand for U.S. technology. Visual Software Inc., of Woodland Hills, Calif., employs about a dozen software engineers who customize graphics and animation code for clients in places such as Cyprus, Austria and Mexico. One foreign government retained the company to make voter-identification cards using unforgible 3-D photo images. Founded just three years ago, Visual says 40% of its $3.5 million of revenue comes from abroad.

Douglas Richard, Visual Software's chief executive, doubts that the U.S. will lose its dominance in software programming anytime soon. "People say India has hundreds of programmers lining up software code at low cost. That's fine as long as the code is like assembling a toaster," he says. "But if you introduce a creative element into the process, which inevitably you do, then [software writing] is much more a craft, closer to writing a novel than building a toaster."

Entertaining Numbers

Ditto for the entertainment industry, the nation's second-largest exporter after aerospace. Disney accounted for a big slice of the industry's estimated 1992 surplus of $6 billion. The company produces the most popular TV shows in Russia and Germany, publishes Italy's bestselling weekly magazine and lures more Japanese visitors to Tokyo Disneyland than almost any other attraction in Japan. Foreign box-office revenue for "Beauty and the Beast" alone hit $200 million.

Mr. Eisner, Disney's chairman, attributes the success of his company and others in Hollywood partly to the size and affluence of the world's English-speaking population. But also, he says, foreigners "sense that what ends up on the screen is freely created. We are making movies about and in a system of freedom . . . that [many foreigners] revere. Our political system creates intellectual products that are hungered for around the world."

Besides entertainment, the world yearns for nuts-and-bolts ideas that lift living standards. Enter U.S. franchisers, some 450 strong with 40,000 outlets worldwide, which are tapping into a rich entrepreneurial vein in many cultures. This is especially true in places such as Eastern Europe and South Africa, where small business has been hobbled for years.

The global expansion of McDonald's is well known, but how about that of I Can't Believe It's Yogurt Ltd.? During its 15 years in the U.S., the Dallas-based franchiser has created a step-by-step procedure for opening and running a frozen-yogurt store anywhere in the world, says James Amos Jr., its chief operating officer. It works closely with local contacts familiar with the requirements and idiosyncrasies of each country, and it promotes franchisees' long-term success by getting most of its profit from product sales rather than up-front franchise fees. In the past three years, the company has opened 127 outlets in 20 countries; it expects to have 1,000 within two years.

"The world is not panting for frozen yogurt because they don't know what it is," Mr. Amos says. "But they are desperate for ways to start a business."

PREPARED STATEMENT OF LUIS NUNEZ

Mr. Chairman, and members of the Senate Finance Committee, I wish to thank you for allowing me the opportunity to provide you with the National Puerto Rican Coalition's view of President Clinton's economic proposal and the possible impact of the package on the Puerto Rican community. The National Puerto Rican Coalition is a membership association composed of over five hundred Puerto Rican community-based organizations and leaders. NPRC's goal is to further the social, economic and political well-being of the more than six million Puerto Ricans throughout the United States and Puerto Rico.

To begin, I would like to make six brief comments about the Puerto Rican community:

1. Puerto Ricans, both in the mainland and on the Island, are United States citizens. Puerto Rican jobs are American jobs;
2. As United States citizens, Puerto Ricans migrate freely between the mainland and the Island—maintaining close familial and economic ties to each;
3. There is a strong interdependence between the Island and the mainland. The viability of the Puerto Rican economy strongly affects the US mainland economy;
4. Puerto Ricans, as loyal and patriotic citizens, have served in every war since World War II, with disproportionate representation when compared to the US general population in the Vietnam and Persian Gulf wars;
5. Ninety five percent of all mainland Puerto Ricans live in urban areas and 75% live in central cities, representing the most urbanized ethnic group in the US; and
6. Puerto Ricans are nearly three times as likely to live in poverty, drop out of high school at a rate exceeding 50% in some major cities such as New York and Boston, have home ownership rates that are one-third the national average, and suffer from AIPS and substance abuse in extremely high numbers when compared to the general population.

While the situation confronting the Puerto Rican economy and Puerto Rican people is truly unique, Puerto Ricans, like the rest of Americans, support the administration's efforts to solve the problems of our nation. Puerto Ricans are prepared to share and contribute to the national effort to help the economy because we believe that the entire nation will benefit from the implementation of the President's proposal. The Puerto Rican community is indeed willing to sacrifice along with the rest of the country, but not if a disproportionate share of the burden is given to the Puerto Rican people.

While we endorse the President's economic package as a whole, we are deeply concerned about the provision that would reduce the tax credit granted to Puerto Rico under Section 936 of the Internal Revenue Code without offering any viable economic alternatives to the Island. To quote a recent Washington Post editorial, we are concerned by his "half a Puerto Rican policy."

Section 936, and the previous provision in Section 931, have clearly moved Puerto Rico from its status as "the poor house of the Caribbean" to the most prosperous economy in Latin America, despite the fact that per capita income on the Island is still half that of the poorest state. Any attempt to repeal or curtail Section 936 benefits without offering comparable economic incentives will adversely affect Puerto Rico's economy.

THE PRESIDENT'S PROPOSAL AND ITS EFFECT ON PUERTO RICO'S WORKFORCE

The administration's proposal would change Section 936 from an income-based to a wage-based tax credit for companies over a three year period and would cap the credit at 60% of wages paid to employees. The tax credit would only extend to wages paid by employers of up to $60,000.

As it stands, the President's proposal will have a deleterious effect on Puerto Rico's workforce. According to recent studies, Section 936 companies directly generate about 115,000 jobs on the Island while indirectly promoting another 200,000 jobs. These 300,000+ jobs represent a third of all the jobs in Puerto Rico. The economic development strategy of Puerto Rico based on tax incentives such as Section 936 has created a significant middle class comprised of managers, engineers, bankers, accountants and entrepreneurs operating small and medium size businesses which serve the needs of 936 corporations. Despite such benefits, Puerto Rico's current unemployment rate is estimated at 18.1%, up 3.3% from December of 1992, a figure which is more than double the stateside level. Coupled with an increased level of investment risk, any attempt to reduce incentives to the companies that provide these jobs in Puerto Rico without offering a viable economic alternative would further cause a surge in unemployment.

In particular, since the 1980s, the overall gain in jobs in Puerto Rico has come from high-skill, capital-intensive, low labor industries such as instruments and related products, and chemicals and allied products, which has overcompensated for the downturn in employment that has come from labor intensive industries such as apparel and other textile products. However, the Administration's tax change provision would hurt these very same Section 936 corporations that have provided growth in the labor force during the last decade.

A wage-based tax credit, such as the one proposed, is earmarked for manufacturing industries that provide many jobs at low wages. Essentially, those companies that have total nominal wages at levels close or equal to the companies' annual income will not be affected by the proposed change. However, those low wage companies are gradually becoming a small portion of 936 corporations. In fact, in the past decade, Puerto Rico has been moving away from a low-wage manufacturing base to more capital-intensive industries in order to remain competitive against low-wage countries. Thus, the President's proposal seeks to promote low-wage industry development in Puerto Rico without taking into account that many low-wage industries have already left Puerto Rico due to some competitive shortcomings, such as high transportation and energy costs, and increased global competition. These are factors that cannot be offset by a wage credit.

THE DISPROPORTIONATE EFFECT OF THE PRESIDENT'S PROPOSAL IN PUERTO RICO

Contrary to President Clinton's commitment to present a tax plan which will have a minimal impact on American families with less than average incomes of $30,000, the 936 provision of his plan will have a major impact on a society where the vast majority of families have incomes significantly below this level (median household income in Puerto Rico is $8,895 compared to $30,126 in US mainland). Further, President Clinton is committed to reducing the high unemployment level facing Americans today. We must continue to reinforce the fact that Puerto Ricans on the Island and the mainland are Americans and deserve the same consideration as everyone else.

In this vein, we consider the Administration's proposal as being disproportionate and unfair to the Island given the socioeconomic reality of Puerto Rico relative to the United States mainland. According to recent estimates made by the economic consulting firm Estudios Técnicos, Inc. in Puerto Rico, Puerto Rico's revenue-sharing burden as part of President Clinton's economic plan would be $4.9 billion over 3 years (1997), while the US mainland would be $213.8 billion. On a per capita basis, that translates into $1,374 per person in Puerto Rico and $834 per person in the mainland for a PR/US revenue-burden ratio of 164.7%. If we take into account that Puerto Rico's per capita income ($6,359) is less than half that of the poorest mainland state (Mississippi—$13,328), and that 58.9% of families in Puerto Rico live below the poverty line compared to 11.5% of families in the US, it is starkly clear that Puerto Rico is being asked to contribute so much when, relatively, it has so little. (See annexed table 1)

Section 936 is of vital importance to Puerto Rico and the Caribbean because its effects ripple throughout all sectors of Puerto Rico's economy and the Caribbean region as a whole. There are stipulations in the law which enable profits earned by U.S. subsidiaries in Puerto Rico to be deposited in the Island's banks in order to keep the cost of credit in the region low. The so-called "936 funds," which are estimated to be over $12 billion, are a vital source of capital for projects in Puerto Rico and elsewhere in the Caribbean. Funds from both Section 936 and the Caribbean Basin Initiative (CBI) have promoted economic growth and stability in the Caribbean, and have resulted in an increased flow of trade and investment between the US and the Caribbean Basin. Any increases in credit costs will lead to downsizing in certain sectors of these economy.

THE EFFECT OF THE PRESIDENT'S PROPOSAL IN THE US MAINLAND

We also feel that the proposed change in Section 936, and its impact on the employment of Puerto Ricans on the Island, might trigger a new exodus of Puerto Ricans seeking jobs in the United States. Since the 1940s, it has been estimated that at least one-third of Puerto Rican Islanders have left Puerto Rico in search of better economic opportunities in the mainland. A future mass exodus of Puerto Ricans from the Island may further strain the already depressed local economies of the mainland's northeastern inner cities where Puerto Ricans reside, cities that offer little with respect to job opportunities for their underserved populations. There will also be an increased need for federal transfer payments to compensate for joblessness in Puerto Rico.

Moreover, the suggested change in Section 936 might hurt rather than help the U.S. mainland economy. According to a recent survey of 50 Section 936 corporations with operations on the Island, a total of $2.3 billion in materials and services in 1991 were purchased from mainland suppliers, generating an estimated 46,000 jobs on the mainland. These companies have a heavy trade relationship with states with large Puerto Rican populations. For example, in 1991, Section 936 companies in Puerto Rico purchased $332 million worth of goods and services from the state of Illinois; $222 million from New Jersey; $204 million from Pennsylvania; and $195 million from New York.

There are more than 700 Section 936 companies in Puerto Rico which have helped the Island become the tenth largest purchaser of goods and services from the mainland with $11 billion in purchases in 1991. These purchases are estimated to support some 220,000 mainland jobs. If the President's proposal is enacted, the mainland U.S. economy will suffer from a decrease in trade with Puerto Rico and eventually a loss of mainland jobs. The US Merchant Marine might be most affected since they rely heavily on trade with the Island. In FY 1991, trade carried by US vessels to and from the Island accounted for 33% of all domestic shipments.

A 936 LENDING PROGRAM FOR US MAINLAND COMMUNITIES

Given the CBI–936 lending program's success, NPRC recommends that an arrangement similar to the present one in which Section 936 funds are used for projects in the Caribbean nations be implemented here in the United States to aid impoverished communities on the mainland. Such a program, which has also been proposed by the Government of Puerto Rico, would have objectives consonant with the President's national economic plan, namely projects fostering community development and job-creation. The 936 lending program could focus its efforts on Congressional districts with 5% or more Puerto Rican/Hispanic population. According to a recent report based on 1990 Census data, there are at least 43 districts that meet this criteria in states such as Connecticut, Florida, Illinois, Massachusetts, New Jersey, New York, and Pennsylvania. (See annexed table 2)

CONCLUSION

In our opinion, Section 936 has accomplished what its authors intended: creation of a modern, technological economy for Puerto Rico and significant improvement of the socio-economic status of the Puerto Rican community on the Island to bring it closer to levels in the US mainland.

We at NPRC believe that President Clinton's economic plan will help this country move forward by controlling the deficit while at the same time investing in our nation's human capital. However, to place Puerto Rico at a disadvantage at a time when its economic future is already threatened by disinvestment and a free trade agreement that encompasses all of North America, without offering any viable alternatives to the development of an advanced economy, is unfair.

We ask you, Mr. Chairman, and members of the committee, to keep in mind that any changes in Section 936 tax credits must consider the unique status and fragility of the Puerto Rican economy as well as the need for a phase-in period to reduce the economic damage to the Island and the United States mainland. Thank you.

Attachment.

Table 1.

PUERTO RICO'S FAIR CONTRIBUTION TO THE PRESIDENT'S REVENUE PROGRAM

	PUERTO RICO	UNITED STATES	RATIO PR/US
GDP PER PERSON	9,528	23,200	41.1%
REVENUE-SHARING BURDEN (1994-97)			
TOTAL IN BILLION $	4.9	213.8	
PER PERSON IN $	1,374	834	164.7%
PUERTO RICO FAIR SHARE (1994-97)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
	343	1,221	
PUERTO RICO FAIR SHARE (1994-98)	PER CAPITA (IN $)	TOTAL (IN MILLION $)	
	428	1,526	

Memorandum Item: Puerto Rico 1992 population 3.565 million.

Source: Estudios Técnicos, Inc.

Table 2.

REPRESENTATIVES OF THE DISTRICTS WITH THE LARGEST PUERTO RICAN/ HISPANIC CONCENTRATIONS (5% & OVER) APRIL 1, 1993

STATE	NAME	DISTRICT	% HISP.	% PR
Connecticut	Barbara B. Kennelly (D)	1	10	8
	Rosa DeLauro (D)	3	5	3
	Christopher Shays (R)	4	11	7
	Gary A. Franks (R)	5	6	4
Florida	John L. Mica (R)	7	6	3
	Bill McCollum (R)	8	11	6
	Sam M. Gibbons (D)	11	14	4
Illinois	Luis V. Gutiérrez (D)	4	65	15
	Dan Rostenkowski (D)	5	13	3
Massachusetts	John W. Olver (D)	1	5	4
	Richard E. Neal (D)	2	6	6
	Martin T. Meehan (D)	5	8	5
	Joseph P. Kennedy II (D)	8	11	4
	Joe Moakley (D)	9	5	2
New Jersey	Robert E. Andrews (D)	1	6	5
	William J. Hughes (D)	2	7	5
	Christopher H. Smith (R)	4	5	3
	Frank Pallone, Jr. (D)	6	6	3
	Herbert C. Klein (D)	8	18	8
	Robert G. Torricelli (D)	9	11	3
	Donald M. Payne (D)	10	12	5
	Robert Menéndez (D)	13	41	17
New York	George Hochbrueckner (D)	1	5	2
	Rick A. Lazio (R)	2	10	5

	Gary L. Ackerman (D)	5	7	2
	Floyd H. Flake (D)	6	17	6
	Thomas J. Manton (D)	7	21	8
	Jerrold Nadler (D)	8	13	6
	Charles E. Schumer (D)	9	8	4
	Edolphus Towns (D)	10	20	13
	Major R. Owens (D)	11	12	5
	Nydia M. Velázquez (D)	12	58	29
	Susan Molinari (R)	13	7	4
	Carolyn B. Maloney (D)	14	11	5
	Charles B. Rangel (D)	15	46	17
	José E. Serrano (D)	16	60	43
	Eliot L. Engel (D)	17	29	19
	Nita M. Lowey (D)	18	10	3
	Hamilton Fish, Jr. (R)	19	5	2
	Benjamin A. Gilman (R)	20	6	3
Pennsylvania	Thomas M. Foglietta (D)	1	10	8
	Robert A. Borski (D)	3	5	3
	Paul McHale (D)	15	5	4

National Puerto Rican Coalition, Inc.
Source: Census, 1990

[Submitted by Senator Packwood]

America's Leadership
in the
Multilateral
Trade Negotiations

May 19, 1993

The Honorable Bob Packwood
United States Senate
Washington, D.C. 20510

Dear Senator:

The MTN Coalition is a broad-based alliance of American private sector interests firmly committed to a strengthened and more effective multilateral trading system. Our 14,000 members include U.S. corporations of all sizes from a broad spectrum of industries, consumer groups, and agricultural interests. We advocate a comprehensive and strong conclusion to the Uruguay Round of multilateral trade negotiations under the auspices of the GATT.

The Coalition supports the President's request for a "clean" renewal of fast track negotiating authority for the Uruguay Round of multilateral trade negotiations at the earliest practicable time.

Many of MTN's members have expressed concern about the direction some of the current negotiations appear to be taking. These concerns have been conveyed directly to the Administration by MTN's individual members. At this time, however, MTN's members would prefer to see a "clean" renewal of negotiating authority, rather than seek amendments to the legislation granting the Administration fast track negotiating authority for the Uruguay Round.

Sincerely,

Bill Brock

William E. Brock
Chairman

1627 Eye Street, NW
Suite 1100
Washington, DC
20006
202/463-8161
FAX
202/463-8167

[Submitted by Senator David Pryor]

SENATE AGING COMMITTEE MAJORITY STAFF ANALYSIS OF
GENERAL ACCOUNTING OFFICE REPORT

"PHARMACEUTICAL INDUSTRY: TAX BENEFITS OF OPERATING IN PUERTO RICO"
May, 1992

BACKGROUND

In November, 1991, Senate Aging Committee Chairman David Pryor (D-Ark) asked the U.S. General Accounting Office (GAO) to determine the nature and extent of the tax subsidies received by the pharmaceutical industry under the section 936 tax credit. This tax credit provides a tax exemption for business income earned by U.S. corporations that manufacture products in Puerto Rico and other territorial possessions of the United States. The stated purpose of the credit is to stimulate the development of jobs in these territorial possessions.

In short, the GAO report concludes that the section 936 tax credit has been significantly more efficient at producing billions of dollars in tax savings for the pharmaceutical industry rather than creating jobs in Puerto Rico. In doing so, the GAO report confirms the similar findings of a September, 1991 Senate Aging Committee staff report, "The Drug Manufacturing Industry: A Prescription for Profit."

The GAO report was requested to provide an independent analysis to the Congress on the tax subsidies that the pharmaceutical industry is realizing from this generous tax credit. The information provided in the report should help Congress restructure the credit so that it meets its stated purpose -- job creation, not profit padding -- and makes it more fair to the Puerto Rican people and the taxpayers of the United States.

SUMMARY AND ANALYSIS OF REPORT FINDINGS

POINT 1: The pharmaceutical industry was responsible for producing only 18 percent of all the section 936 manufacturing jobs in Puerto Rico in 1987 (18,176 of 100,916 section 936 jobs), while in the same year it received about 56 percent of all tax benefits from the section 936 tax credit (about $1.3 billion of the $2.3 billion in total section 936 benefits).

POINT 2: During the period between 1980 and 1990, the drug industry received a total section 936 tax savings of $8.5 billion, and had total tax exempt income of $21.1 billion. GAO states that, for one year that was studied, the section 936 drug manufacturer tax savings identified in this Report, which are based on company financial statements, represented only about two-thirds of actual total section 936 tax benefits reported by drug manufacturers in confidential tax returns. Therefore, GAO says that its own Report significantly UNDERSTATES the amount of the drug industry's section 936 tax benefits.

POINT 3: The annual section 936 tax benefits received per employee by each pharmaceutical manufacturer in 1987 -- $70,788 -- is far in excess of the average wages paid per employee -- $26,512.

POINT 4: The pharmaceutical industry receives the highest per-employee tax break of any section 936 manufacturing industry in Puerto Rico. The Report found that, on average, for each dollar that a drug company paid in wages, it received $2.67 in section 936 tax benefits. The section 936 tax benefits to other industries in Puerto Rico were much smaller. For example, the electronics industry received only 98 cents in tax benefits for each dollar paid in wages; the average section 936 manufacturing company in Puerto Rico received only 68 cents for every dollar paid in wages.

POINT 5: The stark inefficiency of the section 936 tax credit in creating jobs in Puerto Rico is demonstrated by the fact that the electronics industry -- which employs 23 percent of all section 936 employees -- only receives 16 percent of the section 936 tax benefits. In contrast, the drug industry, which has fewer section 936 employees than the electronics industry -- 18 percent -- receives three and a half times MORE benefits than the electronics industry -- 56 percent.

POINT 6: Although a drug company's average section 936 tax savings per employee are about $71,000, the Report found that actual tax savings per employee are substantially higher for many individual pharmaceutical manufacturers in Puerto Rico. The leading drug companies in per-employee tax savings in 1989 were:

RANK/ COMPANY	TAX SAVINGS PER EMPLOYEE	TAX SAVINGS AS % SALARY	TOTAL EMPLYS	% TOTAL 936 EMPLYS
1. Pfizer	$156,400	636%	500	0.5%
2. Merck	$110,495	450%	953	0.8%
3. AmHome	$80,600	328%	1,000	0.8%

POINT 7: During the period between 1980 and 1990, about 52 percent of all tax savings received by the pharmaceutical industry under the section 936 credit went to just six pharmaceutical manufacturers. In fact, just two manufacturers -- Johnson and Johnson and SmithKline Beecham -- received 21 percent of all pharmaceutical manufacturer section 936 tax savings during this period -- $2.1 billion dollars. The tax savings for these 6 companies over the 1980-90 period were:

COMPANY	TOTAL 1980-90 SECTION 936 TAX SAVINGS
1. Johnson and Johnson	$1.117 billion
2. SmithKline Beecham	$ 987 million
3. Abbott Labs	$ 860 million
4. Pfizer	$ 759 million
5. Upjohn	$ 750 million
6. Merck	$ 749 million
TOTAL 1980-90 TAX SAVINGS FOR TOP SIX COMPANIES	**$5.222 billion**

POINT 8: The amount of the section 936 tax credit received by a company has little relationship to the level of employment in Puerto Rico. While Pfizer receives a per-employee tax credit of $156,400, it employs only 500 individuals in Puerto Rico or, only 0.5% of all section 936 employees in Puerto Rico. In contrast, while Baxter receives a per-employee tax credit of $10,521, it employs almost 6,000 individuals in Puerto Rico.

POINT 9: Seventeen of the top twenty-one selling drugs in the United States are approved by FDA to be made in Puerto Rico. As the attached chart shows, in addition to avoiding paying millions of dollars in taxes by making these drugs in Puerto Rico, and in addition to receiving a tax credit far in excess of wages paid for the employees that make these drugs in Puerto Rico, the drug manufacturers of this nation have forced the American public to swallow staggering double-digit price increases on these drug products.

CONCLUSION

Today, American taxpayers are underwriting the costs of new drug research, providing tax write-offs for drug manufacturer marketing and advertising expenses, subsidizing billions of dollars in new drug research at the NIH, and paying drug prices that consistently triple the general inflation rate. To ask the American taxpayer to also continue to subsidize the most profitable industry in the country through the section 936 tax credit is not only unfair, it is a disgrace.

Congress has a responsibility to the American taxpayer to make sure that a program that was developed many decades ago is still meeting its objective today. Given the data and analysis included in this report, and the growing number of unmet, urgent social needs that we have in this country today, it is time for the Congress to re-evaluate the nature and structure of the section 936 tax credit.

For more information contact Ann Trinca, Press Secretary, John Coster, or Chris Jennings of the staff of the U.S. Senate Special Committee on Aging, 202-224-5364; or Steve Glaze of Senator Pryor's Office, 202-224-2353.

PRICES FOR PRESCRIPTION DRUGS MADE IN PUERTO RICO SKYROCKET

DRUG/MANUFACTURER	AVERAGE ANNUAL % CHANGE IN PRICE 1986-91	TOTAL ESTIMATED SECTION 936 TAX SAVINGS RECEIVED BY MFGR, 1986-91 *
Premarin 0.625mg. American Home Products (estrogen replacement)	17.0%	$375 million
Tylenol & Cod #3 Johnson and Johnson (pain killer)	17.0%	$510 million
Halcion 0.25mg. Upjohn (tranquilizer)	15.0%	$340 million
Xanax 0.5mg. Upjohn (tranquilizer)	14.6%	$340 million
Dilantin 100mg. Parke-Davis (epilepsy)	14.4%	$155 million
Capoten 25mg. Bristol-Myers Squibb (hypertension)	13.2%	$285 million
Tagamet 300mg. SmithKline (ulcers)	12.0%	$450 million
Procardia 10mg. Pfizer (hypertension)	12.0%	$345 million
Ceclor 250mg. Eli Lilly (antibiotic)	9.5%	$295 million
Provera 5mg. Upjohn (hormone replacement)	9.4%	$340 million
Vasotec 10mg Merck (hypertension)	8.9%	$340 million

SOURCE: PRIME Institute, Minneapolis, Minnesota and GAO Report, 1992.

* - Estimate based on average annual section 936 tax savings reported in Table I.6 of GAO Report.

For Each

 ($1)

Paid in Wages . . .

. . . Section 936 Tax Benefits Received Are:

Pfizer	$6.36
Merck	$4.50
American Home Products	$3.28
Sterling	$3.14
Bristol-Myers Squibb	$3.02

AMERICA'S RETURN ON OUR MULTI-BILLION DOLLAR DRUG INDUSTRY INVESTMENT

WHAT WE GIVE...

- *FDA Approval for Drugs*
- *Patent Protection*
- *R&D Tax Credits*
- *Orphan Drug Tax Credits*
- *Federally-Funded NIH R&D Grants*
- *Marketing Expense Deductions*
- *Billions of Dollars in Tax Credits for Manufacturing Drugs in Puerto Rico*

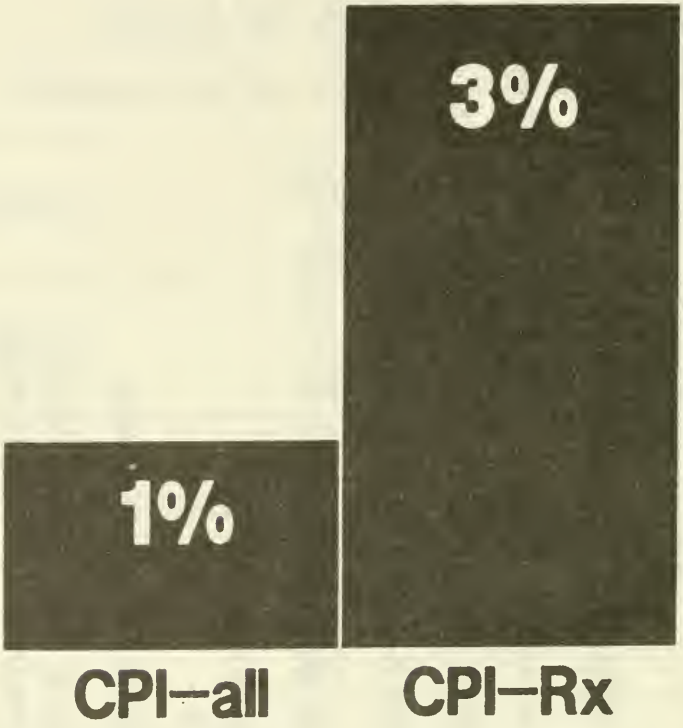
WHAT WE GET...

- *Highest Drug Inflation in World*
- *Highest Drug Prices in World*
- *Too Few Breakthrough Drugs (Many "Me-Toos")*

U.S. Senate Special Committee on Aging, May 1992

Prescription Drug Price Inflation

1st QUARTER, 1992

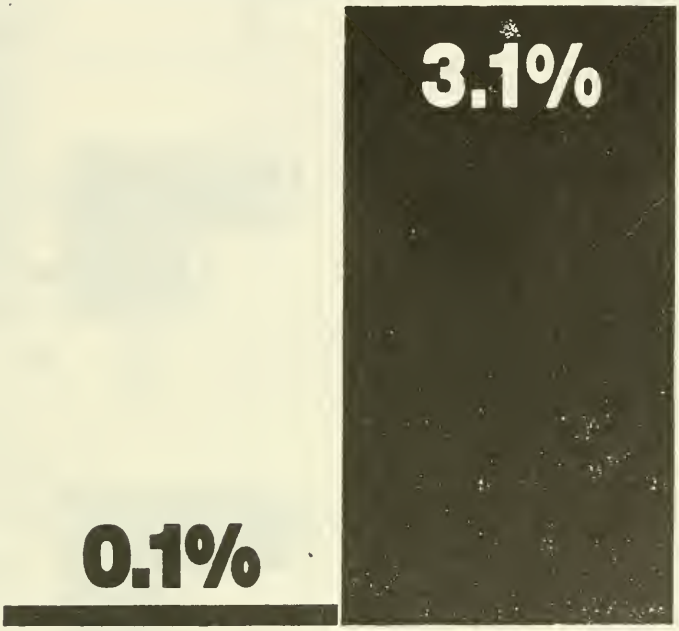


QUARTERB–AGI, 4/92

SOURCE: Bureau of Labor Statistics

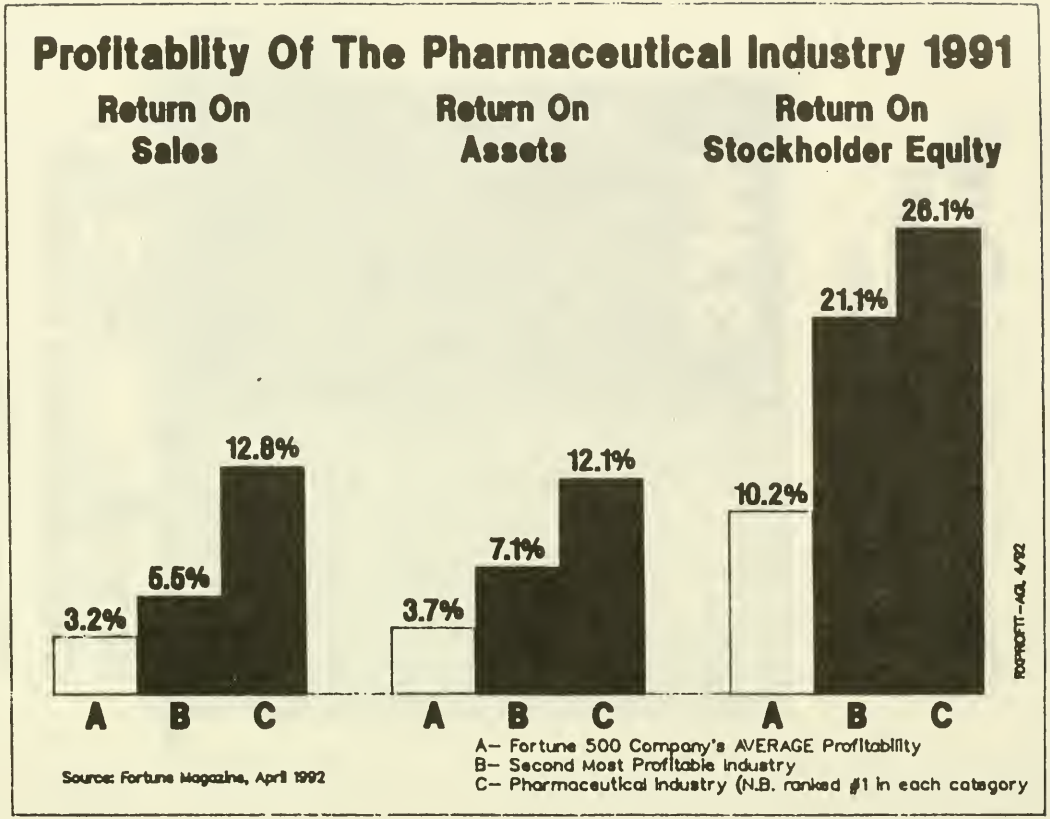
Prescription Drug Price Inflation

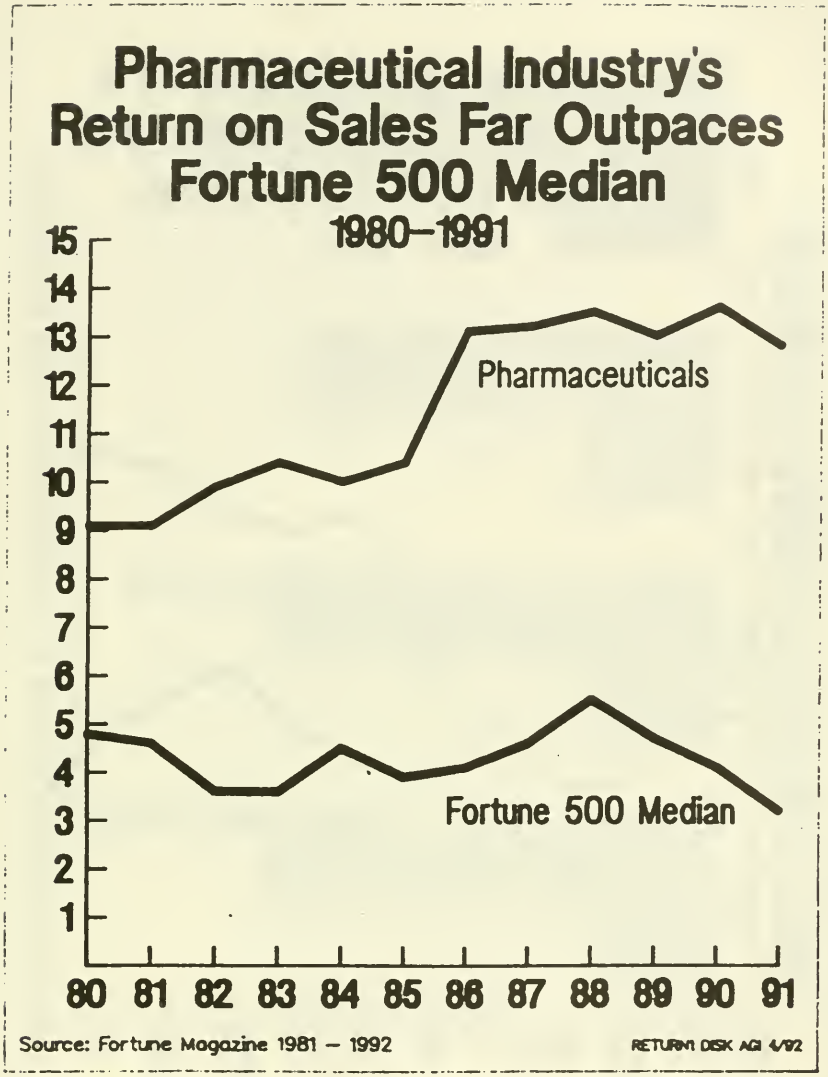
1st QUARTER, 1992



SOURCE: Bureau of Labor Statistics

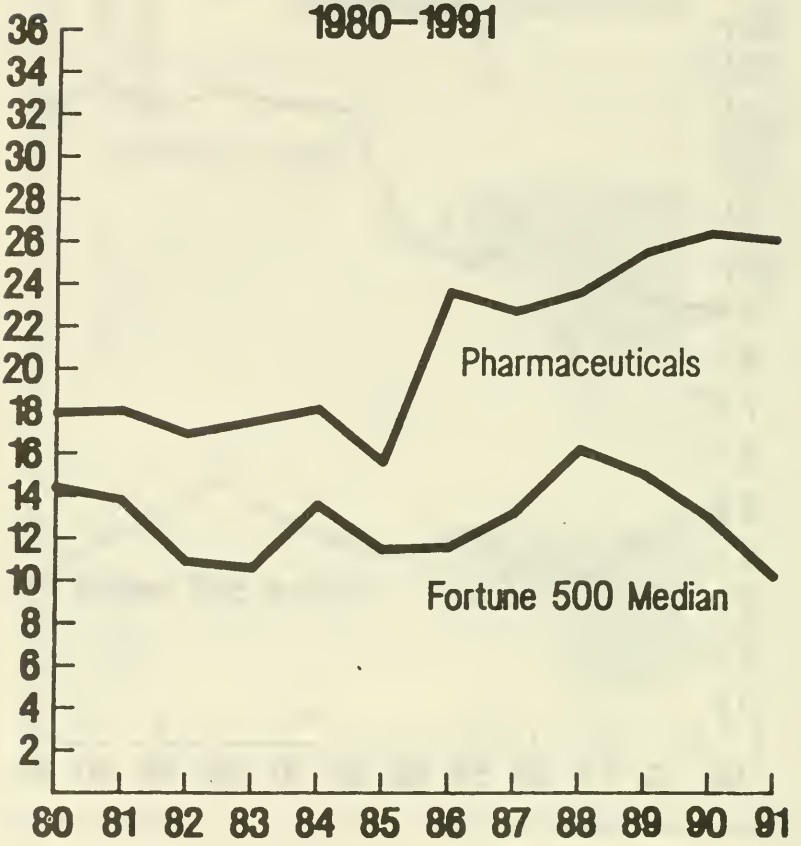
QUARTERA-AG, 4/92


Profitability Of The Pharmaceutical Industry 1991
Return On Sales
Return On Assets
Return On Stockholder Equity
3.2%
5.5%
12.8%
3.7%
7.1%
12.1%
10.2%
21.1%
26.1%
A
B
C
A
B
C
A
B
C
A- Fortune 500 Company's AVERAGE Profitability
B- Second Most Profitable Industry
C- Pharmaceutical Industry (N.B. ranked #1 in each category
Source: Fortune Magazine, April 1992
ROPROFIT-40, 4/92


Pharmaceutical Industry's
Return on Sales Far Outpaces
Fortune 500 Median
1980–1991
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
Pharmaceuticals
Fortune 500 Median
80 81 82 83 84 85 86 87 88 89 90 91
Source: Fortune Magazine 1981 – 1992
RETURN DISK AGI 4/92

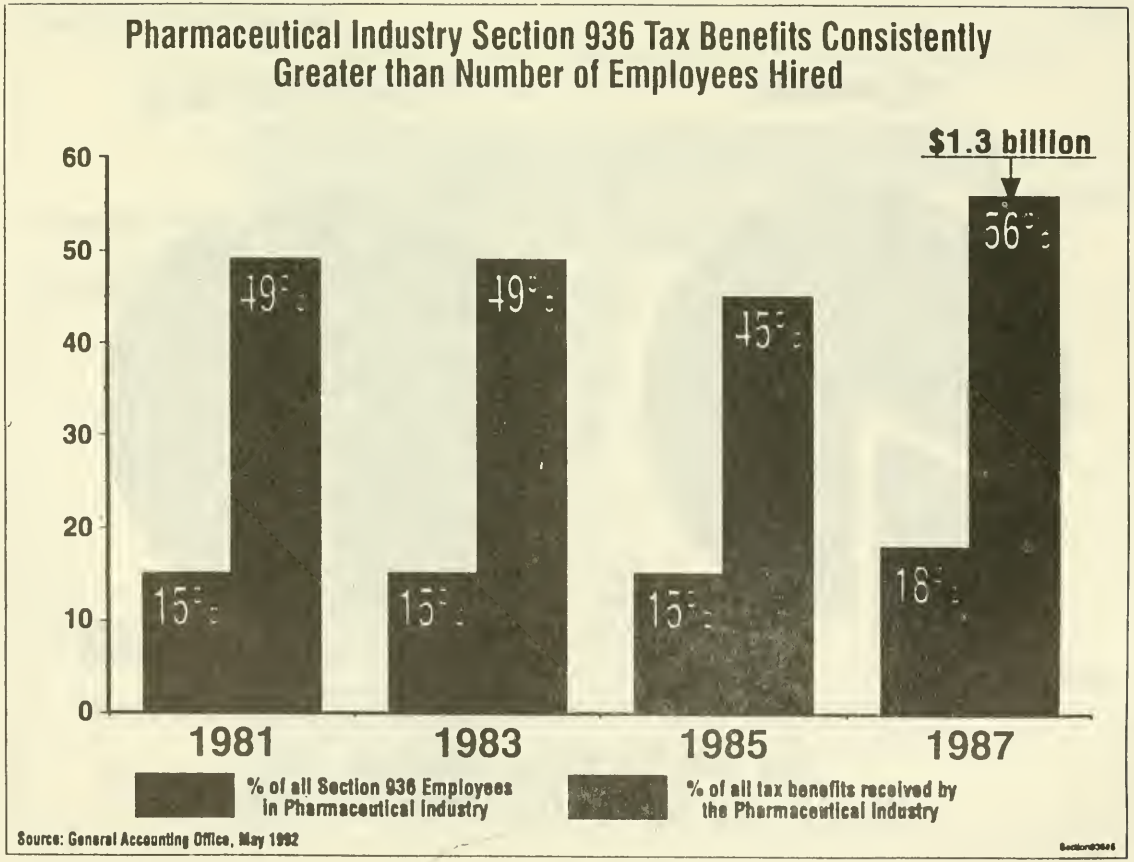
Pharmaceutical Industry's Return on Equity Leads All Fortune 500 Industries

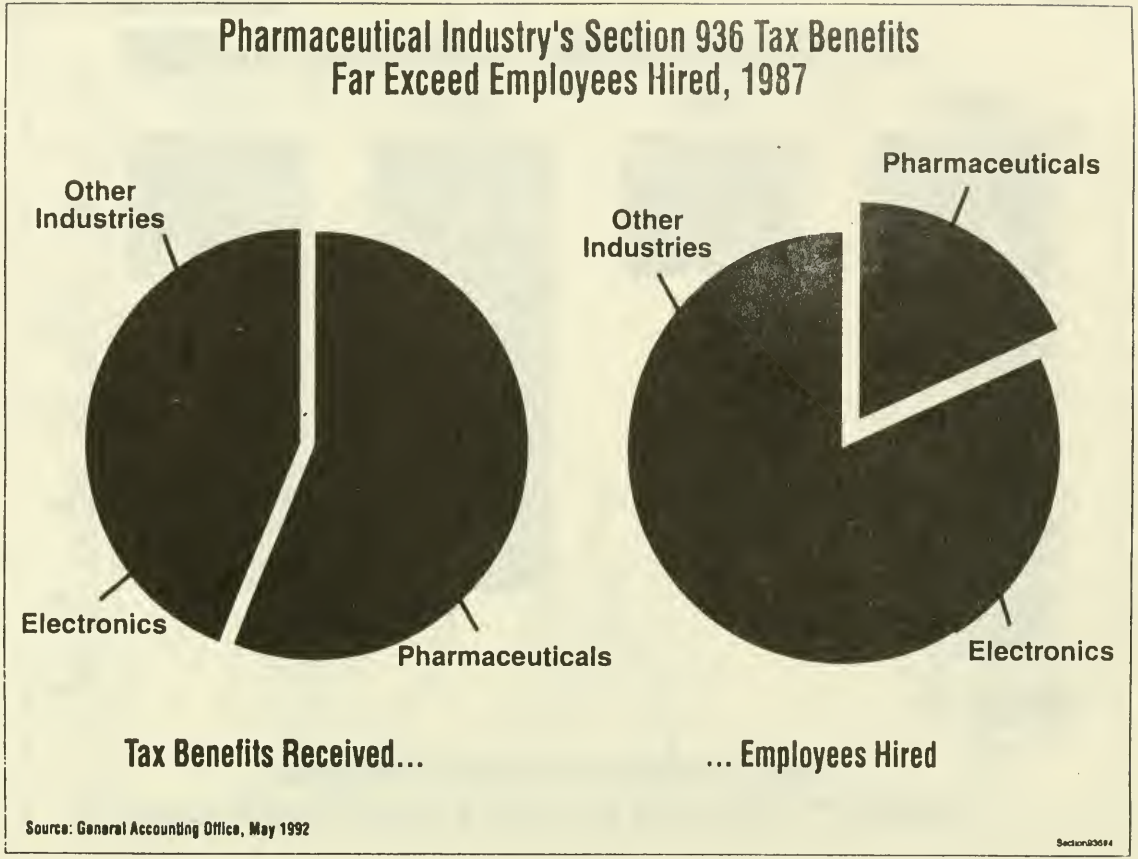
1980–1991

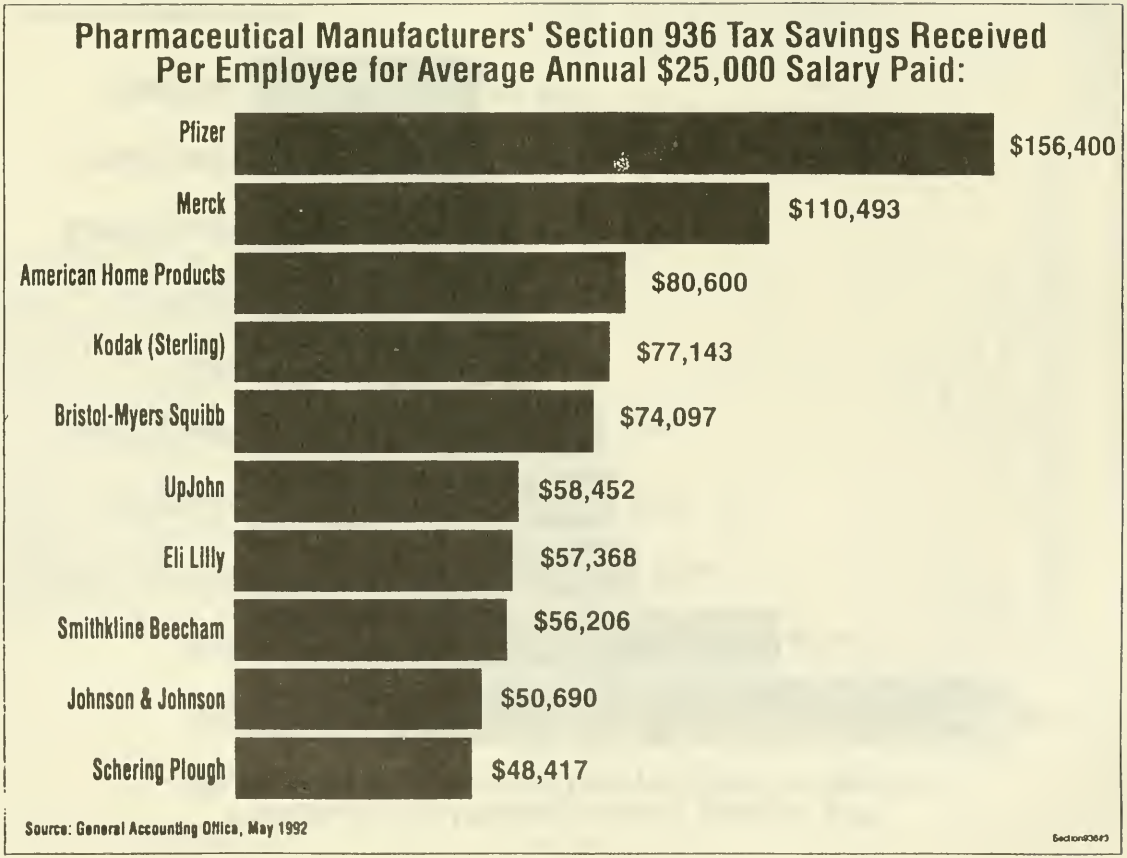


Source: Fortune Magazine 1981 – 1992

RETURN2 DISK AGI 4/92


Pharmaceutical Industry Section 936 Tax Benefits Consistently Greater than Number of Employees Hired
$1.3 billion
60
50
40
30
20
10
0
49%
49%
45%
56%
15%
15%
15%
18%
1981
1983
1985
1987
% of all Section 936 Employees in Pharmaceutical Industry
% of all tax benefits received by the Pharmaceutical Industry
Source: General Accounting Office, May 1992


Pharmaceutical Industry's Section 936 Tax Benefits
Far Exceed Employees Hired, 1987
Other Industries
Electronics
Pharmaceuticals
Tax Benefits Received...
Pharmaceuticals
Other Industries
Electronics
... Employees Hired
Source: General Accounting Office, May 1992


Pharmaceutical Manufacturers' Section 936 Tax Savings Received Per Employee for Average Annual $25,000 Salary Paid:
Pfizer
$156,400
Merck
$110,493
American Home Products
$80,600
Kodak (Sterling)
$77,143
Bristol-Myers Squibb
$74,097
UpJohn
$58,452
Eli Lilly
$57,368
Smithkline Beecham
$56,206
Johnson & Johnson
$50,690
Schering Plough
$48,417
Source: General Accounting Office, May 1992

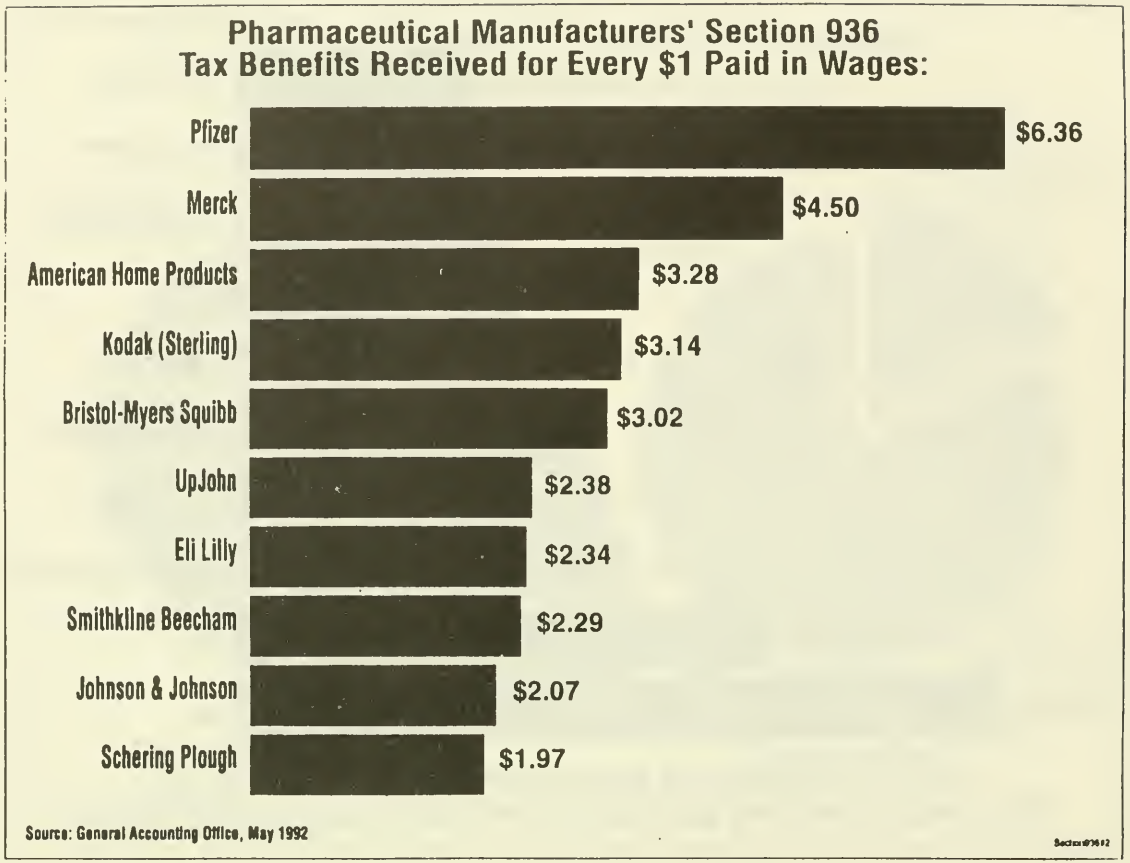

Pharmaceutical Manufacturers' Section 936
Tax Benefits Received for Every $1 Paid in Wages:
Pfizer
$6.36
Merck
$4.50
American Home Products
$3.28
Kodak (Sterling)
$3.14
Bristol-Myers Squibb
$3.02
UpJohn
$2.38
Eli Lilly
$2.34
Smithkline Beecham
$2.29
Johnson & Johnson
$2.07
Schering Plough
$1.97
Source: General Accounting Office, May 1992

Table III-3

Cost of Section 936 per Dollar of Capital, 1987

	Number of Years for Revenue Cost to Equal Net Assets (1)	Subsidy Rate as a Percentage of the Annual Cost of Capital (2)
Pharmaceutical	1.3	372%
Electrical and Electronic Equip	2.6	196
Apparel	3.7	137
Food	2.7	183
Total	1.8	271

Source: Unites States Department of the Treasury, "U.S. Possessions Corporations Returns, 1987," Tables 1 and 2.

The San Juan Star — Wednesday, March 10, 1993

CBS airs segment critical of 936, runaway plants

By DOREEN HEMLOCK
Of The STAR Staff

"CBS Evening News" with Dan Rather featured a critical segment Tuesday night on Puerto Rico's Section 936 tax breaks and runaway plants.

"Workers booted out of their jobs as the government encourages business to move off the U.S. mainland," was the kicker for the "Eye on America" segment which lasted several minutes.

The segment focused on Acme Boot Co., which is closing a factory in Clarksville, Tenn., and opening a plant in Puerto Rico. The island plant gets federal tax breaks under Section 936 of the Internal Revenue Code.

The report said Acme was closing in Tennessee and leaving 450 people jobless despite rising worker productivity and profits there. It said Acme officials acknowledged that "one big reason" for Puerto Rico operations is 936 tax breaks.

"My taxes are really paying for someone to take my job," the segment quoted a laid-off Acme worker as saying.

The CBS report described 936 as a "loophole in the U.S. tax code," and never mentioned why it was created. It claimed that 936 cost the U.S. government about $3 billion a year in potential tax revenues.

It said Washington was aware of the problem.

The segment included a portion of President Clinton's address to Congress Feb. 17, in which Clinton criticized sections of the tax code that give preference for companies to move somewhere else.

It also showed footage of Sen. David Pryor, D-Ark, from a mid-February news conference in which he introduced a bill that would repeal 936. The footage quoted Pryor as calling 936 "the most abusive of all tax shelters, maybe of all time."

[Letters Submitted by Senator Riegle]

Michigan Manufacturers Association

JOHN G. THODIS
PRESIDENT AND
CHIEF EXECUTIVE OFFICER

March 11, 1993

The Honorable Donald Riegle, Jr.
105 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510-2201

Dear Senator Riegle:

It is my understanding that many of our members will be adversely affected by the royalty provision of President Clinton's tax proposal and we would appreciate your effort in having this provision eliminated.

Under the Administration's royalty proposal, foreign dividends and royalties would be treated as separate types of income for purposes of calculation of a company's allowed foreign tax credits. The effect of separating royalties from dividend income will be to greatly increase U.S. taxes on income earned outside the U.S. and brought home. The net effect would be to discourage U.S. companies from bringing earnings back, resulting in a loss of jobs since we would be, in effect, encouraging them to invest in new plants and facilities outside the U.S.

Needless to say, Michigan and, for that matter, the entire country can ill afford tax policy which punishes successful American companies attempting to repatriate hard-earned income from outside the U.S. We all agree that job creation should be the number one priority and we would appreciate your assistance in making sure that the tax proposals now under consideration are not counter productive to this objective.

Thank you in advance.

Sincerely,

John Thodis

124 EAST KALAMAZOO STREET, LANSING, MICHIGAN 48933
TELEPHONE: 517 372-5900

Mary Ann Dirzis
Director
Government Affairs

AVON
212-546-7602
212-546-6611 (Fax)

Avon Products, Inc.
Nine West Fifty Seventh Street
New York, NY 10019-2683

March 30, 1993

The Honorable Donald W. Riegle, Jr.
Committee on Finance
United States Senate
105 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Riegle:

We, at Avon, strongly support your determined efforts to both energize our flagging economy and make substantial reductions to the deficit.

But Avon is very seriously concerned about one provision in the Administration's revenue proposals. This is the rule which would treat all royalty income as passive for purposes of the foreign tax credit limitation. Avon strongly opposes this proposal as one which is both unfair and counterproductive.

Some of Avon's manufacturing operations are located in foreign countries. It is not possible to manufacture all our products in the United States since we must be responsive to local markets, avoid prohibitive foreign tariffs on imports of the finished products, and comply with certain foreign laws (which require a substantial portion of products to be manufactured locally). Importantly, none of these products are manufactured abroad for import to the United States.

For many years, Avon has received royalties on trademarks, trade names, marketing and distribution systems, manufacturing know-how and other business systems from its foreign affiliates. These royalties are not an effort to manipulate the foreign tax credit; rather they reflect business reality. In fact, the IRS insists that Avon charge its foreign affiliates adequate royalties. If these royalties were treated as passive income, Avon's tax burden would be greatly increased as a result of double taxation of Avon's foreign income.

I understand that the purpose of the Administration proposal is to encourage companies to bring foreign manufacturing jobs back to the United States. The fact is that Avon would not be able to save one more U.S. job as a result of the enactment of this proposal. All of our foreign facilities exist for economic, tariff, and regulatory concerns which cannot be overcome.

On the other hand, the additional tax burden which would result from the proposal would put Avon at a competitive disadvantage with foreign-based corporations. The cosmetics and fragrance industry is under attack by Japanese, French and German companies. This proposal would play right into their hands. If this change occurs, there could be a loss of many jobs for Avon's U.S. employees including those supporting the foreign operations.

I also understand that there may be a link between the passive royalty proposal and another proposal which would provide favorable treatment for research undertaken in the United States. In Avon's case, it would be very unfair to link these two proposals. The bulk of our royalties relate to trademarks and marketing and distribution know-how, which do not benefit from research deductions.

Enclosed is a detailed memorandum, explaining the problems with the passive royalty proposal. This memorandum also includes alternative approaches to the issues raised which we feel are fairer and more effective. I would be very grateful for an opportunity to discuss this matter with you or with your staff.

Very truly yours,

Mary Ann Dirgis

MAD/ms
Enclosure

March 8, 1993

AVON PRODUCTS, INC.

Re: Passive Royalty Proposal

One of the Administration's tax proposals would treat all royalties as passive income for foreign tax credit purposes. Avon believes that this proposal will not accomplish its intended purposes and is counterproductive. Avon strongly opposes this proposal.

The apparent rationale for the proposal is that, by imposing greater U.S. tax costs on foreign operations, multinational U.S. companies would be encouraged to return manufacturing jobs to the United States. The proposal also appears to be linked to a separate proposal which would provide more favorable foreign tax credit treatment of research and experimentation ("R&E") expenses.

Arguments Against the Proposal

1. CFC royalties should be treated as active income.--Congress deliberately treated CFC royalties as "active" under the 1986 tax legislation because it recognized that the royalties were a substitute for dividends and in addition could reduce foreign tax. These reasons remain just as valid today.

2. Interest and rents are not treated consistently.--The proposal singles out royalties but does not change the active treatment of CFC interest or rents. This indicates that the proposal is linked to R&E benefits. Such a linkage is unfair, however, where royalties are paid on intangibles which never benefited from R&E deductions, such as trademarks.

3. Present law merely prevents double taxation.--Overall, no taxpayer may claim a foreign tax credit higher than U.S. tax imposed on foreign income. The proposal is another effort to create two artificial foreign tax credit baskets, one for high-tax income and one for low-tax income. Taxpayers will always be the losers under such a regime, which is patently unfair double taxation.

04122.012
March 17, 1993

AVON PRODUCTS, INC.

Re: Passive Royalty Proposal

One of the Administration's revenue proposals would treat all royalties as passive income for purposes of determining the foreign tax credit limitation. This proposal would have a major impact on Avon Products, Inc. ("Avon") and numerous other taxpayers. Avon believes that the proposal will not accomplish its intended purposes and will have a detrimental impact on employment in the United States. Avon strongly opposes the proposal.

Avon makes decisions to locate facilities outside the United States primarily for business and regulatory, not tax, reasons. However, the additional burden imposed by the Administration proposal may force Avon to curtail its activities abroad. This would not create more U.S. jobs, but could eliminate the jobs of U.S. support workers including those providing services to the foreign operations.

The Administration proposal appears to be linked to another proposal providing favorable foreign tax credit treatment for research and experimentation ("R&E") costs. Avon believes that the proposed royalty rule, which would treat royalties unfavorably regardless of whether the intangible property with respect to which they are paid benefited from the R&E rules, is grossly unfair.

Background

Avon is a United States multinational business primarily engaged in the manufacture and sale of cosmetics through independent sales Representatives to customers in their homes. For many years, Avon has actively sought to sell products outside, as well as within, the United States. For business reasons, operations outside the United States are accomplished through in-country subsidiaries of Avon which are controlled foreign corporations ("CFCs").

Avon is required to operate through in-country manufacturing subsidiaries for a number of reasons. Firstly, Avon sells consumer products door-to-door. Avon must have an actual in-country presence to generate consumer demand for these products and to be responsive as rapidly as possible to that demand. Secondly, Avon's experience has been that cosmetics are generally subject to very substantial tariffs worldwide. Total costs to Avon are much lower where the cosmetics are manufactured within the country of sale, rather than being imported into that country. Thirdly, in some countries Avon is required by local law to manufacture a substantial portion of the products sold through an in-country manufacturing corporation, in some cases involving partial ownership by local nationals.

Avon receives royalties from these foreign subsidiaries except where prohibited by law. The royalties are paid for use of Avon trademarks, trade names, marketing and distribution systems, manufacturing know-how and other business systems. These royalties are not an effort to manipulate the foreign tax credit rules but represent the economic reality of the relationships between Avon and its foreign subsidiaries. Indeed, the Internal Revenue Service, when auditing Avon, consistently examines these royalty arrangements to assure that the royalty rates imposed are adequate.

Foreign Tax Credit Implications

The royalties received by Avon from its CFCs are, under present law, included in the general limitation, or "active," basket for foreign tax credit purposes. In those situations where the royalties are not subject to foreign withholding taxes at least equal to U.S. tax on the royalties, Avon is permitted to credit excess foreign income taxes which Avon has paid on other foreign income against the U.S. tax payable on receipt of the royalties.

The royalties also have the effect in general of reducing the foreign income taxes which are imposed on the CFCs. To the extent that the foreign governments involved recognize the validity of the royalties, they generally are allowed as deductions for purposes of computing the base on which the foreign income tax is imposed. Under the current lookthrough rules, these royalty deductions are allocable to the active basket since the income generated by the royalties is sales and operating income.

Administration Proposal

As part of the revenue portion of its economic program, the Administration has proposed treatment of all royalties as passive income for purposes of the foreign tax credit limitation, even if the royalties are derived from a CFC or from an active licensing business. The effect of this proposal would be that royalties received by Avon from its CFCs would be included in the passive, rather than the active, foreign tax credit basket. It would no longer be possible for Avon to offset U.S. tax on the royalties with excess foreign income taxes paid on other foreign active income generated by Avon. Rather, the royalties would be included in the passive basket with other types of foreign income, such as interest, which generally bear little foreign tax. This would significantly increase Avon's current tax burden.

Perceived Rationale for Administration Proposal

The rationale for the inclusion of this particular provision in the Administration proposals is not entirely clear, but it appears to be intended to make foreign operations generally less attractive in an effort to divert employment from abroad back to the United States. If this is the case, Avon believes that the effort is misguided and will likely reduce, rather than increase, U.S. employment.

The stated rationale for the proposal, as set forth in Summary of the Administration's Revenue Proposals 58, is as follows:

> The treatment of substantial portions of foreign source royalty income as general limitation income for foreign tax credit limitation purposes (under either the "active royalty" exception or the "lookthrough" rule) can result in a tax preference for licensing of intangible property to a foreign person for use in production activities abroad. ... In contrast, royalties or other income received from the use of intangible property in domestic production activities are subject to full United States taxation. (Emphasis added.)

Compare A Vision of Change for America 105:

> Another set of provisions will reduce the tax incentives for U.S. corporations to operate abroad. These include encouraging research and development to be performed in the United States and the related products to be manufactured here as well.... (Emphasis added.)

The theory appears to be that taxpayers with excess foreign tax credits have an incentive to locate manufacturing facilities in foreign affiliates. Royalties from intangibles licensed to these affiliates may then be repatriated with relatively low tax by utilization of excess credits from other foreign income. Elimination of this incentive would encourage companies to locate more facilities in the U.S. (Reduced deferral, another Administration proposal, also apparently follows this rationale.)

There may be other, unstated, rationales for the proposal. For unexplained reasons, the proposal is paired with another proposal to provide favorable foreign tax credit treatment of R&E expenditures. It is possible that the R&E and royalty proposals are linked in the minds of the individuals who developed the Administration program. For example, they may have believed that if the cost of developing an intangible asset was deducted against U.S. source income under the R&E rule, then royalties generated by the licensing of that intangible should not produce favorable foreign tax credit treatment.

Arguments Against the Proposal

1. CFC Royalties Should Be Treated as Active Income

The rationale for treating CFC royalties as active income is clearly and articulately set forth in Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 866 (1987):

> Congress decided to subject interest, rents, and royalties, in particular, to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation or other related person. In addition, Congress believed that interest, rents, and royalties from controlled foreign corporations generally should be treated for look-through purposes like dividends from controlled foreign corporations so that payment of the former would not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividend payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of controlled foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by controlled foreign corporations may, therefore, reserve for the United States more of the pre-credit U.S. tax on these corporations' foreign earnings than the payment of dividends. (Footnote omitted.)

This rationale makes as much sense today as it did then. There is no good reason to treat royalties from a CFC as passive if the CFC's income from which the royalty is paid is active.

Royalties for the use of intangible property in domestic production activities are not subject to taxation in foreign jurisdictions nor do they reduce foreign taxes paid for foreign tax credit purposes. It, therefore, seems inappropriate for the Administration to consider foreign-source royalties a tax preference item as compared to U.S. source royalties.

2. Interest and Rents Are Not Treated Consistently

The same "foreign preference" arguments which are advanced to change the treatment of royalty income could be put forward with respect to interest and rents received from foreign affiliates. Interest and rents, like royalties, generally are treated as active business income in these situations to the extent that they are paid from active income of the CFC. Like royalties, the interest and rent payments may be allowed as a deduction by the foreign government in computing the CFC's tax liability. However,

there is no suggestion in the Administration proposal that interest or rent payments be subject to the same treatment as royalties.

This failure to treat royalties, interest and rents consistently is an indication that a significant rationale for the royalty proposal is its linkage with the proposed treatment of R&E expenditures. However, any such linkage would be grossly unfair. In Avon's situation, royalties are paid for trademarks, trade names, and various other intangibles which do not benefit from R&E deductions, as well as some other intangibles which do benefit. It is clearly not appropriate to lump all intangibles together when most plainly do not benefit from R&E.

3. Present Law Merely Prevents Double Taxation

Amidst the discussion of supposed incentives to locate plants abroad, one must not lose sight of the fact that the purpose of the foreign tax credit is to prevent double taxation of income earned abroad. Fairness and prevention of double taxation require the present law rules to be retained.

The foreign tax credit limitation prevents the foreign tax credit from exceeding the U.S. tax which is otherwise payable on the foreign income. Congress has long recognized that, in view of this limitation and out of considerations of fundamental fairness, it is important as a general matter to consider all foreign income and foreign taxes paid in the aggregate. This permits foreign taxes in excess of the allowable limitation on one item of income to offset U.S. tax on another item of income which was not taxed as heavily. On the average, however, the foreign tax credit may not exceed the U.S. tax imposed on the overall foreign income.

Of course, Congress has also recognized that there are some anomalous situations in which the cross-crediting described above could result in distortions. Thus, separate limitations have been provided for certain types of highly mobile portfolio passive income, for financial income, and for oil and shipping income. Nevertheless, these are limited exceptions to the general rule of cross-crediting.

Avon is concerned that the Administration proposal is just another step, albeit a well disguised one, toward a regime in which there are in effect two foreign tax credit baskets, one for high-taxed income, and one for low-taxed income. The effect of such a system would be to put taxpayers in a chronic excess foreign tax credit situation. Taxpayers with foreign operations would be subjected to persistent double taxation. This would distort economic neutrality as much as any other possible regime, and would actively discourage U.S. taxpayers from pursuing foreign opportunities.

The "high tax basket/low tax basket" approach already has a foothold in current law in the form of the high-tax kick-out from the passive basket. The passive basket is intended to include only income which has attracted low foreign tax and on which significant U.S. tax will be payable even after allowance of the foreign tax credit. If however, passive income on which high foreign taxes (in excess of U.S. tax rates) have been paid somehow finds it way into the passive basket, the taxpayer is not permitted to use those high foreign taxes to offset its U.S. tax liability on the other passive income. Rather, the high-taxed income is removed from the passive basket and placed in the active basket, where it is more likely merely to generate additional excess foreign tax credits, rather than to reduce the extent of the taxpayer's double taxation. The concept of placing all royalties in the passive basket merely because they may attract low foreign tax is but another example of this "heads I win, tails you lose" approach to the foreign tax credit limitation.

The Treasury Department's distaste for cross-crediting is illustrated in the Administration's proposals leading to the enactment of the Tax Reform Act of 1986. There, the Administration called for the foreign tax credit limitation to be computed on a per-country, rather than a worldwide, basis. This would prevent high taxes paid to one country from offsetting U.S. tax liability on income from another country where lower taxes were paid. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 389 (May 1985). Fortunately, the Congress refused to enact a per-country limitation. The current Administration's proposal on the taxation of royalty income would have no less an adverse effect on Avon.

4. The Proposal Will Not Create More U.S. Jobs

The proposal appears to contemplate that U.S. multinational companies will carefully weigh the effects of the foreign tax credit in making decisions as to whether to locate additional manufacturing facilities in the United States or abroad. Avon believes that if this rule affects decisions to transfer facilities abroad, it is at the margin and the effect is far overstated.

In Avon's situation, the necessity of placing some manufacturing facilities abroad is driven by economic and regulatory factors, including the need to establish a presence in the foreign market, high tariffs on cosmetic products imported into that market, and local laws on organization and ownership of entities doing business in the foreign country involved. None of these factors would change in the least if the Administration proposal were adopted; the only effect would be a significant increased tax burden on Avon.

5. Any Incentive To Locate Abroad Is Diluted by the Withholding Tax on Dividends

As noted above, in Avon's situation decisions to locate plants abroad are made for non-tax reasons. There may be some other taxpayers who are influenced in some degree by foreign tax credit considerations. Avon believes, however, that the effect of the proposal even on these other taxpayers has likely been greatly exaggerated.

It would not be sound business planning to base fundamental capital investments on a series of foreign tax credit rules which are changed in important ways every few years. However, even if the royalty rules of current law would provide an incentive to some taxpayers to locate plants abroad, that incentive is greatly diminished because location of a plant abroad results in imposition of withholding taxes on dividends, an additional expense not incurred within a U.S. affiliated group, which at least partially offsets the tax advantages associated with the royalties.

In a case where a U.S. multinational company decides to build a plant in the United States, the operations of that plant will be included within the U.S. company's consolidated federal income tax return. If the plant is owned by a subsidiary, dividends paid by the subsidiary to the parent corporation will be eliminated in the consolidated return and will not be subject to U.S. income tax.

If, however, the U.S. multinational locates the plant abroad, dividends paid by the foreign subsidiary will be subject to withholding tax by the foreign government in whose country the foreign subsidiary is located. This tax will typically be at least 5 percent of the amount of the dividends if a tax treaty applies. This is an additional tax which would not have been incurred had operations been located in the United States. The dividend withholding tax may considerably reduce the tax incentive, if any, to locate the plant abroad.

6. The Administration Proposal Will Reduce U.S. Jobs

Certainly in Avon's situation, there is not one U.S. job that would be saved by enactment of the Administration proposal. Some of Avon's manufacturing operations are located in foreign countries. It is not possible to manufacture all our products in the United States since we must be responsive to local markets, avoid prohibitive foreign tariffs on imports of the finished products, and comply with certain foreign laws (which require a substantial portion of products to be manufactured locally). Importantly, none of these products are manufactured abroad for import to the United States.

If the Administration proposal is enacted, it will add a significant cost to Avon. In some cases, this additional cost will make the risks of the foreign operation unjustifiable. Avon would then be required, not to move the operations back to the United States, but to close them down. This would create no U.S. jobs and, in fact, could eliminate significant support jobs in the United States including those related to the foreign operations.

Possible Alternatives

Avon recognizes that there is a concern over jobs in the Administration proposal which the Administration is anxious to address. Avon suggests that that concern is more properly addressed by a "runaway plant" concept. That is, where a CFC manufactures products abroad which are imported into the United States, it might be appropriate to curtail the benefits of royalties paid by that CFC. This concept has been proposed for some time in connection with restrictions on deferral. (See, for example, S. 26, introduced by Senator Dorgan, which would end deferral for runaway plant income and put such income in a separate foreign tax credit basket.)

However, even in this situation, care would have to be taken where multinationals are, for reasons of economic efficiency, not trying to export U.S. jobs but are simply manufacturing some products in the U.S. for worldwide distribution and other products abroad for worldwide distribution. Rules recognizing exceptions where such arrangements are economically justified, or at least allowing U.S. exports to be netted against any U.S. imports before determining that goods are being manufactured abroad for import into the United States under this rule, would be essential.

A second alternative, to the extent that the rationale for the Administration proposal is a linkage with the R&E proposal, would be to apply the Administration proposal only to royalties generated by intangibles which benefited from the deduction of R&E expenses in the United States. This would prevent the application of the rule to royalties for the use of trademarks and trade names, as well as most non-manufacturing intangibles. That would be a much fairer rule than the crude categorization of all royalties as passive as proposed by the Administration.

A third alternative, if the royalty rule is viewed as some type of unjustified double benefit when combined with the R&E sourcing rule, would be to permit taxpayers to elect to forgo the benefit of the R&E sourcing rule and retain the benefit of present law with regard to royalty characterization.

Pitney Bowes

Chairman of the Board
and President

April 1, 1993

The Honorable Donald W. Riegle
United States Senate
105 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Riegle:

As an employer of nearly 350 people in the state of Michigan and 24,000 in the United States, Pitney Bowes would like to express its concerns regarding President Clinton's deficit reduction package, which includes various proposals to increase corporate taxes. Several of these proposals are counter-productive to their desired outcomes of economic stimulation and job creation.

Corporate Tax Rate Increase

The President's proposed two-percent increase in the corporate tax rate will severely penalize U.S.-based publicly held companies. The performance of such companies, evaluated based on earnings per share (EPS), must be continually improved in order to meet shareholder expectations. Even a small reduction in EPS can significantly depress a company's stock price and ability to compete globally.

Because a two-percent tax increase would result in a significantly higher tax charged against current-year earnings, it would result in an immediate and substantial decrease in EPS performance. To mitigate the impact of the higher corporate tax rate, publicly held companies will be forced to reduce all controllable expenditures including employee headcount, workforce training, research and development, and investment in new equipment.

Instead of increasing corporate tax rates, one option would be to not enact into law the proposed temporary investment tax incentive for large business. From Pitney Bowes' perspective, in light of a corporate tax rate increase, the proposed investment tax credit would not provide sufficient economic incentive to increase spending on equipment. In fact, to offset the negative impact on earnings of a corporate rate increase, Pitney Bowes would be forced to reduce its investment in new equipment.

Royalties Sourced as Passive Income

President Clinton's deficit reduction package contains a proposal which includes royalties in a separate passive basket for foreign tax credit purposes. We urge the President and Congress to not make piecemeal changes to U.S. international tax policy. Instead, the foreign tax credit system should be reviewed comprehensively in the context of

Pitney Bowes

international tax reform. In order for the United States to regain its economic strength and viability, it must be able to compete in a global economy. Our current tax system places American companies at a disadvantage compared to their foreign competitors, and comprehensive changes to the system should be made to eliminate these competitive disadvantages.

The current U.S. foreign tax credit system exposes U.S.-based multi-nationals to double taxation of their foreign earnings by requiring companies to allocate and apportion U.S.-incurred expenses to foreign source income. As a result, U.S. companies receive a smaller foreign tax credit, and are thereby in effect denied a portion of their deductions for interest, salaries, taxes, accounting and other expenses. This restricts the ability of U.S. businesses to compete globally with foreign-based multi-nationals, and discourages U.S.-based companies from repatriating foreign-source income to the U.S.

The current treatment of royalty income is one of the few adjustments in the foreign tax credit system which helps U.S. companies offset these harsh and unfair expense allocation rules. This treatment enables U.S. companies to bring foreign-source income back to the U.S. while minimizing double-taxation of these funds.

The President's proposal, if implemented, will make it more difficult for companies to repatriate foreign-source income without double taxation. This will even further discourage companies from repatriating funds which are currently invested outside of the U.S.

The government should instead make it easier for companies to repatriate these funds, which would be used to invest in jobs, training and technology here in the U.S. We feel that companies should be permitted to place all foreign dividends in a separate basket to which no expenses would be allocated. This would permit U.S.-based companies to repatriate foreign earnings without exposing them to double taxation.

Other Proposals

We strongly support proposals which would permanently extend the R&D tax credit and which would allocate 100 percent of U.S. R&D expenditures to U.S.-source income. Both of these proposals will help provide increased incentives for conducting R&D in the United States.

Thank you for your consideration of our concerns.

Sincerely,

George B. Harvey

Wm. **WRIGLEY** Jr. Company
OFFICE OF THE PRESIDENT

WRIGLEY BUILDING • 410 N. MICHIGAN AVENUE • CHICAGO, ILLINOIS 60611 • TELEPHONE 644 2121

April 2, 1993

The Honorable Daniel Patrick Moynihan, Chairman
Senate Finance Committee
United States Senate
464 Russell Senate Office Building
Constitution Ave. between Delaware Ave.
and 1st N.E.
Washington, D.C. 20510

Dear Mr. Chairman:

This letter is to express objection to the Treasury Department proposal to effectively increase the taxation of foreign royalty income by treating it as "passive" income. I hope that you, as Chairman of the Senate Finance Committee, will consider my views and those of other businesses and reject this ill-conceived aspect of the Treasury tax package.

The effect of the Treasury proposal on the Wm. Wrigley Jr. Company and many other businesses will be detrimental, and I would urge you and the other members of Congress to consider the following points:

- The Treasury proposal has been defended on the grounds that it will encourage U.S. companies to export goods rather than to produce abroad. Unfortunately, for many food companies our products cannot be exported from the U.S. and still compete effectively in foreign markets. Barriers like freight and duty costs, product spoilage, and local import restrictions make it mandatory either to produce in foreign markets or not compete. In a business like ours, we can maximize U.S. income by licensing trademarks and know-how to wholly-owned foreign manufacturing subsidiaries and repatriating royalties to the parent company in the U.S.

- Royalties received by companies like ours contribute significantly to reduce the U.S. balance of trade deficit. Last year in our company, we generated a net positive U.S. balance of payments totaling $121 million, including a contribution of $21 million in royalties from our foreign subsidiaries. Increasing the tax cost of repatriating these royalties will only lead companies to shelter that income.

- The flow of income to the U.S from foreign subsidiaries creates many U.S jobs that would not otherwise exist. In the food industry this is especially true in areas like research, engineering, and in the exporting of production equipment and ingredients to foreign subsidiaries.

- Increasing the U.S. taxation of foreign royalties is a disincentive to U.S. companies to compete abroad. In 1992, our company paid 38.4% in taxes on foreign earnings, a rate that would increase to 43.8% under the Treasury proposal. Increasing the tax burden on foreign earnings, which in our case is already higher than the U.S. corporate rate, makes it less likely that U.S. companies will continue to expand into new foreign markets. It would also reduce our competitiveness in existing foreign markets.

- The full effect of the Treasury proposal on many companies apparently has either been misunderstood or underestimated. Our projections show that the cost to our company of the royalty taxation proposal will be twice as great as the cost of increasing the corporate tax rate from 34% to 36%. An earnings reduction of that magnitude will have an extremely detrimental effect on the individuals and institutions that rely on the dividends and value created by the ownership of stock in U.S. firms. That in turn will be harmful to the U.S. economy.

In summary, I urge you to oppose the Treasury proposal on royalties when it is considered by your committee. And thank you for considering our views.

Sincerely yours,

William Wrigley

WW/ch

cc - Members of the Senate Finance Committee:

Hon. Max Baucus
Hon. David L. Boren
Hon. Bill Bradley
Hon. George J. Mitchell
Hon. David Pryor
Hon. Donald W. Riegle Jr.
Hon. John D. Rockefeller IV
Hon. Tom Daschle
Hon. Kent Conrad
Hon. John Breaux
Hon. Bob Packwood
Hon. Bob Dole
Hon. William V. Roth Jr.
Hon. John C. Danforth
Hon. John H. Chafee
Hon. Dave Durenberger
Hon. Charles E. Grassley
Hon. Orrin G. Hatch
Hon. Malcolm Wallop

Charles D. Miller
Chairman and
Chief Executive Officer

150 North Orange Grove Boulevard
Pasadena, California 91103
Phone 818 304-2000
FAX 818 568-0588

April 28, 1993

The Honorable Donald W. Riegle, Jr.
United States Senate
Dirksen Senate Office Building
Room 105
Washington, D.C. 20510

Dear Senator Riegle:

I am writing to you to express my deep concern over the tax treatment accorded royalty income under the Clinton Administration's Economic and Deficit Reduction plan. There is little question that the provision to place royalty income in a separate passive basket for foreign tax credit purposes will have the effect of jeopardizing investment in the United States. A corollary to this is likely to be an expansion of investment abroad with job creation outside of this country. That is contrary to what I understand is the avowed purpose of the Administration's plan. I would like to explain how this provision would affect Avery Dennison's operations.

Avery Dennison has no choice but to manufacture where its markets are located. Being customer focused with speed in delivery a competitive necessity, Avery Dennison could not compete globally unless it manufactures where its customers are based.

Since our customers are primarily in developed countries, our manufacturing facilities principally are also located in developed countries. The tax rate that Avery Dennison's foreign subsidiaries incur offshore are generally equal to or greater than the U.S. tax rate.

If the provision to treat royalty income as separate passive basket income were adopted, Avery Dennison would not be able to repatriate earnings from foreign subsidiaries without severe incremental tax cost. Any dividend payments would be taxed in the United States without the benefit of offsetting the U.S. tax cost by crediting foreign taxes paid in earning the income. Thus, the dividends would be subject to double taxation.

Given this, Avery Dennison, which has repatriated substantial sums to the United States these past few years, would be forced to accumulate these earnings offshore rather than suffer the cost of double taxation through repatriation. Avery Dennison would seek to employ the funds in its operations. The funds would be located outside the United States. Avery Dennison would have to consider transferring functions offshore in order to utilize these trapped funds.

All of the alternatives which come to mind have the effect of increasing employment outside the United States at the expense of domestic employment opportunities. We believe that this is contrary to the Clinton Administration's objectives.

Thank you for your thoughtful consideration of this matter which seriously affects Avery Dennison, its shareholders, and employees.

Sincerely,

Charles D. Miller

CDM:pvs

Lester M. (Les) Alberthal, Jr.
Chairman of the Board
President and Chief Executive Officer

EDS

April 27, 1993

The Honorable Donald W. Riegle, Jr.
United States Senate
105 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Riegle:

I would like to express my concern that the royalties provision of the President's economic package could have a serious negative effect on companies in the information technology services industry. The provision would classify royalty income associated with foreign operations as passive income for tax purposes. This would penalize companies that must license software to their subsidiaries in order to provide information technology services to customers located outside the United States.

I believe that this provision may have been driven by a misunderstanding of the way in which many multinational companies do business. The software that EDS licenses for use by our subsidiaries is central to our active business operations. A large majority of this software is developed and owned by EDS in the United States. We cannot, however, provide service to customers in other countries without the ability to use our software where our customers are located.

If EDS' royalty income is classified as passive income, the effective tax rate on our foreign income will increase substantially. This will make it more difficult for EDS to compete in a global economy. It will provide an incentive for U.S. companies to develop software outside the United States and will lead to a reduction in U.S. jobs and royalty income.

I realize that the development of tax legislation is not easy. I applaud the efforts of the Administration to reduce the deficit and promote increased economic development. However, I believe that this particular provision is contrary to good tax policy and that it will undermine the economic goals that the Administration hopes to achieve. I hope that you will be willing to work with EDS and other multinational companies to resolve the problems that this proposal would create.

Sincerely,

LMAJr/mkl

Praxair, Inc.
39 Old Ridgebury Road
Danbury, CT 06810-5113
Tel (203) 794-4820

John A. Clerico
Vice President, Treasurer and
Chief Financial Officer

May 19, 1993

Sharon B. Heaton
c/o U. S. Senator Donald W. Riegle, Jr.
U. S. Senate
Washington, D. C. 20510

Dear Ms. Heaton:

In his February address before Congress, President Clinton correctly stated that the private sector is the engine of economic growth in America. He added that "our immediate priority is to create jobs." The President's economic proposal contains some worthwhile recommendations. However, the change in taxing earnings of our foreign subsidiaries is particularly punitive. If enacted, this would stifle growth and sacrifice American jobs. I want to bring this to your attention, given your expertise with tax legislation.

I am John Clerico, the Chief Financial Officer of Praxair, Inc. Praxair is a leading producer of industrial gass in the North and in South America. We employ over 4,000 in the United States and have facilities in your state.

We are particularly concerned with the international tax provision cutting back on the deferral on foreign earnings. I oppose the proposal to accelerate the U.S. tax on foreign earnings generated by a foreign subsidiary in the conduct of an active trade or business before such earnings are received by the U.S. entity. It is my understanding that this provision was included in the package to prevent the movement of U.S. plants offshore. However, this provision targets more than companies moving plants abroad. The provision adversely impacts all U.S. based companies that do business overseas. This result is particularly damaging since the proposal has no impact on our foreign-based competition.

A general premise of this tax proposal is that companies locate their operations overseas for tax reasons. However, in virtually all cases, companies locate operations abroad for business reasons and not for tax reasons. In my industry, the Industrial Gas business, we make products overseas because that is where our customers are. Our products (oxygen, nitrogen and argon) cannot be exported economically. We must source overseas to remain viable. To now tax these foreign earnings before they are returned home to the U.S. would deprive us of badly needed capital to grow our business both here and abroad. This tax change would handicap our ability to compete with foreign-based companies who are also making product in the U.S. By being a worldwide company we create jobs for Americans because much of the design and manufacture of our overseas plants occur in the United States. High quality supervisory, administrative and engineering jobs supporting our foreign expansion are usually located in the United States. Any cutback in deferral will reduce the profitability and market share of U.S. based firms, which will impede exports from the United States.

In addition, this proposal is contrary to the tax principle applied to U.S. shareholders of U.S. corporations. It is prejudicial in that it levies the U.S. tax on foreign income of a foreign entity without giving U.S. recognition to foreign losses of such foreign entities. It imposes a U.S. competitive tax burden on foreign operations when there is a capital need for retained earnings in countries which have a lower effective income tax rate than the U.S. On the other hand, existing law does provide adequate protection of the U.S. revenue through Subpart F as to passive income generated abroad, which might not be repatriated to the U.S. so as to avoid U.S. taxes.

In assessing the effects that a cut-back in deferral on U.S. businesses operating abroad might have, the experience of the financial service industry should be heeded. The 1986 Tax Reform Act repealed deferral for financial services companies. A study engaged in the financial services industry abroad indicate that the effect of repealing deferral has been to cause a sharp reduction in retained earnings to pay the U.S. tax, thereby placing those companies at a competitive disadvantage relative to foreign-owned companies in the same market.

Finally, this proposal applies to prior year accumulated earnings and assets. For example, a company can have losses in all years after enactment and still be subject to the tax. It can have no new investments in passive assets in all years after enactment and still trigger the tax. In this respect, the proposal constitutes an unprecedented departure from any existing provision of the Internal Revenue Code. Never in the history of the income tax law has the Congress imposed such a tax upon pre-enactment year earnings.

In conclusion, as you can see this proposal will not discourage runaway plants. It will have a negative impact on U.S. competitiveness. As a result, if this proposal is enacted U.S. jobs will be lost not created. I hope you see this as an anti-business tax proposal.

I would be happy to answer any questions you may have in regard to this matter.

Sincerely,

The Dow Chemical Company
Midland, Michigan 48674

April 28, 1993

The Honorable Donald W. Riegle, Jr.
105 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Riegle:

I would like to express the concerns we at The Dow Chemical Company have regarding the Administration's proposal to treat royalty payments as passive income for foreign tax credit purposes. We believe the proposal would levy a significant penalty on the foreign operations of U.S. chemical companies.

Overall, the royalty proposal penalizes U.S. firms practicing U.S.-developed technologies overseas to compete in global markets. The chemical industry is a worldwide market. Of the world's largest chemical companies, for instance, the largest U.S. companies rank fifth and sixth. Chemical manufacturers must locate plants in local markets in order to expand their presence and broaden the mix of products offered to customer. Many of the products we manufacture cannot be transported long distances in a cost effective manner. Often, if a chemical company does not have a plant near the foreign customer, it will not be able to sell its products in that market. Our data proves this foreign production increases exports in support of U.S. production and jobs.

The chemical industry exports over $44 billion with a favorable balance of trade of $16 billion. Dow's comparable numbers are $1.3 billion and $0.7 billion, respectively. Changing the current treatment of royalties penalizes Dow and similar companies in this activity. It will therefore impede the growth of high-quality U.S. jobs. The enclosed paper discusses this issue in further detail with the use of Dow-specific data.

We encourage Congress to eliminate the royalty proposal from the budget reconciliation legislation. We believe the effect of this provision runs counter to the President's stated objective of creating jobs and making the U.S. more competitive in high-technology industries. Thank you for considering our concerns.

Sincerely,

Frank P. Popoff

Frank P. Popoff
Chairman and Chief Executive Officer

FPP:fer

Enclosure

BENEFITS TO THE UNITED STATES FROM NON-U.S. CHEMICAL MANUFACTURING

The chemical industry is one of the most global of all industries. It is highly competitive and made up of large, well financed companies. Of the ten largest chemical companies, only two are domiciled in the United States, ranking fifth and sixth in size. The U.S. chemical industry has historically been a major exporter, and it was the largest U.S. exporter in 1992.

The chemical industry produces through a highly integrated network combining world scale plants with other, smaller facilities. Plants are built where the cost of supplying customers is lowest. In most cases, this means plants are located in manufacturing complexes either close to the source of raw materials or close to the customers. The key factors of production that have the most influence on location of chemical plants include transportation costs, tariff and nontariff barriers, the ability to provide service (including "just in time" delivery and technical support), and the need to reap economies of scale. Since these factors of production are equally available to all competitors, companies have little choice as to where they will build their plants. Not locating in a particular market often means abandoning that market.

For example, STYROFOAM*[1] used for insulation is very light but bulky. Transportation costs are high in relation to the

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[1]*Trademark of The Dow Chemical Company

value of the product, and it therefore must be manufactured close to where it will be used. S/B latex is another example. This product is used in a wide variety of industrial applications, from carpet backing to paper production. The finished product contains a significant amount of water, and therefore the product cannot be economically transported very far. In addition, the product requires continuous technical support and individual customer design and manufacturing. As a result the product must be produced close to the customer. A substantial percentage of Dow products face similar economic factors.

Chemical industry investment in foreign manufacturing plants is beneficial to the U.S. economy in several respects. First, exports are increased. This relationship is clearly shown by individual company data and that of the industry as a whole. For example, as is shown by the attached graph, Dow's exports from the U.S. increased as it opened non-U.S. manufacturing facilities. That increase is fastest when a company first opens foreign plants, but continues even as its foreign manufacturing sites mature. For the industry, in 1989 exports by U.S. parents to foreign affiliates exceeded imports by $7.1 billion.

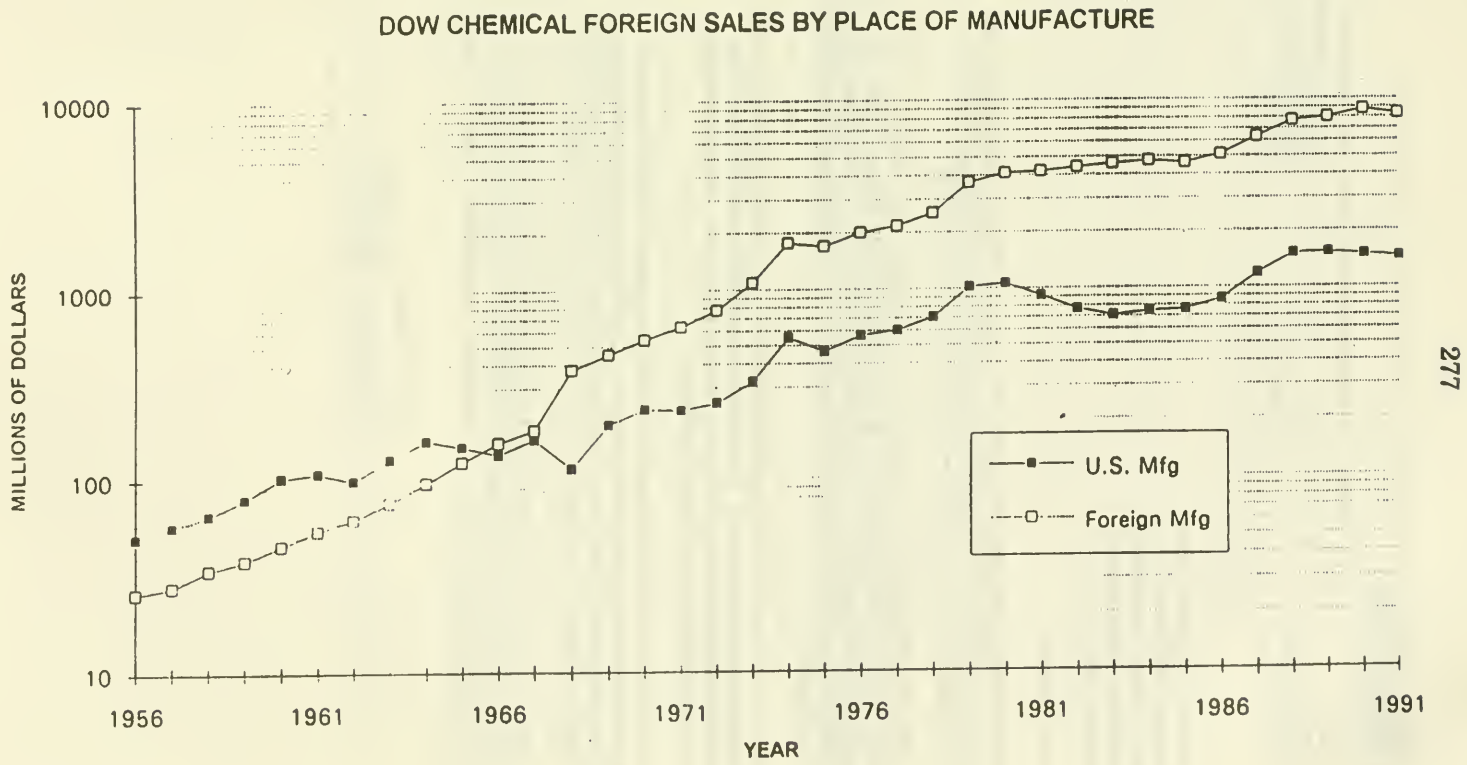
The increased exports resulting from investment in foreign manufacturing sites is due to a variety of factors including: (1) production specialization: the most sophisticated products are produced first in the United States where the research base is, and exported to foreign affiliates and their customers; without the foreign manufacturing sites and the relationships formed because of them, those exports would not be possible; and (2)

intermediate materials are produced at world scale plants in the United States and exported to foreign affiliates for further processing.

Second, U.S. research and administrative jobs are increased. A world-wide manufacturing and sales base increases the rate of return on investments in "headquarters" intangibles such as research and development, marketing, and administrative infrastructure. Absent the world-wide manufacturing and sales bases, rates of return on these intangibles would be lower as would companies' investment in them. For U.S. multinationals that investment takes place primarily in the United States, and a reduction in the amount invested would translate directly into a reduction in the amount of high quality jobs located in the U.S.

For these reasons, foreign manufacturing is extremely beneficial and necessary to the creation of jobs in the United States and to a favorable U.S. balance of trade.

Increasing the tax rate on royalties will increase the tax rate on foreign manufacturing operations by 5 percentage points. U.S. companies already pay tax on non-U.S. income at a rate 4 to 10 percentage points higher than that paid by our foreign competitors. This competitive disadvantage can be expected to reduce the amount of such operations, with the direct result of lower exports and fewer jobs in the U.S.


DOW CHEMICAL FOREIGN SALES BY PLACE OF MANUFACTURE
MILLIONS OF DOLLARS
10000
1000
100
10
1956
1961
1966
1971
1976
1981
1986
1991
YEAR
U.S. Mfg
Foreign Mfg

PREMARK
INTERNATIONAL

Warren L. Batts
Chairman and
Chief Executive Officer

Premark International, Inc.
1717 Deerfield Road
Deerfield, Illinois 60015
708-405-6200

May 3, 1993

The Honorable Lloyd M. Bentsen
Secretary of the Treasury
Main Treasury - Room 3300
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Secretary:

We would like to join the many other multinational companies who are very concerned by the Administration's proposal to treat active business royalties from our foreign manufacturing subsidiaries as passive for purposes of calculating our U.S. foreign tax credit.

We believe that this proposal not only represents unsound tax policy, but would be counterproductive to the Administration's desire to create stable, high-paying U.S. jobs. This provision will discourage our repatriation of foreign dividends and make U.S. companies less competitive in the global marketplace where they compete with companies not similarly affected by this proposal.

Premark's Tupperware and Food Equipment manufactures, sells or distributes products in over 50 countries throughout the world. The decision to locate facilities outside the U.S. is done essentially because of required proximity to our markets. In fact, none of Premark's foreign manufacturing takes place in tax haven jurisdictions.

As you are aware, the Internal Revenue Code, Treasury regulations and IRS enforcement of these provisions have together served to bring about a significant increase in royalties coming into the United States. We view this as very positive for the U.S. The fact that royalties have increased should not be viewed as an opportunity to impose higher taxes on dividend income.

In summary, if enacted, this proposal would encourage companies to significantly reduce repatriation of their overseas earnings which is clearly contrary to this Administration's objectives on U.S. jobs and technological leadership. Accordingly, we respectfully urge you to reconsider your support for the royalty proposal.

Very truly yours,

Warren Batts

PREPARED STATEMENT OF CARLOS ROMERO-BARCELÓ

Mr. Chairman and Committee Members, good morning.
I appear before you today as Puerto Rico's sole elected representative to Congress and on behalf of 3.6 million American citizens who reside in my district, Puerto Rico. Mr. Chairman, I represent 6 times more Americans than any other Congressman and more Americans than a majority of your fellow Senators. But, unfortunately, they are all disenfranchised Americans.

I have already testified before the House's Ways and Means Committee concerning President Clinton's proposed changes to the tax credits provided by section 936 of the Internal Revenue Code. I fully supported the President's efforts to reduce the deficit and his proposed Economic Stimulus Program. Nevertheless, I think that the issue raised by the changes to the 936 credits require careful analysis and certain modifications for the following reasons:

1) For the first time in history, federal taxes will be collected from income generated in Puerto Rico,

2) Puerto Rico has traditionally been excluded from or underfinanced in many federal programs because Congress and the Executive Branch have pointed out that the island does not pay income taxes to the Federal Government from income derived in Puerto Rico, and that income taxes were the source of financing for the different programs. For example, Puerto Rico has only token participation in the Medicaid program. We receive only 79 million dollars, whereas we would receive over one billion dollars if we were treated as a state.

3) Section 936 has been very inefficient in creating jobs, and its benefits, although entrenched and intertwined in Puerto Rico's economy, do not provide a firm basis for sound economic growth, and may actually be inhibiting our economic progress.

And beyond those reasons, there is a very serious policy issue that must be addressed: Is it fair and healthy for a society to exempt the wealthiest corporate citizens from payment of income taxes and thereby create an undue tax burden upon the less affluent middle and working classes?

Allow me to explain the factual basis for the reasons I just enunciated.

Puerto Ricans, as you known, do not pay federal income taxes because the President and Congress have seen fit to forego collection of taxes on income in Puerto Rico, probably based on the fact we are disenfranchised and deprived of voting

representation in Congress. Consequently, corporations engaged in business in Puerto Rico, which are subsidiaries of mainland corporations, are also exempted from federal taxation. However, other federal taxes do apply to Puerto Rico, including, among others: excise taxes, social security and unemployment taxes. In 1990, the IRS collected almost 1.9 billion dollars in federal revenue from Puerto Rico.

Because of the 100% tax-credit, Puerto Rico, throughout the years, has been classified and conceived of as a "Foreign Investment Area" by the U.S. Treasury and by investors. This designation, maintained because of section 936, has actually hurt the Puerto Rican economy since the island is excluded from considerations involving domestic investment and future expansions.

As a result of being identified as a foreign investment are, mainland corporations do not consider Puerto Rico in their domestic investment strategy and thereby overlook the island at the moment when critical investment and financial decisions are made.

Similarly, federal government decisions often overlook the island. For example, the President's economic recovery plan excludes Puerto Rico in certain areas by virtue of Puerto Rico's different fiscal relationship to the federal government. This is so in the case of increased income tax credits, since these benefits to wage earners in the 50 states are inapplicable in Puerto Rico, just as increased SSI allocations will be irrelevant to my constituents, because this program has not been extended to apply in Puerto Rico. The reason -- we do not pay federal income taxes. The workers and the poor are punished as the wealthiest are rewarded.

Therefore, when considering that the Administration is seeking to collect revenue from Puerto Rican sources, applicability of federal programs to Puerto Rico cannot be overlooked, and this is the time to make those decisions. Particularly in view of the fact that the Administration's proposed changes to section 936 would give the Treasury an estimated 7.2 billion dollars in a 5-year period. $7.2 billion it would not otherwise receive. The Congressional Budget Office estimates are even higher, predicting $8.3 billion in tax revenues collected from up-to-now tax exempt corporations in Puerto Rico.

Thus, given the unprecedented fact that the federal government will, in all probability, collect significant income tax revenues from Puerto Rico, it follows that the island should receive adequate compensation for the new tax burden that is being imposed on it. We are asking for equal treatment, at least, in all health services related programs like Medicaid, specifically in Medicaid and the President's new health care reform proposal. This decision must be made now.

This Committee has jurisdiction over the 936 tax-credit issue and the funding of Medicaid and the new health care plan to be presented to Congress by the President next month. On the 936 tax-credit issue there are at least three proposals on the table: 1) the President's recommendations which could raise $7.2 billion during the next 5 years, 2) my proposal to increase the wage tax-credit to 100% of payroll, which with certain modifications could raise an amount less than but not too far from the President's goal, and 3) the proposal which is being made today by the Governor of Puerto Rico, reportedly proposed and sponsored also by the 936 tax-exempt corporations, which according to press reports, would raise about half or less than the President's goal.

I have been asked to support the proposal to be presented by the Governor, which I have not yet seen or discussed with him. In analyzing any proposal, I must consider that I was elected to represent the people of Puerto Rico, not the interests of tax-exempt corporations.

If their interests coincide with those of my people, then I support them, otherwise no. If the Governor's proposal can get more benefits for the 936 tax-exempt corporations, than from those proposed by me, I would support the Governor's proposal subject to the following:

First, that the White House and the leadership in the Senate and the House make the policy decision to treat Puerto Rico as a state in the Medicaid program and the new health care plan to be approved.

We must recognize that we cannot "have our cake and eat it too". The economic benefits to Puerto Rico in terms of health care jobs created and economic stimulus generated by the extension of full health care benefits to the American citizens in the island would be very significant.

We would be doing a poor service to the people of Puerto Rico and the Nation if our people were to be denied equal benefits and services in health care, based on the argument that the Federal Government gave up too large an amount of tax revenues in order to appease the demands of tax-exempt corporations.

Second, I would support the alternate tax-credit option to reduce the existing 936 tax-credit by 10% per year, only if the alternate tax-credit option is extended to continue at a 10% annual reduction until it is eliminated. In other words, establish a complete phase-out of the existing 936 tax credit which has been proven to be inefficient and too expensive as an incentive to creation of new jobs.

Let me turn now to a discussion of the impact of section 936 in Puerto Rico's economy and try to separate reality from fiction. Individuals and institutions which have vested interests in the corporations who benefit from the 100% tax credits provided by section 936 have created a hysteria on the island by predicting a total collapse of the Puerto Rican economy, multiple shut-downs, mass exodus of manufacturing plants and tens of thousands of unemployed if the changes proposed by President Clinton are adopted.

I understand, to some extent, their zealousness in protecting their special tax breaks, which amount to over 1.3 billion dollars per year. Any sector in the community which was asked to pay over one billion dollars a year would certainly put up a fight.

However, what this Committee, this Senate and the Administration must understand is that most of the assertions and the hysteria created by the so-called 936 corporations, the banks which handle their deposits at lower rates because of the tax credits, their lobbyists and the multi-million dollar propaganda, are gross speculations and exaggerations not supported by facts. All you have heard and will hear from them is that if their tax credits are reduced as proposed they will shut-down and leave Puerto Rico, relocate to a foreign country and stop buying goods from your states.

You will hear conclusions based on assumption which are not proven. Ask them for specific facts, not at the industry level, but on a company-by-company basis. Ask each company - What was their net income in Puerto Rico during last year? Multiply that income by 36% and you will have the amount of taxes each corporation would pay in any of the 50 states. Then ask them what their payroll was during last year and multiply that amount by 65% or by 100% (as I have proposed), and you will have the amount of the tax-credit to be deducted from their tax. When you do this exercise, you will find that a majority of the now tax-exempt corporations will not pay any federal income taxes, many others will pay only 25% or less of what they would pay in any state. The irony of the existing 100% tax-credit is that the more money they make, the lower is the proportion of the dollar expenditure in wages to net income and the lower the tax credit would be under the President's proposal. See Exhibit One.

However, a 25% tax-credit is still a substantive incentive to invest. Particularly if wages, as happens in the case of Puerto Rico, are lower than in the other states of the Union and the workers are more productive, as is the case in Puerto Rico. Section 936 has been portrayed by its beneficiaries as the foundation of the Puerto Rican economy, even though jobs generated by companies which benefit from 936 credits have remained at a virtual standstill for the last ten years. As a matter of fact, the percentage of manufacturing jobs in Puerto Rico, in relation to all jobs, has been steadily decreasing for the past decades. It has decreased from 19.3% in 1972 to 16.8% in 1992 (See Chart #4, Exhibit One).

The companies that generate about 15% of the jobs created by the 936 tax beneficiary companies enjoy about 60% of the total tax breaks under this section. The more revenues they make, the lower their payroll in relation to their benefits. Therefore, they will criticize and fight against wage tax credits in lieu of the 100% income tax credits they now enjoy because they will have to pay some taxes they do not pay under present law. However, the fact that they will have to pay some taxes does not translates into closing-up or reducing operations in Puerto Rico.

In addition, it is repeatedly asserted that earnings generated by section 936 companies, the so-called "936 funds", are an indispensable money supply for loan demands on the island. This assertion cannot be further from the truth. What about the 50 states of the Union? Do they have 936 funds? Where does the money come from? Cannot money come from the same place in Puerto Rico as in the 50 states of the Union?

Do the 936 funds provide lower credit rates to the people of Puerto Rico? NO -- the cost of credit to the average citizen in Puerto Rico is higher than in the mainland. This is evidenced by interest rates in conventional mortgage loans, auto loans and credit-card rates. Exhibit Two shows indexes obtained just last week from local and national newspapers which compare mainland and insular rates.

As we can see, in the states of the Union, where there are no 936 funds, interest rates to the average citizens are lower than in Puerto Rico, which has 936 funds. An explanation for this apparent contradiction may be found in the way that 936 investments, from qualified passive income, impact the local financial scene. Many 936 companies concentrate exclusively in short-term investments that do not have a long-lasting effect that would benefit the island's economy.

In certain circumstances, 936 investments actually hurt average citizens by depriving them of certain investment tools. Such is the case of the Ginnie-Maes, where the 936 lower interest funds are used to buy, in block, the higher interest paying Ginnie-Mae bonds which then become unavailable to middle-class citizens, such as elderly retirees and widows who seek safe investment instruments with good tax-exempted returns.

From the consumer's perspective, the vast amount of low-cost 936 funds available to the banks has affected the available banking services. Section 936 may be directly linked to the recent reduction of bank competition wherein two major national banks, Citibank and Chase, decided to close all their retail branches in Puerto Rico. They still retain a strong presence on the island, but concentrate in commercial wholesale banking activities. Why did they close their branches? Probably because it is a lot easier to operate with 936 funds than by seeking deposits from the people and servicing their accounts.

However, the consumer in Puerto Rico has suffered the consequences of reduced competition among banks, as evidenced by the higher credit rates. The impact of 936 to local banking activities has been constantly mentioned by the banks and brokerage houses as a reason why section 936 should be kept as it is. As indicated above, the opposite is true.

Although Puerto Rico's Commissioner of Financial Institutions estimates that about 7.5 billion dollars account for local bank deposits, the smaller domestic native Puerto Rican banks trace about 17% percent of their total deposits to 936 funds. If you exclude the largest local bank, Banco Popular, the percentage of 936 deposits in local banks is even lower.

In contrast, foreign and domestic Canadian and Spanish-owned banks, which are the largest banks with the exception of Banco Popular, trace about 42% of their deposits to 936 funds. The local banks are competing at a great disadvantage. With a possible reduction of funds available from 936 sources, banks will have to look at other sources of money supply, such as the Eurodollar market and other markets. The rates paid to individual depositors with savings accounts and certificates will probably increase as the availability of 936 funds is reduced.

Impassioned advocates of 936 constantly mention the contributions of 936 companies to the local communities and to the island's treasury.

What these companies contribute to the local communities and in local taxes is ridiculously low in relation to their revenues.

Caribbean Business, a highly regarded business weekly, published in its April 8th edition the results of an investigative report. It reveals that 38 of the most profitable 936 corporations entered into a deal with the former administration in Puerto Rico, whereby tollgate taxes were waived in exchange for certain diminimis concessions. Between 1987 and 1992 then-governor Rafael Hernández Colón encouraged them to increase repatriation of earnings back to the mainland in order to hike tollgate tax income in those years. In return the companies obtained reductions or waivers on tollgate taxes in future years. Puerto Ricans are now paying the consequences for such outrageous deals, since the probably illegal concessions made by former governor Hernández-Colón will cost the island $500 million in forgone tax revenue during the next five years.

As stated in Caribbean Business, "a legacy and a financial crunch that will be felt until 1997". The same leaders who were elected or held appointed offices during the Hernández-Colón

administration, the same leaders that gave the tax-exempt corporations $500 million in additional local tax breaks, are the same ones that will be here today defending those companies which subsidized their political campaigns.

One of the companies that benefitted the most from this deal was the Coca-Cola Co., who in 1991, with profits of 375 million dollars from its Puerto Rico operations, did not have any tollgate tax liability. The tax credits provided by section 936 saved the company 137 million dollars in federal taxes which placed Coca Cola, with 371 employees, on top in terms of 936 tax benefits per employee. A ratio of $371,350 per employee. Outrageous even when compared to the already outrageously high ratio of pharmaceuticals, $70,788 per employee.

Coca-Cola's total tax liability (local income, property and municipal permits) during that year was 31 million (an effective local total tax rate of 11%). Not much considering $375 million in profits. Thus, it is very hard to embrace the argument of significant local contributions to Puerto Rico by 936 companies. When compared to their incomes, their tax contributions are very low indeed.

Many 936 tax-exempt corporations, their lobbying associations and lobbyists, as well as other individuals who have financial interests in the 936 tax credits and those with political agendas, have stated that many 936 tax-exempt companies would leave Puerto Rico in the event the current tax scheme is altered or significantly changed. The pro-Commonwealth status leaders, which were part of the Hernández-Colón administration, have gone so far as alleging that 300,000 jobs will be lost in Puerto Rico if the tax-credit, as it exists, is tampered with.

However, Mr. Marcos Rodriquez-Emma, President of Puerto Rico's Government Development Bank (hereinafter, GDB), has recognized that, and I quote, "the Clinton economic proposal is a concerted effort to reduce the federal budget deficit through the elimination of tax loopholes that may allow American corporations to transfer operations somewhere else in search of tax savings. Therefore, it follows that Section 936 corporations that choose to abandon Puerto Rico will probably have to move to the (mainland) and not to foreign jurisdictions".

If tax incentives in a U.S. Territory (Puerto Rico) are reduced, it is also important that tax incentives in foreign countries also be reduced. If such measures are adopted, as proposed by the President, then other countries, even Mexico with NAFTA approved, could not lure investments away from Puerto Rico.

Section 936 notwithstanding, Puerto Rico offers very good reasons for businesses to settle or expand operations on the island. These include:

1) availability of a large highly trained and easily trainable workforce,

2) a higher productivity index than the national average,

3) lower wages, which average approximately 50% of comparable mainland jobs,

4) the island's strategic geographical location at the center of North and South America, with easy access to most vital commercial sea lanes and air routes to all countries in America,

5) it's infrastructure, which compares to and/or supersedes those found in many states,

6) it's political stability,

7) the U.S. dollar, which is the only currency used in Puerto Rico, which eliminates money exchange problems; and,

8) it is the only jurisdiction in the U.S. (in America as a matter of fact), where both English and Spanish are official languages.

Not only can Puerto Rico offer all of the above enumerated incentives, but also the 936 companies have already invested over 6 billion dollars in plant and equipment which makes relocation quite expensive.

The ones that could relocate inexpensively are the ones that will receive 100% or a very substantial tax-credit. As stated in a Congressional Budget Office Report in April 1990, "Beyond their fixed capital investments, going concern operations in Puerto Rico have substantial investments in the training of their staff to carry out their operations. They have already organized supply and distribution networks, developed relations with local unions and government organizations and other institutions, and acquired an understanding of the local culture. These efforts were all made at a substantial cost, a cost that would need to be incurred again if these firms moved to a new location. In addition, moving assets to a foreign location would entail paying tax on any capital gains that had accrued to the assets while in Puerto Rico".

I welcome and encourage the presence and establishment of new and more manufacturing firms in Puerto Rico. I believe strongly we should encourage growth and development of "high-tech" industry. However, they must recognize that they too, like everyone else, must contribute to the costs of infrastructure, health services, education and public safety in our society.

Let us turn now to the alleged negative impact that 936 companies would endure under the President's plan, that is, the 65% wage-credit proposed in lieu of the current income credit. According to GDB estimates (See Exhibit One), under the 65% wage-credit proposal, the ratio of profit to total receipts remains healthy and exceeds average profit margins of these companies in the mainland. To illustrate this point, consider that the effective tax rate of the pharmaceutical industry would be 20%, still much lower than the proposed federal corporate tax rate of 36%.

The GDB has concluded that under the President's proposal, corporations that employ 36% of all 936 tax-exempt company employees would not be affected at all under the Administration's proposal. It also concluded that 20% of all tax-exempt company employees work for corporations whose current tax benefits would be affected by less than 25%. Thus, almost 60,000, or 55%, of all employees in 936 tax-exempt companies work in corporations that would be impacted very little or not at all by the wage-credit plan.

In my proposal (See Exhibit Three), 80% of all employees work in tax-exempt corporations whose current tax benefits would not be affected at all or would only be affected by less than 25%.

Under either proposal, only 20% work for companies that would lose 50 to 75% of their tax benefits. Quoting from GDB's report, "the changes being suggested regarding section 936 would maintain Puerto Rico's ability to retain manufacturing corporations already operating under section 936 and continue the island's industrial promotion campaign". As was established earlier, even a tax-credit of 25% of current tax liability is quite an incentive. Particularly if it is perceived as being available in a domestic (U.S.A.) investment area and not in a foreign investment area.

Having said this, let us concentrate on realisticly reforming section 936 making sure that the Nation's interests are protected as well as our goal of encouraging economic and manufacturing expansion in Puerto Rico.

Most important, I urge you, Mr. Chairman, I urge this Committee, the Senate, the House and the Administration, to treat Puerto Rico fairly in the decision-making process concerning applicability of federal programs in Puerto Rico. Critical at this juncture, as I have stated, is the inclusion of the island in the nation's health care system. The current Medicaid cap in Puerto Rico deprives hundreds of thousands, more than a million United States citizens of adequate health care.

Considering the fact that this Committee and the U.S. Treasury will be taking an unprecedented step by recommending that corporate taxes from income generated on the island be collected, then it is only fair that Puerto Rico be included as a full partner in health care. This Congress and the President can no longer allow the orphans and widows of men who died defending their Nation to be denied access to quality health care that is provided to foreigners who live in the 50 states of the Union, based on a geographic discrimination which has prevailed against American citizens who reside in Puerto Rico.

PREPARED STATEMENT OF PEDRO ROSSELLÓ

Mr. Chairman, distinguished members of the Committee on Finance: My name is Pedro Rosselló. I am the Governor of Puerto Rico. I welcome this opportunity to testify regarding changes, proposed by the Administration, to Section 936 of the Internal Revenue Code.

A letter from President Clinton was read aloud at my inauguration ceremony, this past January 2nd. The following is a direct quotation from that letter:

> ". . . As President, I will try to ensure that the federal government does its part to help Puerto Ricans with the issues that they face . . . The Administration will consider the circumstances and needs of Puerto Rico as it develops and implements policies that would substantially affect the island . . ."

To date, I am sorry to report, the recommendations of the Executive Branch—with respect to Section 936—have contradicted that promise. They also contradict the intended purpose of President Clinton's policy of providing opportunity for all Americans.

We in Puerto Rico support the President's objectives, and are fully prepared to assume our proportionate share of the burden. Indeed, we strongly endorse many of the Administration's specific proposals . . . among them, the rebuilding of our nation's infrastructure, and reform of the health-care system.

In one key area, however, Executive Branch policy-planners seem to have lost sight of President Clinton's bottom line: that, of course, is *jobs* . . . jobs for American citizens.

Nowhere is the need for jobs greater than in Puerto Rico, where unemployment exceeds 18 percent—two-and-one-half times the national level . . . where per-capita income is less than 30 percent of the national average . . . and where the proportion of families subsisting on poverty-level incomes approaches 60 percent—while the mainland figure stands at about ten percent.

Despite these data, the Administration is advocating Section 936 amendments that would actually *cripple* our island's capacity to attract—and even to retain—job-creating private-sector investment.

Currently, more than 105,000 Puerto Rico residents are employed directly by firms operating under Section 936. These companies also create a Significant number of indirect additional jobs, elsewhere in our economy.

Section 936 employees account for almost 70 percent of the manufacturing jobs in Puerto Rico . . . and approximately 11 percent of the island's total employment. Accordingly, whenever the Federal government contemplates changing Section 936,

it is of vital importance to Puerto Rico's government that such changes imperil neither the island's current employment, nor its future economic development. What is in essence a marginal decision for the Federal government is a vital and central issue of economic survival to Puerto Rico.

However, peril is pervasive in the Administration's latest Section 936 modification plan.

We estimate that these proposals:

- Would reduce the annual tax-benefits of Section 936 companies by more than 60 percent;
- Would increase the effective tax rates of such enterprises to a level that, when Puerto Rico tax levies are factored in, would leave the island non-competitive;
- Would drain the pool of Section 936 funds by 75 percent;
- And would slash, by amounts ranging from 25 percent up to 75 percent, the tax benefits pertaining to companies that employ over 66-thousand persons . . . or just about two-thirds of all the men and women now working at Section 936 enterprises.

That is what I mean by pervasive peril.

None of this is intended to imply that the status quo is ideal. Section 936 *can* be rendered more effective. I am not here to insist that this incentive program be treated as a sacred cow. As I have already said, Puerto Rico is fully prepared to accept its proportionate share of sacrifice, in the national interest.

Nevertheless, using whatever parameters you may choose, the sacrifice being proposed by the Executive Branch is disproportionate . . . and is crippling to our objective of building a competitive economy.

The inequity, to which I refer, can easily and dramatically be quantified. The Administration's national economic blueprint envisions sacrifice, in the form of tax increases, that total about twelve-hundred dollars-per-person in the average state. Puerto Rico, by contrast, would be expected—solely through changes in Section 936—to generate new federal revenue at a level equivalent to two-thousand dollars-per-person.

In the context of relative income differentials, this is *six times more* than the contribution per capita being sought from mainland citizens.

By any yardstick, that is unfair.

Moreover, we must also keep in mind the extraordinary economic challenges that Puerto Rico confronts:

- Although the island's population density is 15 times the national average, Puerto Rico's current territorial political status has left our people without full access to many basic services—just last week, the Census Bureau revealed that Puerto Rico trailed all 50 states in Fiscal 1992 Federal spending per person, receiving barely *half* the amount spent in an average state . . . obviously, that helps explain why our economy is less robust;
- The provisions of the North American Free Trade Agreement would reduce our ability to compete with foreign countries, for several types of labor-intensive enterprise;
- And I respectfully submit that, in any of your states, 18 percent unemployment would constitute a dangerously explosive situation.

Yet it is against this backdrop, on the premise that it can yield $73-billion in revenue over the next five years, that the Executive Branch of the Federal Government today advocates the virtual destruction of Puerto Rico's principal economic development tool.

This cannot be decided merely as a numbers game. The President has asked us to "put people first." That is precisely our plea to the Senate, the House of Representatives, and the White House.

President Clinton has stated that he wants to create more jobs, better jobs, and higher-paying jobs for the American people. Where Puerto Rico is concerned, the Administration's current proposal would do just the opposite.

All rational analysis shows that the Administration's current proposal will result in a weakened, more-dependent economy . . . a significant loss of American jobs . . . greatly diminished local tax revenues . . . and higher capital costs.

The price tag on that projected $73-billion in new revenue is simply too high. It sadly reminds me of the Vietnam war story, about the village that supposedly had to be "destroyed in order to save it": the Federal Government cannot foster renewed economic growth by *taking jobs away from a community of 3.6-million American citizens that needs new jobs perhaps more than any other!*

As an alternative to the Administration's plan, we propose the enactment of an incentive comprised of two options . . .

Under the first option, a 936 firm would receive a tax credit, equal to the sum of:

- The total compensation it pays to its employees;
- All of the corporation's Puerto Rico income and tollgate taxes;
- Federal income taxes attributable to the company's qualified possessions source investment income; and
- Ten percent of its new capital investment in plant, machinery and equipment.

OR, under the second option, the 936 corporation would receive an income-based credit that would be phased down to 90 percent of the existing Section 936 credit in 1994, and to 80 percent in subsequent years. This plan would provide new Federal revenues of 2.8-billion dollars.

Today we bring before you this proposal, which will allow Puerto Rico to participate in the sacrifices being asked of all Americans, but which will also permit us to build a more productive, more competitive, and less dependent economy. We seek not handouts, but instruments for productive development.

Our proposal—which I am submitting to you in more detail as an addendum, and which I urge you to accept—offers a realistic approach to revenue-enhancement . . . and thus to proportionate shared sacrifice by Puerto Ricans. Unlike the Administration's proposal, this plan has broad-based backing from labor, business, financial, and professional organizations on the island, as well as Latino and Hispanic leadership groups on the mainland.

But most of all, my proposal provides a foundation upon which Puerto Rico can continue to construct a more self-sufficient economy . . . one that will propel us closer to equality . . . equality of rights, equality of opportunity, equality of responsibility . . . the equality with which you and your constituents are blessed.

We ask for this as fellow American citizens.

Thank you very much.

Attachment.

Comparison of the Executive Branch and Governor Pedro Rosselló Proposals for Section 936

1. INTRODUCTION

The Executive Branch has submitted a plan to cap the benefits available to participating firms operating under Section 936. This proposal allows companies operating in Puerto Rico to exempt an amount of profit, not to exceed 60% of the FUTA wages paid by the firm, from federal taxation. On the surface this may seem like an innocuous change to the Section 936 provision. However, this is not the case. In the succeeding sections of this memorandum we will explain why this proposal will cause severe economic problems in Puerto Rico. As a matter of urgent necessity the Governor of Puerto Rico has had to develop an alternative to the Executive Branch's proposal that would be fair to the 3.6 million U. S. citizens residing in Puerto Rico and that would also address the objectives of the U.S. Treasury.

2. THE EXECUTIVE BRANCH PROPOSAL II

The Executive Branch has made two proposals concerning changes with Section 936. The more recent version of their proposal specifies that:

(a) the operating earnings eligible for the 936 credit cannot exceed 60% of the FUTA wages paid by the firm; and,

(b) the qualified possession source investment income ("QPSII") will be limited such that the amount of assets that can be invested to earn QPSII cannot exceed 80% of the firms' adjusted tangible assets in Puerto Rico.

3. SHORTCOMINGS OF THE EXECUTIVE BRANCH PROPOSAL II

The Executive Branch proposal imposes severe economic consequences upon Puerto Rico's economy. More specifically, we identify the following specific consequences resulting from their proposal:

(a) The Executive Branch proposal is designed not to make any type of firm better off, but to make the majority of the firms worse off. Specifically, the way the incentive is structured, it makes the most labor intensive firms no worse off than they are under the current system, but it makes the more capital intensive high tech firms worse off than they currently are by the imposition of new federal taxation.

The Executive Branch proposal has an adverse impact (i.e. results in a new federal tax liability) upon almost 60% of the firms operating under Section 936. These firms which are adversely affected, presently employ 63% of all Section 936 employees and account for almost forty percent of the entire manufacturing employment in Puerto Rico.

Puerto Rico has been losing labor intensive jobs to third world countries for the last twenty years. There has been a 32% loss in labor intensive jobs since 1973! Our recent employment growth in the high tech sectors has offset losses in the labor intensive sectors and enabled the island to maintain the same level of manufacturing employment for the last twenty years.

By making the high tech sectors worse off than they are under the current system the Administration proposal will reduce future employment growth in these high tech sectors. As a result of this fact, combined with the normal loss of labor intensive jobs to low-wage countries, we will begin to evidence real job losses in the manufacturing sector.

The NAFTA agreement will accelerate the loss of labor intensive and moderate capital intensive jobs to Mexico. This will further intensify the adverse force of the Treasury proposal on Puerto Rico's economy.

(b) The Executive Branch proposal includes a cap based solely upon the actual wage paid. In our opinion the employee's full compensation should be incorporated into the cap amount. Fringe benefits and payroll taxes are an integral component of the labor cost that a firm bears for hiring a worker. In order for Puerto Rico to maintain our competitive position for labor intensive jobs relative to locations such as Mexico and the Dominican Republic we must include the total compensation under the cap. Our fringe benefits alone in Puerto Rico, for labor intensive jobs, are higher than the entire compensation paid to workers in these third world countries.

(c) The Executive Branch proposal is one dimensional in that it attempts to provide an incentive to the labor intensive sectors for employing workers. It does not provide any incentive for the employment of capital in plant, equipment and machinery.

(d) The Executive Branch proposal does not consider the Puerto Rican tax base and will result in the substantial loss of tax revenues to the Government of Puerto Rico. The Administration proposal could result in the loss of some 15% to 18% of the general revenue funds (all personal and corporate income taxes, all inheritance and gift taxes, all license fees, and all excise taxes collected on local consumption) of the government. This sizable loss in the Government's tax base is a devastating problem.

(e) The Executive Branch proposal is basically unfair and inequitable to the people of Puerto Rico. On average the revenue raising aspects of the President's package raise $1,200 per person for the nation as a whole. However, for Puerto Rico the Treasury proposal for Section 936 alone raises $2,000 per person. This represents a significant difference, almost 75% more, in the per capita revenues to be raised in Puerto Rico from the Executive Branch's program.

When the relative income of Puerto Rico versus that for the whole nation is factored into the analysis, the relative burden on Puerto Rico is six times more than that for the nation as a whole.

3. THE ROSSELLÓ PROPOSAL

The Governor of Puerto Rico, Dr. Pedro Rosselló, has developed a proposal that deals in a fair and responsible, manner with possible revisions to Section 936. This proposal consists of two options that a participating firm may choose. One option includes a total compensation based cap upon the Section 936 credit and the second option is an income based incentive. Each of these will be briefly detailed below (the full proposal is attached as an appendix to this memorandum):

(a) *Compensation Based Option.*—A Section 936 firm electing this option may not take a Section 936 credit that is greater than the sum of: (1) 100% of the FUTA wages, fringe benefits and payroll taxes attributable to its workers in Puerto Rico; plus (2) an investment tax credit of 10% of the new investment in plant, machinery and equipment; plus (3) taxes paid to the Government of Puerto Rico (up to a maximum of 9%) on the earnings of the business enjoying the benefit of Section 936.

In addition, a firm's qualified possession source investment income ("QPSII") earnings retain their current exclusion from federal taxation.

Those firms, which have excess credits when the total credits exceed the tax liability from the Section 936 firms' operations, may utilize these excess credits against their combined taxable income attributable to products manufactured in Puerto Rico.

To insure that firms hire employees to engage in productive work and not simply to maximize their total compensation credit we have incorporated strict limitations within Governor Rosselló's proposal for Section 936.

(b) *Income Based Option.*—A firm may select an income based incentive which provides: (1) 90% of the Section 936 credit during 1994; and (2) 80% of the Section 936 based credit in 1995 and- for all succeeding years.

This option also continues the full exemption for the qualified possession source investment income.

This alternative reduces by 20% the tax benefits of those more profitable companies which would not elect the total compensation based option. This 20% reduction is greater than the amount proposed last year by the Chairman of The House Committee On Ways And Means.

4. UNDERLYING RATIONALE FOR GOVERNOR ROSSELLÓ'S PROPOSAL

The overriding consideration for the Rosselló proposal is to insure that Section 936 generates a sufficient number of new job opportunities for the 3.6 million in. S. citizens residing in Puerto Rico, and to do so in a cost effective manner. The Rosselló proposal accomplishes this goal. The specific elements by which this is accomplished are:

(a) The Rosselló proposal includes two options. One option will be attractive for the high tech capital intensive firms and one option will be more attractive to the more labor intensive firms. The Executive Branch proposal was one dimensional and did not have an attraction for the high tech capital intensive types of firms. By having two specific options, one that appeals to each type of firm, the Rosselló proposal addresses this issue. We will provide an array of incentives to attract the full spectrum of firms.

(b) The Rosselló proposal results in a fair increase in the federal tax burden upon the most profitable firms operating under this provision. By doing so there will be a significant amount of revenue raised for the in U.S. Government to reduce its deficit. However, these changes will not impair the incentive Program for the future development of Puerto Rico.

(c) The Rosselló proposal permits our workers to obtain high-skilled, high-wage jobs in an expanding high-tech manufacturing sector along with, and not exclusively as in the Executive Branch proposal, labor intensive jobs that can be promoted with our inclusion of the combined taxable income concept into the revised incentive program.

(d) The maintenance of the concept of qualified possession source investment income in the incentive program will retain the advantage of lower cost investment funds for Puerto Rico's economic development funding requirements.

(e) The allowance for the full credit of taxes paid to the Puerto Rican government will avert a major budget problem for our government. Under the Executive Branch program the Puerto Rico Government could lose up to 15% to 18% of its total tax revenues. This is not a problem under the Rosselló alternative.

APPENDIX A: SECTION 936 PROPOSAL OF GOVERNOR PEDRO J. ROSSELLÓ

I. A Section 936 Corporation will be entitled to compute the Section 936 tax credit, at their option, under either of the following formulas:

A. A Section 936 credit equal to the sum of the following, against the Combined Taxable Income for products manufactured in Puerto Rico by the electing corporation, as defined in IRC Section 936(h)(5)(C)(ii)(II):

(i) 100% of total compensation, including all fringe benefits and payroll taxes;

(ii) All Puerto Rico income taxes and withholding taxes on dividends, paid by the 936 corporation, up to a 9% effective tax rate;

(iii) All in. S. income taxes on the qualified possession source investment income ("QPSII"); and,

(iv) An amount equal to 10% of investments in plant, machinery and equipment placed in service by the 936 company after December 31, 1993. This would be available for use in the year when the investment is placed in service, or during any of the following two taxable years, at the option of the taxpayer.

The maximum amount of compensation to be taken into account for each employee will be limited to the amount subject to federal social security withholding (currently $57,600), and the 936 corporation will be entitled to a full deduction for compensation paid.

The credit for investments would grant incentives for future investments in plant, machinery and equipment in Puerto Rico, and should provide full depreciation for investments in plant, machinery and equipment.

Special rules and limitations would be established to avoid the possibility of increases in compensation and tax credits without a corresponding increase in business operations in Puerto Rico, solely for the purpose of benefiting from the total compensation credit against combined taxable income. These limitations would only allow credits for future compensation increases to the extent they fall within a 1990 to 1992 average benchmark ratio of total compensation to net sales. Exemptions from the benchmark ratio would be available if the 936 corporation is able to justify, subject to Treasury's audit, that the ratio should be raised: (i) due to expansion of operations and added production in Puerto Rico which is more labor intensive; (ii) hiring during 1994 of a number of workers which is equal to its 1991–1992 average of temporary workers or; (iii) hiring of workers which previous to 1993 had worked directly as contractors, or employees of contractors for the 936 corporation. Furthermore, consistent with the significant business presence rules of IRC Section 936(h)(5)(B)(iii)(II) and IRC Regulations Section 1.936.5(c) Question and Answer Number 4 for contract manufacturers, compensation paid by a 936 corporation would include the labor costs of contract employment agencies; if these can be established, otherwise 50% of the amounts paid to contract manufacturers, independent contractors or temporary employment agencies, provided the contract manufacturer, independent contractor or temporary employment agency is not a Section 936 corporation and all their services are rendered within Puerto Rico.

B. The current Section 936 credit is reduced to the following percentages:

1994	90%
1995 and in succeeding years	80%

In addition, the Section 936 corporation will be entitled to a full Section 936 credit for "QPSII" subject to the current "QPSII" limitations.

SUMMARY OF GOVERNOR ROSSELLO'S PROPOSAL

							OPTION A USABLE CREDITS					OPTION A & B	
YEAR	GROWTH	ACTIVE INCOME	INCOME RETAINED	NET INCOME	EFFECTIVE TAX RATE	U.S. TAX LIABILITY	100 % C/C	10 % CAP INVEST.	P.R. TAX PAID	C.T.I. CREDIT	TOTAL	U.S. REVENUES OPTION A	COMBINED U.S. REVENUES
1989		7,123.4	*										
1990	1.10	7,835.7											
1991	1.10	8,619.3											
1992	1.10	9,481.2											
1993	1.09	10,334.6											
1994	1.08	11,162.3	80 %	8,929.8	30 %	2,679.0	1,640.6	41.0	276.4	108.0	2,066.0	613.0	267.0
1995	1.07	11,943.7	80 %	9,554.9	30 %	2,866.5	1,728.5	25.2	292.9	104.2	2,150.8	715.7	572.0
1996	1.07	12,779.7	80 %	10,223.8	30 %	3,067.1	1,815.2	22.8	310.7	100.5	2,249.2	817.9	613.0
1997	1.07	13,674.3	80 %	10,939.4	30 %	3,281.8	1,902.2	20.6	336.3	97.1	2,356.2	925.6	655.0
1998	1.07	14,631.5	80 %	11,705.2	30 %	3,511.6	1,993.6	21.2	363.6	93.7	2,472.1	1,039.5	701.0
				51,353.2		15,406.0	9,080.1	130.8	1,579.9	503.5	11,294.3	4,111.7	2,808.0

PREPARED STATEMENT OF MURRAY S. SCUREMAN

Good morning. My name is Murray Scureman and I am Vice President of Government Affairs for the Amdahl Corporation. I am a businessman with 25 years of experience in the computer industry, nearly 15 of which have been spent at Amdahl, in a variety of line and staff positions. My last assignment was as vice president of the company's federal sales division, a $100 million operation. In 1989, I opened Amdahl's Government Affairs Office. I report to the CEO and Chairman.

Founded in 1970, Amdahl is a California company that designs, manufactures, sells, and services a complete line of state-of-the-art mainframe computers and associated software and peripherals; had 1992 revenues of $2.5 billion; R&D spending of $372 million; and over 8,000 employees in 25 countries worldwide.

I would like to thank the Finance Committee for the opportunity to testify on these important international tax proposals.

Amdahl does have some fundamental concerns with the impact of certain elements of the program on the competitiveness of U.S. companies, specifically, the partial repeal of deferral and the treatment of royalties as passive income for foreign tax credit purposes. My testimony will focus on the problem that these proposals create for business. Attached is a copy of the testimony of Mr. Paul Oosterhuis, before the Committee on Ways & Means, which outlines the tax policy arguments against the proposal.

1. PARTIAL REPEAL OF DEFERRAL

The partial repeal of deferral will add additional costs to U.S. companies that will not be incurred by our foreign competitors, all of whom receive either tax deferral or tax sparing. In an environment that is already extremely competitive, and sure to become more so with the implementation of EC92, such an additional cost will give our competition a significant advantage. The repeal of deferral as a fundamental concept of our tax laws should be compared with the favorable treatment our foreign competitors enjoy via the extensive "tax sparing" treaties negotiated by their governments. As a result, our foreign competition has a built-in cost advantage relative to the U.S.

Why Does Amdahl Have a European Plant?

Amdahl has been profitable from its beginning until 1991, and suffered its first loss in 1992. Despite this favorable history, it was clear from the outset that the U.S. market alone could not support the volumes necessary to finance both the cost of operations and the significant R&D investment required to remain competitive.

Amdahl's aggressive expansion to markets outside the U.S. led to the building of a plant within Europe to establish a local marketing, service and logistical presence, which was necessary because all of Amdahl's competitors were already there. Ireland was chosen and the facility was opened in 1978, to service Europe and the Pacific Basin markets. Amdahl did not flee the U.S. seeking lower wages. In fact, today Irish and American factory wages are comparable. The cost of manufacture of a mainframe is the same in either factory. An Irish mainframe is imported into the U.S. only in an emergency customer situation.

Why Do Companies Need to Have Cash Reserves Offshore

The initial investment in the Irish plant was relatively small and the operation existed in a temporary facility. With earnings accumulated from the Irish operation, the first phase of a permanent manufacturing plant was built

In 1981. Subsequent phases were added in 1986 and 1989–91. As of 1992, Amdahl had invested $50.6 million in land and buildings and $64.4 million in equipment in our Irish plant.

Amdahl Ireland also invests in intangible assets through its cost-sharing agreement with its U.S. parent. To date, this investment has totalled $400 million in payments from Amdahl Ireland to Amdahl Corporation. Investments in intangible assets are just as important, if not more so, to high technology companies such as Amdahl, as investments in physical assets. As Amdahl continues to develop technologies in the U.S., Ireland will share in these costs via cost sharing payments. As a result, Amdahl's Irish operation owns significant technology rights.

Amdahl has consistently had the philosophy of funding its operations using equity rather than debt financing. Therefore, sufficient cash reserves are needed to satisfy these vital future commitments.

Amdahl's products are very expensive and customers often finance their purchase through a leasing arrangement. Recent conditions in Europe in the third party leasing market caused Amdahl to consider retaining a larger portion of leases than had previously been done in the past. The internal funding of a leased asset base requires a large amount of cash. However, due to the lower than expected volume of sales within Europe over the past two years, Amdahl has temporarily placed on hold plans to initiate a large internal leasing operation until volumes increase to a level sufficient to justify such an operation.

The last reason for offshore cash is business prudence. The mainframe computer industry in general has undergone severe losses in the past two years which Amdahl has funded with its accumulated cash reserves. Without such reserves Amdahl would have been forced to borrow funds at less than desirable terms, further aggravating difficult economic conditions. Our company needs to have the flexibility to react to adverse economic conditions with the strategies that it deems most appropriate. In our case, this would include having sufficient cash reserves to fund loss operations over an extended period of time.

For example, as of 1992, the amount of cash offshore was 40% less than the amount in 1990. This large decrease was due to the fact that Amdahl's Irish operations lost money in 1991 and 1992. As this trend demonstrates, a computer company can utilize large amounts of cash in a very short period of time.

Amdahl has had significant business and economic reasons for accumulating cash in its Irish operations. These actions were taken in good faith based upon the tax laws in effect at that time. To penalize Amdahl by imposing a retroactive change to the concept of tax deferral is extremely disturbing. Amdahl has operated in accordance with the rules that have been in effect and believes it unfair that such rules be changed after the fact. The retroactive repeal of deferral is unprecedented, to our knowledge, and is not a trend we would like to see established.

Amdahl's Foreign Investment Helps Create U.S. Jobs

Many high quality supervisory, administrative and engineering jobs located in the U.S. are needed to support our international operations. Although as much as 45% of Amdahl's sales are to foreign customers, 97% of Amdahl's R&D is performed in the U.S. These R&D activities provide jobs requiring high skills that provide good wages. However, without cost effective foreign operations, Amdahl could not afford to continue its current level of R&D spending. The partial elimination of deferral will reduce Amdahl's profitability and cost effectiveness of foreign operations. The effect of this may be the necessity for Amdahl to cut costs in other areas, including a possible loss of U.S. support jobs so that the company can continue to compete in a very competitive global market.

2. TREATMENT OF ROYALTIES AS PASSIVE INCOME

The proposed treatment of royalties as passive income for foreign tax credit calculations is inconsistent with the Administration's goal of encouraging research and investment within the U.S. and does not enhance U.S. competitiveness. The proposal penalizes the typical high technology company, such as Amdahl, that performs most R&D within the U.S. and then licenses the developed software technology around the world. Here, the impact is especially severe, where the licensing of software intangibles is the standard method of operations.

Software revenues are expected to be a significant part of future revenue growth. Revenue generated by the licensing of software is subject to tax in the same fashion that hardware revenue is subject to tax. Yet this proposal makes the arbitrary distinction that software royalties will be classified as passive income, but sales income will be classified as general limitation income. The stated purpose of this proposal is to eliminate the possibility of cross-crediting for foreign tax credit calculations, therefore raising revenue by limiting foreign tax credits. This is another example of a cost to U.S. companies that our competitors do not face.

A possible outcome of this proposal is the movement of R&D activity to foreign locations that provide incentives for such activities, or at least do not put the companies performing such activities in the unenviable position of paying tax twice on the same income on a worldwide basis. High technology companies will have to consider such alternatives if they are to remain competitive in the future.

Conclusion

We strongly oppose the partial repeal of deferral and the characterization of royalties as passive income. Tax laws to the extent they affect business decisions should encourage the creation of jobs within the U.S. and help to equalize matters for U.S. companies in relation to their foreign competition.

STATEMENT OF PAUL OOSTERHUIS,
PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM,
ON BEHALF OF THE DEFERRAL PRESERVATION COALITION

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

APRIL 1, 1993

Mr. Chairman and Members of the Committee. My name is Paul Oosterhuis. I am a tax partner in the Washington D.C. office of the law firm Skadden, Arps, Slate, Meagher & Flom. I am here today representing the Deferral Preservation Coalition. The Deferral Preservation Coalition is an ad hoc group of companies from a variety of technology-based industries, including electronics, telecommunications, medical equipment and pharmaceutical. Attached to my statement is a list of our members.

John Young, the former CEO of Hewlett-Packard Company, one of our coalition members, will be testifying on the next panel from a businessman's viewpoint about the anti-competitive aspects of the Administration's

proposal on deferral. I will not duplicate that effort. Rather, I am here to talk about the tax policy aspects of the proposal.

Deferral Cutback Proposal: A Description

The proposal would tax U.S. shareholders of controlled foreign corporations (CFCs) on their pro rata portion of the lower of two amounts: (i) the excess of passive assets over 25 percent of total assets or (ii) the CFC's total current and accumulated earnings and profits (E&P). As we understand it, the definition of passive assets will refer to or utilize similar rules to those in the passive foreign investment company ("PFIC") regime. The proposal would apply on a phased-in basis to all current and accumulated earnings beginning in taxable years after 1993.

Stated Tax Policy Goals of the Proposal

The Administration's explanation of the proposal states that it is intended to reduce the incentives under present law for companies to move plants abroad. For two reasons, nothing could be further from reality.

In this respect, the proposal constitutes an unprecedented departure from any existing provision of the Internal Revenue Code, including to my knowledge all prior provisions that have taxed the passive income or accumulated earnings of a corporation. Never in the history of the income tax law has the Congress imposed such a tax upon pre-enactment year earnings.

For example, the accumulated earnings tax provision, which was the original incorporated pocketbook provision enacted in 1913, applied at the shareholder level to only "that part of the profits of the corporation for the year which might have been distributed but were not distributed." As such, it only applied to current earnings after the enactment date.

Similarly, the personal holding company tax rules, which were enacted in 1934 and the foreign personal holding company rules enacted in 1937, only apply to the corporation's post-enactment income.

The Subpart F rules, enacted during the Kennedy Administration in 1962, only applied to earnings after 1962. Indeed, even today, the accumulated E&P accounts of CFCs go back only to 1962 so as to not tax retroactively the income earned by these entities prior to the enactment of these rules. Section 956, which taxes a CFC's earnings invested in U.S. property, is probably most analogous to the Administration's current cutback proposal. Yet even that section, enacted in 1962, only targets property acquired after 1962. Thus, earnings invested in U.S. property acquired before the enactment of Section 956 in 1962 are not only exempted from tax under the Section 956 investment in U.S. property rules, but are totally irrelevant in determining the amount of current inclusion under that section.

Finally, the PFIC rules, which were enacted most recently in 1986, also only target post-enactment earnings. Under those rules, a foreign corporation is a PFIC if 75% or more of its gross income is passive or if 50% or more of the value of its assets are passive. The U.S. shareholders of a PFIC have the option of either paying tax with an interest charge when there is a distribution of earnings accumulated after 1986 or paying taxes on a current basis with respect to the current earnings of the PFIC. In either case, the rules only apply to earnings from years after its enactment. Disvent any incorporated pocketbook abuses for this type of company.

The Provision Disproportionately Hits High Tech Companies

As the above rate of return analysis indicates, the proposal disproportionately affects high tech companies because its 25% threshold is very tight for companies which have high rates of return. The proposal discriminates against high tech companies in other ways as well.

The proposal favors companies that can debt finance their foreign manufacturing operations. Such companies can utilize profits to pay off debt and can take out new debt to finance expansion which can also be paid off through retained earnings. Companies with substantial debt capacity associated with foreign manufacturing thus can easily avoid the 25% threshold. Equity financed companies, however, must save up their retained earnings to finance their next facility. These companies can easily run up against the 25% threshold. High tech companies are most often equity financed; the debt-equity ratios of major companies in the electronics and pharmaceutical industries are perhaps the lowest of any manufacturing industry. Thus, these companies have the least ability to avoid the 25% threshold by debt financing.

Finally, the provision discriminates against high tech companies because a substantial portion of the assets of their foreign manufacturing facilities are likely to relate to intangibles rather than plant and equipment. These intangibles may have substantial value (and thus substantially increase the 25% threshold), but determining the value of these intangibles is subjective and therefore subject to dispute. It can thus be readily predicted that enactment of the 25% threshold will lead to serious valuation questions with respect to high tech foreign manufacturing facilities. Other companies, with investments dominated by plant and equipment costs, have more readily ascertainable asset values, resulting in the more predictable application of the 25% threshold.

DEFERRAL PRESERVATION COALITION MEMBERSHIP

COMPANIES

Abbott Laboratories
Amdahl Corporation
American Home Products Corporation
Apple Computer
AT&T Corporation
Baxter International
Digital Equipment Corporation
Hewlett-Packard Company
Intel Corporation
Johnson & Johnson
Eli Lilly & Co.
Lotus Development Corporation
Merck & Co.
Millipore, Inc.
Motorola
Pfizer, Inc.
Schering-Plough Corporation

ASSOCIATIONS:

American Electronics Association

Computer and Business Equipment Manufacturers Association

Electronic Industries Association

Pharmaceutical Manufacturers Association

PREPARED STATEMENT OF HARRY SULLIVAN

INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. My name is Harry Sullivan. I am Senior Vice President and General Counsel of the Food Marketing Institute (FMI).

FMI is a nonprofit association conducting programs in research, education, industry relations and public affairs on behalf of its 1,500 members -- food retailers and wholesalers and their customers in the United States and around the world. FMI's domestic member companies operate approximately 19,000 retail food stores with a combined annual sales volume of $190 billion -- more than half of all grocery store sales in the United States. FMI's retail membership is composed of large multi-store chains, small regional firms and independent supermarkets. Its international membership includes 250 members from 60 countries.

I am appearing here today as a Co-Chairman of the Tax Reform Action Coalition (TRAC), of which FMI is a founding member.

GENESIS OF THE TAX REFORM ACTION COALITION (TRAC)

Prior to the enactment of the Tax Reform Act of 1986, the numerous deductions, exclusions and credits which complicated the tax code were used as tools to influence so-called "economic" decisions. However, over time the accumulation of special tax relief and preference provisions resulted in a highly uneven and economically counter-productive distribution of "benefits" among taxpayers and various types of economic activities.

Wide disparities were created in the effective tax rates paid by different economic sectors, and even by individual firms within the same sector. While some businesses could substantially reduce their tax obligations through preferential tax credits and deductions, a similar opportunity was not available, as a practical matter, to others with the same income, because the activities which generated these credits were not a significant part of their natural business endeavors.

As a result of these disparities in the Tax Code, the Coalition to Reduce High Effective Tax Rates was formed in 1983. The Tax Reform Action Coalition (TRAC) evolved, in turn, from this coalition. TRAC was initially formed in June of 1985 by six business associations and corporations which were committed to enacting federal tax reform legislation to substantially reduce the then-existing high nominal individual and corporate tax rates in return for the reduction of preferences in the code.

The Coalition's basic objective resonated powerfully within the business community and membership grew rapidly. By the time the Tax Reform Act of 1986 was enacted, TRAC's membership had grown to 250 individual corporations and associations. TRAC's membership came to include major manufacturers of products ranging from cars to electronic devices to computers, food products, clothing and petroleum products as well as major financial services and investment companies, major real estate developers, trucking companies, wholesaler-distributors, retailers, and a host of small businesses of all types. All told, the Coalition's membership roster represented more than 100 of the FORTUNE 500 industrial companies and over one million businesses nationwide. TRAC's membership demonstrated broad business support for fundamental tax reform, in a rather admittedly divided business community.

Today, TRAC is even larger and more broad based in its composition, with 339 associations and corporations as members. (A current membership roster is attached as APPENDIX A.)

TRAC enthusiastically supported the 1986 Tax Reform Act because of the substantial reduction in marginal tax rates it provided in return for base broadening. While the Act explicitly projected that large tax increases would be imposed on the business sector, as businessmen we nevertheless felt it constituted a fair and desirable compact and was worthy of support. Throughout the process, TRAC focused solely on the issue of tax rates and a broad base of income and the Coalition retains that focus today.

Following enactment of the 1986 Act, TRAC decided to remain organized as an action group to help insure, if necessary, that the rate reductions in the law would be implemented and maintained. Our decision was a prudent one, because over the past six years there have been many attempts to either delay the implementation of rate reduction, increase them, or impose surtaxes. And, today, as I appear before the Committee, the spirit and letter of the Tax Reform Act of 1986 has again been called into doubt.

Mr. Chairman, the Tax Reform Act of 1986 represented much more than a revamping of the tax code. It was a victory of principle over narrow special interests and demonstrated that American politics can work to the benefit of all of the people, not just a chosen few.

Tax reform had many strong and effective advocates on this committee in 1986 including Senator Bradley, Senator Packwood, and yourself, Mr. Chairman. You and your colleagues made it clear why tax reform had your support, when in the Report of the Committee on Finance to accompany H.R. 3838 (Report No. 99-311 dated May 29, 1986, Page 3), you observed:

> *"The current tax system intrudes at nearly every level of decision-making by businesses and consumers. The sharp reductions in personal and corporate tax rates and the elimination of many preferences will directly remove or lessen tax considerations in business and consumptions decisions. Business will be able to compete on a more equal basis, and business winners will be determined more by serving the changing needs of a dynamic economy, and less by reaping the subsidies provided by the tax code."*

Mr. Chairman, the encouragement and support you and your colleagues gave to TRAC made it possible for us to help you and the Congress to make tax reform a reality. And, we are here today to try to keep it a reality.

TRAC'S POSITION ON THE PROPOSED INCREASE IN TAX RATES

Since TRAC focuses only on rates, we have no position, as a coalition, on the President's overall economic plan. Individually, I certainly am prepared to assume that our members applaud and support the President's objective of significantly reducing the deficit. Again, individually, we may agree or disagree on various aspects of his plan other than those dealing with rates.

The President's economic proposal will increase the the top individual tax rate from 31 percent to 36 percent.and the top corporate rate from 34 to 36 percent. It would further impose a 10% surtax on certain individuals. Simultaneously, the proposal provides for the reinstatement of some tax preferences ostensibly in the interest of stimulating the economy in the short term and keeping it growing over the long term.

America's long-term economic growth is a matter of concern to all of us. It was in fact a conclusion of the 1985-1986 debate that a high-rate, specially preferenced tax law had become a retardant of economic growth.

We feel it is critically important to remember that the most important aspect of what tax reform achieved was to cause investment decisions to be economically motivated, not tax-motivated. Tax reform was enacted because the code was fundamentally unfair and inefficient and it treated taxpayers unequally by inducing investment decisions on the basis of tax, rather than economic considerations.

Our explicit and implicit understanding in working with this Committee was always that tax preferences had to be exchanged for lower rates, if the goals of reform were to be achieved. We supported this compact, and continue to do so. The President's proposals in their current form reflect the reverse of this, namely, a reestablishment of preferences and an increase in tax rates. Down that path lies both the unfairness and economic inefficiency of prior law.

It is also important to note that both the individual and corporate rate increases as proposed will dramatically increase business' tax burden. Under the proposal, the business burden alone will increase by a net $113 billion over the next five years -- reducing cash flow which is desperately needed in the private sector to create jobs and stimulate the economy.

Contrary to statements made by some advocates of an increase in the corporate tax rate, it is not correct that corporate America has not been paying its "fair share" of the tax burden. According to an analysis by the National Association of Manufacturers, corporations, in fact, paid an average effective tax rate of 32.5 percent in 1990, while individuals paid an effective rate of 10 percent. While the Tax Reform Act of 1986 was expected to and was adopted in the face of the calculation that it would shift $120 billion in tax burden from individuals to corporations over five years, these revenue expectations were not met for the simple reason that corporate income decreased or did not increase as projected during that period. The reason this occurred was not because of the '86 changes in the code, but simply because corporate profits did not reach anticipated levels due to the recession. Corporate America does pay its fair share of the tax burden; in fact, it could be argued that it pays more than "a fair share."

Another argument used for increasing the corporate rate to 36 percent is that both individual and corporate rates need to be at the same level. Mr. Chairman, never in the history of the American income tax have the top corporate and individual rates been at the same level. Attached to our testimony as APPENDIX B is a chart derived from this Committee's publication, Overview of the Federal Tax System , which reveals the wide disparities over time between the corporate and individual tax rates. The historic disparity has ranged from 1 percent in 1909 (when individuals paid no income tax at all) to 64 percent in 1936. Indeed, the average spread between top individual and corporate rates over the life of the income tax is 31 percent. In 1991 and 1992, the corporate and individual top rate spread was 3 percent -- the closest the two rates have been in ten years, except for the transition year of 1987. We have heard no one arguing that the top corporate rate should be lowered so that it equalled the top individual rate. There is no good reason now to raise it to achieve a parity that has not been the historical case.

The five percent increase in the individual rates will have a devastating effect on businesses which pay taxes as individuals. It is important to remember that most of the businesses which pay taxes as individuals -- sole proprietors, partnerships or S Corporations -- are small to medium-sized businesses, which have provided the largest share of new jobs in the country over the past ten years. Additionally, small businesses which file as individuals must pay tax on what the businesses earn after deductions, not just on the business owner's personal income. This tax increase will seriously undermine the ability of a small business owner to reinvest the profits from a fledgling enterprise and create new jobs and reinvest capital. The only advantage we can see to this staggering tax increase on small businesses is that new enterprises will be formed to assist taxpayers at finding new and innovative ways to evade paying the higher taxes they face through tax shelters.

CONCLUSION

TRAC supported the 1986 Tax Reform Act because of the rates it contained and the promise they held for economic and tax equity. We supported base broadening through the elimination of preferences. This compact was the linchpin of tax reform. With profound respect for this landmark legislation, TRAC strongly urges Congress not to increase rates and not to restore preferences.

In this regard, we have a specific recommendation to make: abandon the temporary ITC proposal -- it has garnered no support in the corporate community -- and leave the corporate rate at 34%. The President's package proposes business tax incentives costing $56.5 billion. It raises business taxes by $170.1 billion. This is a ratio of $3.00 in business tax increases for each $1.00 in proposed business tax incentives. The revenue loss associated with the temporary ITC is $9.1 billion. The revenue gain projected from the corporate rate increase is $30 billion. This is consistent with the 3 to 1 ratio which characterizes the President's overall proposal.

Thus, in proposing the trade-off outlined above, we believe that it is consistent with the President's logic to offset the full corporate rate increase with abandonment of the temporary ITC.

If you wish to establish a framework for jobs creation, you must, in addition, deal with the impact of the President's proposals on small businesses. In many respects, they are hit the hardest by the President's proposals.

Over a two-year period, Congress labored forcefully to produce the 1986 Tax Act. Cynics insisted that it could never be accomplished in the Senate. Overcoming enormous odds, Mr. Chairman, you and the membership of this Committee did it.

Increasing the rates now would immediately shatter the compact Congress made with the American people. TRAC urges this Committee, in the strongest possible terms, to reject the proposed increases in the top rates.

Attachments:
APPENDIX A
APPENDIX B

APPENDIX A

TAX REFORM ACTION COALITION (TRAC)

STEERING COMMITTEE

American Business Conference
American Dental Association
American Home Products Corporation
American Insurance Association
American Management Systems, Inc.
American Trucking Associations
Amway Corporation
Apple Computer, Inc.
BP America, Inc.
Beneficial Management Corporation of America
Consolidated Freightways Incorporated
The Dial Corporation
Du Pont Company
E-Systems, Inc.
Electronic Industries Association
Eli Lilly & Company
Fleming Companies, Inc.
Florists' Transworld Delivery Association
Food Marketing Institute
General Mills, Inc.
Georgia-Pacific Corporation
W.R. Grace & Company
Grocery Manufacturers of America
Harris Corporation
Hershey Foods Corporation
Household International
I B M Corporation
International Mass Retailing Association
Kellogg Company
Kmart Corporation
The Kroger Company
Levi Strauss & Company
Merrill Lynch & Company
National-American Wholesale Grocers' Association
National Association of Chain Drug Stores
National Association of Wholesaler-Distributors
National Federation of Independent Business
National Restaurant Association
National Retail Federation
National Soft Drink Association
NYNEX
PepsiCo, Inc.
Pharmaceutical Manufacturers Association
Philip Morris Incorporated
Printing Industries of America
Procter & Gamble Manufacturing Company
Ralston Purina Company
RJR Nabisco, Inc.
Roadway Services, Inc.
Sara Lee Corporation
Sun Company, Inc.
United Technologies Corporation
UST Inc.
Wine & Spirits Wholesalers of America
Winn-Dixie Stores Incorporated
Yellow Freight System, Inc. of Delaware

TAX REFORM ACTION COALITION (TRAC)

GENERAL MEMBERSHIP

Air Conditioning & Refrigeration Wholesalers
Air Delivery Service Incorporated
Air Transport Association
Air Van North American
Allentown-Lehigh (Pennsylvania) County Chamber of Commerce
Alter & Sons Shoes Incorporated
American Association of Advertising Agencies
American Electronics Association
American Express Company
American Foundrymen's Society
American Furniture Manufacturers Association
American Institute of Merchant Shipping
American Machine Tool Distributors Association
American Meat Institute
American Movers Conference
American Nurses Association
American Paper Machinery Association
American Pipe Fittings Association
American Supply Association
American Traffic Safety Services Association
American Veterinary Distributors Association
American Wholesale Marketers Association
Appliance Parts Distributors Association
Ardmore (Oklahoma) Chamber of Commerce
Arkansas Freightways
Armstrong World Industries, Inc.
Associated Equipment Distributors
Association for Suppliers of Printing and Publishing Technologies
Association of American Railroads
Association of Floral Importers of Florida
Association of Steel Distributors
Automotive Parts Rebuilders Association
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association
B. F. Fields Moving & Storage
Batesville Area (Indiana) Chamber of Commerce
Bearing Specialists Association
Beatrice Companies Inc.
Beauty & Barber Supply Institute
Bechtel Group, Inc.
Bicycle Wholesale Distributors Association
Biscuit & Cracker Distributors Association
Campbell Soup Company
Can Manufacturers Institute
Carlton Trucking Company Incorporated
Carolina Freight Corporation
Ceramic Tile Distributors Association
Chilton Corporation
CIC Plan
Citizens for a Sound Economy
The Clorox Company
Columbia Motor Express Incorporated
Computer Dealers & Lessors Association
Consolidated Papers Incorporated
Contractual Carriers Incorporated
Coors Brewing Company
Copper and Brass Servicenter Association
Coshocton (Ohio) Area Chamber of Commerce
Council for Periodical Distributors Association
Craig Transportation Company
Criber Truck Leasing Incorporated
Crouse Cartage Company
Crowley Maritime Corporation
D. L. Merchant Transport Incorporated
Dart Trucking Company Incorporated
De Fazio Express Incorporated
Dobson Mover
Eddie Bauer Incorporated
Edison Electric Institute
Edmac Trucking Company Incorporated
Electrical Apparatus Service Association
Electrical-Electronics Materials Distributors Association
Elmer Buchta Trucking Incorporated
Engine Service Association
Equifax, Inc.
Fairmont Area (Minnesota) Chamber of Commerce
Farm Equipment Wholesalers Association
Federal Express Corporation
Federated Department Stores Incorporated
Federation of American Health Systems
Fluid Power Distributors Association
FMC Corporation
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Fort Howard Corporation
Friedl Fuel & Cartage Incorporated
GenCorp
General Delivery Incorporated
General Merchandise Distributors Council
General Mills Incorporated
General Nutrition Incorporated
Grass Valley and Nevada County (California) Chamber of Commerce
Greater East Dallas (Texas) Chamber of Commerce
Greater San Diego (California) Chamber of Commerce
Greater Seattle (Washington) Chamber of Commerce
Greater Syracuse (New York) Chamber of Commerce
Greenfield Transport Incorporated
Griffin Distributing
Hardwood Plywood Manufacturers Association
Hartford Dispatch & Warehouse Company Incorporated
Health Industry Distributors Association
Hewlett-Packard Company
Hobby Industry Association of America
Hospital Corporation of America
Household Goods Forwarders Association of America
Independent Medical Distributors Association

Independent Sealing Distributors
Independent Xray Dealers Association
Industrial Distribution Association
Insutute of Industrial Launderers
Insulation Contractor Association of America
International Association of Plastics Distributors
International Communications Industries Association
International Hand Protection Association
International Hardware Distributors Association
International Sanitary Supply Association
International Snowmobile Industry Association
International Truck Parts Association
International Wholesale Furniture Association
Irrigation Association
Kelly Services Inc.
Kemp Furniture Industries Incorporated
Kent (Washington) Chamber of Commerce
King Transfer Incorporated
King Van & Storage Incorporated
Krenn Truck Lines Incorporated
Lacy's Express Incorporated
Land Trucking Company Incorporated
Larmore Incorporated
Locute Corporation
Machinery Dealers National Association
Manitowoc-Two Rivers Area (Wisconsin) Chamber of Commerce
Material Handling Equipment Distributors Association
Materials Research Corporation
Matterson Associates Incorporated
The Maxwell Company
McCourt Cable Systems
McRae s Incorporated
Metro Milwaukee (Wisconsin) Association of Commerce
Metropolitan Life
Mid-West Truckers Association
Minnesota Trucking Association
Mississippi Chemical Corporation
Monroeville Area (Pennsylvania) Chamber of Commerce
Montana Power Company
Moore & Son Trucking
Motorcycle Industry Council
Music Distributors Association
National Aggregates Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Flour Distributors
National Association of Hose and Accessories Distributors
National Association of Meat Purveyors
National Association of Recording Merchandisers
National Association of the Remodeling Industry
National Association of Service Merchandising
National Association of Sign Supply Distributors
National Association of Solar Contractors
National Association of Sporting Goods Wholesalers
National Association of Truck Stop Operators
National Association of Water Companies
National Association of Wholesale Independent Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electrical Manufacturers Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Brokers Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Medical Enterprises
National Moving & Storage
National Paint Distributors
National Paper Trade Association
National Private Truck Council
National Ready Mixed Concerete Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Screw Machine Products Association
National Solid Wastes Management Association
National Spa & Pool Institute
National Tire Dealers & Retreaders Association
National Tooling & Machining Association
National Truck Equipment Association
National Utility Contractors Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
NCR Corporation
New Berlin (Wisconsin) Chamber of Commerce
Newark (Ohio) Area Chamber of Commerce
North American Heating & Airconditioning Wholesalers
North American Horticulture Supply Association
North American Wholesale Lumber Association
Odisco Transportation
Optical Laboratories Association
Opticians Association of America
Oracle Corporation-Government Affairs
Outdoor Power Equipment Distributors Association
PACCAR Incorporated
Pennsylvania House
Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America

Plattsburgh & Clinton County (New York) Chamber of Commerce
Power Transmission Distributors Association
Precision Metalforming Association
Priority Freight System Incorporated
Produce Marketing Association, Inc.
The Quaker Oats Company
Red Lobster Inns of America
Red Star Truck Lines
Safety Equipment Distributors Association
Safeway Stores Incorporated
Salt Institute
Servicestation and Automotive Repair Association
Shared Medical Systems
Shoe Service Institute of America
Slidell (Louisiana) Chamber of Commerce
Small Business of America Inc.
South Hills Movers Incorporated
Specialty Equipment Market Association
Specialty Tools and Fasteners Distributors Association
Square D Company
St. Lucie County (Florida) Economic Development Council
Steel Service Center Institute
Suspension Specialists Association
The Talbots Incorporated
Tarzana (California) Chamber of Commerce
Telecommunications Industry Association
Textile Care Allied Trades Association
Unifi Incorporated
United Fresh Fruit & Vegetable Association
United Products Formulators & Distributors Association
Valmont Industries, Inc.
W. H. Fitzgerald Incorporated
Walgreen Company
Wallack Freight Lines Incorporated
Wallcoverings Association
Ward Transport Incorporated
Ward Trucking Incorporated
Warehouse Distributors Association for Leisure and Mobile Products
Warren Trucking Company
Washington Water Power Company
Water & Sewer Distributors Association
Water Systems Council
Waukegan/Lake County Chamber of Commerce
Western Suppliers Association
Wheeler Transport Service
Whirlpool Corporation
White Sulphur Springs Chamber of Commerce
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
William E. Stowe & Associates
The Williams Companies, Inc.
Winfield (Illinois) Chamber of Commerce
Woodworking Machinery Distributors Association
Woodworking Machinery Importers Association
Zayre Corporation

APPENDIX B

TOP INDIVIDUAL AND CORPORATE TAX RATES

YEAR	INDIVIDUAL	CORPORATE	SPREAD
1991-1992	31	34	3
1988-1990	28	34	6
1987	38.5	40	1.5
1982-1986	50	46	4
1981	69.125	46	23.125
1979-1980	70	46	24
1971-1978	70	48	22
1970	71.75	49.2	22.55
1969	77	52.8	24.20
1968	75.25	52.8	22.45
1965-1967	70	48	22
1964	77	50	27
1954-1963	91	52	39
1952-1953	92	52	40
1951	91	50.75	40.25
1950	91	42	49
1948-1949	82.13	38	44.13
1946-1947	86.45	38	48.45
1944-1945	94	40	54
1942-1943	88	40	48
1941	81	31	50
1940	81.1	24	57.1
1938-1939	79	19	60
1936-1937	79	15	64
1932-1935	63	13.75	49.25
1930-1931	25	12	13
1929	24	11	13
1928	26	12	14
1926-1927	26	13.5	12.5
1925	26	13	13
1924	46	12.5	33.5
1922-1923	56	12.5	43.5
1919-1921	73	10	63
1918	77	12	65
1917	67	6	61
1916	15	2	13
1913-1915	7	1	6
1909-1912	No Income Tax	1	1

Source: Overview of the Federal Tax System, Committee on Ways and Means, April 10, 1991

PREPARED STATEMENT OF GEORGE A. WACHTEL

Introduction

Good morning, Mr. Chairman and members of the committee. My name is George A. Wachtel. I am Director of Research and Government Relations for The League of American Theatres and Producers. I am delighted to be here this morning representing, in addition to The League: Actors' Equity Association (36,000 members), The International Alliance of Theatrical Stage Employees (75,000 members), The League of Resident Theatres, and the National Alliance of Musical Theatres -- organizations which represent diverse interests in the performing arts, including labor, the nonprofit theatre, and the commercial theatre. All of these organizations are intensely concerned about the fragile nature of the arts today and the prospects for the future.

While about 8 million people see Broadway shows each year in New York, another 20 million see Broadway shows on tour throughout the nation as almost 100 cities are visited each season by touring companies. Annual attendance at nonprofit professional theatres totals 16 million. And other regional musical theatre and dinner theatre welcome another 10 million. Professional theatre attendance totals over 50 million each year.

Theatre and performing arts generate jobs, in addition to the direct employment of the theatres and performing arts centers, through the unique phenomena whereby audiences and visitors complement their attendance with spending for food, lodging, travel, and retail goods. **Arts employment occurs in and around urban centers** where, economically and socially, jobs are sorely needed. **Commercial theatre creates a favorable balance of payments** by licensing the rights for productions in other countries and English language productions which tour with American casts. For example, an American company of *Les Miserables* will travel to Singapore for 12 weeks with 81 people and play to over 150,000 Singaporeans.

The Fragile Economic Condition of the Performing Arts

The President's tax proposal includes a reduction in the business entertainment deduction from 80 percent to 50 percent. The result would be an additional blow to the already fragile economic condition of the Broadway Theatre and the performing arts.

Nearly half of the nation's nonprofit professional theatres[1] ended the 1990-91 fiscal year in the red for an aggregate deficit of $2.8 million. Seven theatres ceased operation in 1991, bringing the five-year total to 25 closed theatres. Nonprofit professional theatre attendance dropped in that season for the first time in the history of the survey.

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[1]90 of 184 theatres in the Theatre Communications Group's survey, "Theatre Facts 91." The first survey was conducted in 1974.

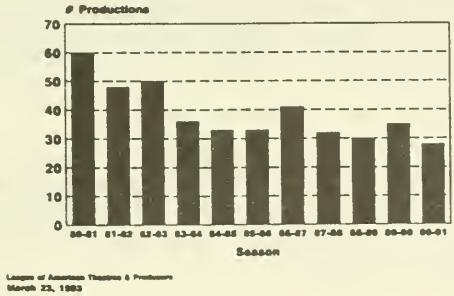
Fifty percent of symphony orchestras[2] carry deficits, an increase from 47 percent in 1980-81. Support from government sources for orchestras shrank from 9 percent of their budgets in 1990 to 8 percent in 1991. In 1980-81, government funding represented 13 percent of total income. During the past decade, four orchestras shut their doors, and others have been forced to reduce their seasons.

Forty-nine percent of opera companies[3] posted deficits -- the same percentage as the year before -- but the aggregate deficit for these companies tripled. Public support for opera dwindled nearly one percentage point to 1.6 percent of all income. For the first time in more than five years, contributions from individuals and corporations dropped in 1990-91, mirroring the hard economic times.

Of the 46 dance companies[4] surveyed, 16 (35 percent) reported deficits. Among the eight ballet companies, the average deficit was $327,693. The eight other companies reported an average deficit of $81,701.

The Broadway Theatre is virtually 100 percent dependent on ticket sales for its income. It receives no subsidy nor does it benefit from broadcast revenues as do sports teams. Only one out of five Broadway shows ever return their investment. Fewer new shows are being produced each year. Witness the decline from 60 new productions in the 1980-81 season to 28 in 1990-91. Broadway theatre pays municipal, state, and federal taxes.

NEW BROADWAY PRODUCTIONS
1980-81 thru 1990-91 Seasons



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[2]American Symphony Orchestra League survey of 118 of the largest orchestras in the United States.

[3]Opera America which surveyed 53 nonprofit professional opera companies.

[4]Dance/USA has 46 member companies: 25 ballet and 21 modern and other genres.

Theatre and performing arts budgets are extremely labor intensive. Sixty percent of regional theatre budgets pay for artistic, administrative, and production/technical personnel, while 62 percent of Broadway theatre expenditures are for union labor and artistic royalties. The largest portion of dance company budgets is also devoted to personnel, comprising 55 percent of total expenses. And personnel expenses for opera companies reached a new high, accounting for 65 percent of all costs.

Income Loss from Reduction of the Business Entertainment Deduction

Of the twenty or so shows running on Broadway at any given time, a handful are outright hits, but the majority are either attempting to recoup their initial investment or holding on until they close, often at a sizeable, if not total, loss. Most shows operate at such close margins that the loss of any portion of income would force them to close.

The reduction in the deduction from 80 percent to 50 percent would reduce business spending on entertainment an estimated 30 percent.[5] Ticket brokers account for almost 10 percent of Broadway theatre sales, almost all of which are for business entertainment. Furthermore, credit card sales and other sources of information suggest that total business entertainment sales are on the order of 20 percent. *Thus, a reduction of 30 percent in these ticket sales would result in a weekly box office loss of six percent.*

Operating costs for Broadway musicals range from approximately $350,000 to $500,000 per week. The average weekly gross box office (ticket sales) is $413,000. A musical with weekly operating expenses of $400,000 might stay open while weekly ticket sales average $403,000. However, a six percent reduction in the ticket sales, which would reduce weekly income to $380,000, would close the show.

Just how many shows are in this category?

At the present time, about 30 percent of the Broadway shows are operating close enough to their minimal weekly operating expense that a reduction in ticket sales could force them to close. Additionally, even the greatest hits would have shorter runs. Any show which loses a percentage of its potential audience will suffer to the degree of that loss.

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[5]Charles Clotfelter, "Tax-Induced Distortions and the Business-Pleasure Borderline: The Case of Travel and Entertainment," American Economic Review, December 1983, pp.1053-1065.

The result of shows closing means lost jobs for actors, musicians, stagehands, ushers and ticket takers, wardrobe personnel, hairdressers, box office treasurers, mail and telephone order clerks, advertising personnel, house and company managers, administrative personnel, accountants, lawyers, even tutors for the children in the cast. A typical Broadway musical employs over 100 people -- all union personnel. And when actors and creative people such as designers, authors, directors, and choreographers find less employment in theatre and eventually leave the field, it diminishes the available pool of labor for the other performing arts and entertainment in general.

And the losses do not stop there! Theatregoers dine out, travel to their destination (49 percent in New York visit from elsewhere in the United States and other countries), shop at retail stores, and consume other entertainment. Less frequent theatre attendance means less business at restaurants and at other theatre-dependent activities.

Theatregoers' spending on these theatre-related expenditures is estimated to average between one and two times the amount of ticket sales, depending on the market. The closing of just one musical show could result in as much as $42 million in lost ancillary spending and a negative economic impact of $100 million per year.

Where Broadway Theatre and the Performing Arts Fit In

The Treasury Department estimates the impact of the reduction in business meals and entertainment deduction from 80 percent to 50 percent at $16-billion. The increase in revenue would come from the reduction in the allowable expense for meals and entertainment at restaurants, commercials sports, theatre and the performing arts and other entertainment. As shown below, entertainment at Broadway theatre and other commercial theatre activities account for only a fraction of the total.

According to the 1987 Census of Retail Trade (last available) published by the U.S. Department of Commerce, there were 391,303 establishments classified as "Eating and Drinking Places" with total sales of $148,776,497,000 (SIC code 58), 3,184 "Commercial Sports" establishments with receipts of $5,023,194,000 (SIC code 794), and 7,847 "Theatrical Producers, Bands, Orchestras, Entertainers, and Miscellaneous Theatrical Services" (SIC code 792), of which only 3,253 were specifically "Theatrical Producers and Services" (SIC code 7922). Receipts for the entire entertainment category (SIC 792) totaled $4,904,224,000, while receipts for Theatrical Producers and Services were $2,543,391,000.

Activity	SIC Code	Receipts (Billion $)
Eating and Drinking Establishments	58	149
Commercial Sports	794	5
Theatrical Producers, Bands, etc.	792	5
(Theatrical Producers and Services)	(7922)	(2.5)
	Total	$159 billion

Theatrical producers and services represent $2.5 billion in receipts out of a total of $159 billion, or 1.6 percent of meals and entertainment expenditures.

However, this is a significant overestimate. The SIC code 7922, "Theatrical Producers and Services," includes many establishments in addition to legitimate theatre producers, such as producers of live radio and television, talent agents, casting agencies, and costume designers, which are neither ticketed events nor would qualify for a business entertainment deduction.

Conversely, the performing arts are not included in the retail census as they are not subject to federal income tax. If we temporarily overlook the broad scope of the SIC code and add to it the performing arts ticket sales figures which amount to $890 million[6], theatre and performing arts total $3.4 billion. Thus, theatre and performing arts represent only 2.1 percent[7] of the entire category of meals and entertainment.

Industry data suggests ticket sales for theatre and performing arts amount to about half of that calculated in the census above. Using the data below, the proportion of meals and entertainment accounted for by theatre and performing arts is only 1.1 percent. (Ticket sales below are for the 1991 fiscal year for the performing arts and 1992 for Broadway and national tours.)

[6]Represents a very conservative estimate as most performing arts financial data is collected by service organizations through surveys, the response to which are never equivalent to the universe.

[7]$3.39 billion divided by the combined total of $159 billion + 890 million (performing arts).

	Ticket Sales (million $)
Broadway	292
Broadway national tours	503
Nonprofit professional theatre	203
Other regional music and dinner theatre	225
Symphony	263
Opera	151
Dance	63
Performing Arts Presenters	93

1991 fiscal year; 1992 for Broadway and tours

Total $1.793 billion

Impact on the Treasury

Using the industry total of $1.8 billion, the current 80 percent rule applied to 20 percent of total arts expenditures at a corporate tax rate of 34 percent results in $98 million per year. At a business entertainment deduction rate of 50 percent, assuming expenditures remain constant, and a 36 percent corporate rate, the total would be $65 million, or a difference of $33 million per year. Over the life of the projection, the impact on the Treasury would be on the order of $150 million.

This gain would be offset by losses in federal income tax revenues owing from people who have lost jobs in the arts industry as well as from employees of businesses which rely on the arts to generate income -- restaurants, hotels, transportation, retail stores.

Broadway as an Export Product

In addition to national tours, Broadway shows and other theatres are licensed for production worldwide. An estimated $10 million in royalties were earned last year for American plays and musicals produced in other countries. Licensed companies are frequently comprised completely of American actors, an American creative team, as well as an American conductor and key musicians. This is especially true of English language productions which is a growing industry overseas.

To indicate the breadth of American theatre overseas, one major licensing company is currently involved in or has licensed for future production shows in: Hungary, Poland, Holland, Belgium, Germany, Austria, Switzerland, Spain, Denmark, South Africa, Columbia, Finland, Bulgaria, Sweden, Argentina, Chile, Namibia, the Bahamas, Japan, Hong Kong, Singapore, the Philippines, Israel, Saudi Arabia, Iceland, France, Norway, Canada, the U.K., Ireland, Australia, and New Zealand.

The 1990 Tony® Award winner for Best Musical, *Jerome Robbin's Broadway*, closed on Broadway without recouping its investment[8], yet toured for ten weeks in Japan paying weekly operating expenses to American cast and crew and earning income for the investors. Many American shows travel to Canada -- all with their American casts. As examples, Broadway's *The Secret Garden* employed 55 people weekly and *Buddy* traveled with 45 people.

In addition to the tours abroad, musicals and plays are licensed in the domestic secondary market for stock, LORT/regional, and amateur productions. The extent of this secondary theatre audience is enormous. Total royalties paid for performances of U.S. musicals and plays both here and abroad are estimated at $50,000,000 annually, with a potential audience of 30 to 40 million. This is in addition to the figures cited above. However, the global demand for American theatre continues to depend on the flow of new shows which comes from successful new productions on Broadway and at regional theatres nationwide.

Conclusion

The cost to the arts industry of a reduction in the business entertainment deduction would be a burden from which many commercial productions and nonprofit institutions would be unable to recover. The aftershocks would be felt in every state in the union. The Pittsburgh Cultural Trust reports that there are 1,200 business subscriptions to their Broadway series. What would replace that source of income? As to the ripple effect of this business spending at arts events, an economic impact study conducted for the Actors Theatre of Louisville (ATL) reports that "for every dollar in ATL's annual expense budget there seems to be a seven dollar output generated for the local economy."

We urge you to continue the present level of tax deductibility for business entertainment and not to promote policies that further exacerbate the already fragile economic condition of the performing arts in America.

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[8]An extremely large cast and extensive rehearsal time contributed to the inability of this well-received musical to earn back its investment on Broadway. It is an prime example of the type of show that business entertainment tickets can make or break, or at least, extent its run long enough to create interest in the show in other markets.

COMMUNICATIONS

STATEMENT OF THE AMALGAMATED CLOTHING AND TEXTILE WORKERS UNION, AFL–CIO

Chairman Moynihan and Members of the Committee: The Amalgamated Clothing and Textile Workers Union (ACTWU) represents nearly a quarter of a million workers concentrated primarily in the men's and boy's clothing, textile, leather and footwear industries. ACTWU also has significant membership in the automotive trim, medical products and photocopying equipment industries.

ACTWU has members in Puerto Rico as well as the U.S. mainland and Canada.

936 REFORM

The Amalgamated Clothing and Textile Workers Union supports President Clinton's proposal to reform Section 936 tax benefits for Puerto Rico. It clearly shifts the emphasis of these benefits toward greater job creation and produces greater tax equity. But this reform needs some additional elements to make it more effective in promoting economic development in Puerto Rico.

We call for the explicit denial of 936 benefits when they involve runaway shops or when a company is found to have violated labor, health and safety or environmental laws. We also call for 936 funds to be available only for further investments in Puerto Rico or the U.S. mainland. A portion of the funds must be mandated for worker training, skills upgrading, infrastructure necessities and other such improvements that the island clearly needs.

We believe that the Administration should also look at other means to enhance economic growth in Puerto Rico, in the context of NAFTA and the CBI program. Alternative development policies that depart from the prevailing neo-liberal, export-oriented model are needed for Puerto Rico and the Caribbean. We need a *comprehensive* development strategy for Puerto Rico and the entire region, not the piecemeal and contradictory approach of past administrations. However, if Puerto Rico is to be effectively involved in such a strategy, its people must posses the political means to participate in the design and implementation of those policies in a truly democratic way.

ADDITIONAL ACTION IS NEEDED

Section 936 of the Internal Revenue Service code exempts U.S.-based companies operating in Puerto Rico and other U.S. possessions from paying federal income taxes. Almost all 936 companies are located in Puerto Rico, many of which are Fortune 500 companies.

The ostensible purpose of Section 936 is to promote U.S. investment that creates new jobs and development in Puerto Rico. Section 936 has not succeeded in meeting those objectives as anticipated, while it certainly has made it possible for some U.S. multinational companies and financial interests to avoid paying federal income taxes and thereby obtain excessive profits.

The Administration's proposal of replacing the current income tax credit with a wage credit is a step towards putting "people first" by redirecting 936 to its intended purpose of creating jobs in Puerto Rico. The proposal also asks those companies who have obtained the highest profits and are responsible for the least number of jobs in Puerto Rico to contribute their "fair share of sacrifice" in helping the Administration to increase tax revenues to enable a reduction in the deficit and an increase in public investment.

ACTWU strongly urges Congress and the Treasury Department to address the following issues in reforming 936:

1. **Deny tax credit to runaway factories.** The tax credit must be denied to runaway companies, i.e., companies that relocate plants or transfer jobs from the mainland to Puerto Rico and from Puerto Rico and the mainland to other Caribbean Basin countries. The U.S. Labor Department should be charged with deciding what is and what is not a runaway, and requiring public disclosure of the names of companies that apply for Section 936 benefits.

2. **Include labor and social requirements.** The tax credit must be denied to any 936 company that violates local and federal laws and regulations in the areas of labor, occupational safety and health and environmental protection.

3. **Put Puerto Rican people first, too.** A significant fraction of the anticipated federal revenue from reforming 936 must be directed to prepare Puerto Rico for the 21st century. At *least* 25% of the federal revenue obtained from reforming 936 should go to an infrastructure and adjustment fund for Puerto Rico. The main purpose of these monies would be to improve infrastructure, the environment, education and worker skill levels, and help displaced workers in Puerto Rico. Such public investment would help Puerto Rico shift its development strategy from heavy reliance on federal tax credits and low wages as a means of attracting U.S. investment to one of building up the island's basic economic capacity and worker productivity.

4. **Tax passive income and redirect 936 low interest loans to Puerto Rico and the U.S.** Only the income earned by 936 companies from active operations should qualify for the wage credit. Income earned from eligible passive investment (i.e. interest earned on deposits) should be taxable at time of repatriation at the prevailing income tax rate. Eligible passive investments, including low interest loans from 936 funds, should be limited to financing private and public investment in Puerto Rico and/or the U.S.

The 1986 amendment to Section 936 which made investment in the Caribbean Basin countries an eligible form of passive (financial) investment using 936 funds must be eliminated. The bulk of this investment has been directed to establishing plants in export processing zones where the violation of workers' rights is common.

To encourage the deposit of 936 profits in Puerto Rico, 936 companies should be required to keep their deposits in Puerto Rico banks and other financial institutions for an established period of time. Earlier repatriation of 936 profits should render all their income taxable. Interest earned by commercial and investment banks and other financial institutions as a result of lending 936 funds should also be subject to taxation except when those funds are directly used to finance investment on productive capacity and create new jobs in Puerto Rico.

SHORTCOMINGS OF SECTION 936

ACTWU supports economic incentives that create jobs and help economic development in Puerto Rico. However, we have strong reasons to believe that Section 936 and other income tax exemptions that preceded it have not served Puerto Rico nor the U.S. well:

Subsidized destruction of jobs

- *The number of jobs created under Section 936 have been much less than anticipated.* Although 936 was conceived to create new manufacturing jobs in Puerto Rico, almost twenty years after the passing of Section 936 manufacturing employment remains stagnant and unemployment rates continue to be more than twice as large as on the mainland, despite much lower rates of labor participation and massive migration to the mainland. And, while Puerto Rico has promoted the establishment of 2,243 plants and the creation of 29,847 jobs on the island during 1970–90, during the same period, 1,931 plants closed down, eliminating 51,800 jobs. This net *loss* of more than 20,000 jobs was partly due to the substitution of labor intensive industry for more capital intensive industry, the latter being generally favored under the present income-based tax credit of Section 936.
- *936 companies often employ temporary and part-time workers through temporary employment agencies.* Some, like American Home Products, have abused programs like the Job Training Partnership Act by engaging in the shady practice of hiring students at subsidized wages for short periods of time with no intent to train them for permanent jobs.
- *Some 936 companies relocate rather than expand production from the mainland to Puerto Rico, resulting in the loss of mainland jobs.* The existing weak prohibition on runaway plants has never been enforced. In a study of just 25 plant relocation cases (16 of them pharmaceutical or medical product companies, most located in the Northeast), the Midwest Center for Labor Research found that over 7,000 direct jobs (or up to 30,000 indirect jobs) were lost on the mainland as a result of Section 936 related layoffs or plant closures. Many more jobs may

have been lost as a result of Section 936 plant closings in older industrial communities on the mainland where a large number of minorities, including Puerto Ricans, live. Two glaring examples of recent runaways are American Home Products from Elkhart, IN to Guayama, and Acme Boot from Clarksville, TN to Toa Alta.

- *936 funds provide low cost loans that have been used to finance the relocation of jobs from the mainland and Puerto Rico to the Caribbean and Latin America.* The use of 936 funds (profits deposited in Puerto Rico by 936 companies) to finance export oriented manufacturing in this fashion amounts to a subsidized destruction of domestic jobs and has played an important role in promoting the Caribbean Basin Initiative of Reagan and Bush.

Subsidized super-profits

- *U.S. corporations (virtually all of them 936 companies) attribute one-fifth of all their foreign direct investment profits to their Puerto Rico operations.*
- *Most of the $3 billion annual 936 tax savings are captured by a handful of companies.* In 1989, for example, $1.123 billion in federal taxes were avoided by just 13 companies. The leading tax savers were: Johnson & Johnson ($147 million), Coca-Cola ($143 million), Pfizer ($106 million), Merck ($105 million), Digital ($88 million), American Home Products ($80 million), Abbott ($79 million), Baxter International ($75 million), Bristol Meyers ($64 million), Eli Lilly ($53 million), Pepsi Co. ($52 million), Schering-Plough ($49 million), Upjohn ($49 million) and Warner Lambert ($39 million).
- *Excessive profits have been obtained by high-tech, capital intensive companies in Puerto Rico (like those in pharmaceuticals, scientific instruments, electronics, and electrical machinery).* For instance, only 77 of the 500 companies benefiting from this tax incentive are pharmaceuticals, yet that single industry obtains half of the total 936 tax savings, close to $2 billion annually. The financial and political clout of pharmaceuticals in Puerto Rico is very disproportionate to the relatively few jobs they create.
- *936 companies artificially allocate corporate profits to Puerto Rico with the purpose of avoiding paying federal income taxes.* Through "transfer pricing" some 936 companies manage to declare excessive profits in Puerto Rico. Transfer prices are prices charged in transactions of goods or services between different parts of the same corporation. Some 936 companies manipulate such prices in order to disguise profits from the IRS. They do so by overpricing products "sold" from their Puerto Rico plants to the mainland and underpricing products "sold" from the mainland plants to the Puerto Rico establishments. There are numerous cases of companies that have been accused or found guilty of using transfer pricing to declare tax-exempt profits in Puerto Rico, involving companies like Eli Lilly, Parke Davis, Pfizer, Abbott Laboratories, G.D. Searle, Timberland and others. *Section 936 companies contribute little to the treasury of the Government of Puerto Rico.* In addition to full federal income tax exemption, 936 companies enjoy close to full income tax exemption from local taxes. Tollgate taxes, designed so the Commonwealth government can recover up to 10% of the profits that 936 companies repatriate to the U.S., are often waived or not collected, making tollgate taxes just 2% of the local government revenue (instead of the 12% often quoted by 936 defenders). As a result of so many tax exemptions granted to the 936 companies, sales and income taxes for Puerto Rican households and businesses are among the highest under the U.S. flag.

Subsidized poverty and stagnant wages

- *Despite their high labor productivity, companies utilizing 936 tax advantages have not greatly increased the wages and living standards of their workers in Puerto Rico.* Most companies, including pharmaceuticals, only pay a fraction of U.S. mainland wages. They have vigorously fought unionization, and used lower wages in Puerto Rico as an excuse for meager pay increases—often concessions—from their mainland workers. 936 companies have not contributed significantly to reduce the male-female wage gap in Puerto Rico. Currently, almost 70% of the workers employed by Section 936 companies are women who are paid lower wages than their male counterparts.
- *Since the passage of Section 936, union representation and average manufacturing wages (adjusted for inflation and relative to the U.S.) have sharply declined, and the wage gap between mainland and Puerto Rico keeps growing.*
- *As a result of relatively low wages and high unemployment, more than 60% of the population of Puerto Rico lives in poverty and partially depend on federal income transfers.*

Subsidized dependency and underdevelopment

- *Section 936 has aggravated the dependence of the island on U.S. investment and has distorted its economic development, orienting it towards largely export-oriented, capital-intensive, highly toxic manufacturing production with few linkages to the local economy.*
- *It has helped subordinate, not integrate, the economy of Puerto Rico to that of the U.S.* Puerto Rico's dependency on a single instrument of economic development (federal income tax exemption) over which it has no political control is a very fragile and unstable foundation for long term growth. Since the passage of 936, the island's dependency on external investment has increased, with these companies accounting for two-thirds of manufacturing employment, and more than half of exports and national income.
- *The largest fraction of 936 profits are not reinvested to expand capacity in Puerto Rico but kept in the form of passive (financial) investments.* These funds amount to more than $15 billion, compared to less than $5 billion invested in plant and equipment. About $10 billion of the passive (financial) investment are bank and other financial deposits, almost one-half of Puerto Rico's bank deposits. More than $5 billion are kept as financial instruments by 936 corporations, the bulk of which are Caribbean Basin oriented bonds. As a result, they contribute little to long term economic development in the island. Financial deposits of 936 profits ("936 funds") generate excessive profits for the local banking industry, which is dominated by a few U.S. and foreign banks. The Economic Development Bank and other public financial agencies indirectly account for less than 10% of 936 deposits, and even this fraction exists only as a result of recent local regulations.
- The current income tax credit is biased toward capital intensive companies. These companies, by virtue of their large (gross) profit margins, multinational operations and patented products can readily use "transfer pricing" to declare profits in Puerto Rico and thus avoid paying additional income taxes in the mainland.

Subsidized environmental damage

- Some Section 936 companies (again, mostly the pharmaceuticals) have caused significant and irreparable damage to the environment, workers and their communities. According to the Environmental Protection Agency and independent environmental studies, they have turned areas Puerto Rico into some of the most polluted regions within the U.S., further undermining the scarce natural resources of the island, and contributing to the decline of local industries like fishing and agriculture. The environmental damage is so great that the local Environmental Quality Board estimates that 10% of Puerto Rico's coastline is unfit for swimming. EPA studies point to those municipalities with greater concentration of pharmaceuticals (like Barceloneta, Manatí, Guayama, Humacao and Carolina) as the regions with the largest toxic waste. The only waste-treatment facility for hazardous waste fluids in Puerto Rico, owned by Safety-Kleen Corp., is inadequate for the island's large concentration of chemical companies, and has been recently fined by the EPA for violating environmental laws.
- *Almost all (72%) of toxic waste in Puerto Rico is the result of dumping by a handful of chemical companies.* The most recent EPA report (1993) on Toxic Waste in Puerto Rico singles out companies like Schering, Du Pont (Manatí); Abbott, Upjohn, Viskase, Merck Sharp & Dohme, Pfizer, Sterling (Barceloneta); Phillips (Guayama); and Squibb (Humacao). Two years earlier, the EPA identified Phillips, Chevron, American Home Products, Revlon, General Electric, Becton Dickinson, Upjohn, Motorola, Harman Automotive, Teledyne Packaging, the U.S. Defense Department, and the Puerto Rico Industrial Development Corporation Co. as responsible for twelve of the island's most hazardous waste sites. EPA estimates that the cleanup of each site will cost $20 million—a total of $240 million.
- 936 companies often ignore safety and health conditions in the workplace. Some of them, like Parke Davis, have been found guilty of exposing workers to highly toxic materials without adequate protection. The fact that all pharmaceuticals are non-union leads many safety and health violations to go unreported.

The need to address the above shortcomings of 936 motivates ACTWU to endorse the Administration's proposed wage credit and to call for additional measures that help Puerto Rico's economic development without negatively affecting working people and their communities. Additional measures must include the redirection of tax revenue from 936 profits to restore public infrastructure, education and the environment, as well as denying 936 tax credits to runaway companies and companies that

violate local and federal laws and regulations in the areas of labor, occupational safety and health, and environmental protection. In addition, a meaningful reform of 936 must include the taxation of passive (financial) income and the redirection of 936 low interest loans to Puerto Rico and the U.S. mainland.

THE CLINTON PROPOSAL

As part of its economic plan, the Administration has proposed to reform Section 936. The Administration's plan calls for substituting the income tax credit with a wage credit over a three year period, starting in 1994. Wages and salaries up to the current FICA income cap ($57,600) will qualify for the wage credit. Under the wage credit, Section 936 companies will deduct from their corporate income taxes up to 60 of wages paid on their Puerto Rico operations—a total credit of more than $1.3 billion annually, about half of the current total income credit.

The changeover from the current income tax credit to the wage credit will be such that in any given year in the three year transition period companies would receive either the current income tax credit or the wage credit, whichever provides more revenue to the Treasury. In addition, 936 companies would receive an investment credit of 80% of the (depreciated) value of all investment in plant, equipment and inventories by those companies in Puerto Rico—a significant credit for high tech companies.

ACTWU supports the Clinton plan because it helps correct some of the present shortcomings of Section 936 while keeping in place a significant economic incentive to help create jobs in Puerto Rico. The Administration's initiative does not seek to eliminate Section 936. While the shift from an income tax credit to a wage credit greatly reduces the current tax savings enjoyed by a handful of sectors (including pharmaceuticals), the large majority of companies now benefiting from Section 936 will still obtain substantial tax savings under the new arrangement, which should help protect the jobs of the large majority of manufacturing workers in Puerto Rico. Tax rates for Section 936 companies will continue in effect to be lower than in the U.S. mainland, especially when state and local taxes are added to both the mainland and the Puerto Rico effective corporate tax.

CLINTON'S WAGE CREDIT WILL NOT CRIPPLE SECTION 936

Our gross estimate of the impact of President Clinton's proposed changes to Section 936 suggest that changing the current income-based tax credit to a wage-based tax credit will reduce the tax savings of 936 companies in Puerto Rico by a modest amount.

The table appended illustrates the impact that replacing the current income tax credit with a 60% wage credit could have on Section 936 tax savings. These are gross estimates that probably overestimate the actual impact of the wage credit since we abstract from the gradual way in which the wage credit would be implemented and we leave out of our calculations the Administration's proposed investment tax credit for 936 companies. Our main findings are that:

- *936 corporate tax rates will be only about half of the proposed U.S. corporate tax rate.* On average, 936 companies will end-up with an 18% corporate tax rate compared to the Administration's proposed 36% corporate tax rate for the mainland (the current mainland rate is 34%). Such a significant tax differential between Puerto Rico and the U.S. mainland should keep Section 936 as a major tax incentive for U.S. companies to maintain and expand operations in Puerto Rico. Recent estimates by the Economic Development Administration and the Economic Development Bank of Puerto Rico show that corporate tax rates for 936 companies may be even lower than our own estimates. According to their own calculations, the average 936 corporate tax rate may be only 15.4%.
- *Manufacturing sectors that account for 70% of 936 jobs will experience only a small reduction (or no reduction at all!) of 936 tax savings.* Six labor intensive industries (apparel, textile, paper, fabricated metal, leather products, and rubber which in 1989 employed over 55,000 people) will likely see their 936 tax savings remain unchanged. Four "high-tech" industries which employed over 40,000 people in 1989 (industrial machinery, electrical equipment and electronic products, petroleum and scientific/medical instruments) will probably see their income tax rates increase to a mere 11.6% to 14.6%—between one-third and one-half of the mainland corporate income tax rate.
- *The most affected industries will see their tax rates increase to no more than 10 percentage points below the U.S. corporate tax rate.* Food and kindred products, which employed 20,000 people in 1989, could end up paying an income tax rate of 19.8%. But the major beneficiaries of 936 credits in these industry are also those that employ the fewer number of workers. Just two companies, Coca Cola

and Pepsico, which attribute as much as 23% of their total *global* profits to their Puerto Rico operations, accounted for two-thirds of all 936 tax savings in food processing in 1989, while they employed only 4% of all 936 food processing workers—less than 500 jobs. These and a few other food processing companies enjoy average *pre-tax* operating profit rates in Puerto Rico that are four times higher than the corresponding *pre-tax* rates in the U.S. mainland.

In 1991, Coca-Cola obtained $137.4 million in tax savings, about $371,350 in 936 benefits per employee, five times more than the benefits per employee received by the average pharmaceutical company, fifteen times more than those of an average 936 manufacturing company, and yet Coke employed only 371 people in Puerto Rico and paid no local taxes.

Section 936 companies in the chemical industry may end up paying an average 26% corporate income tax rate, which is still 10 percentage points less than the proposed mainland rate. The sector that will be most impacted will be the pharmaceutical industry, which employs less than 20,000 people but earns more than half of all 936 tax benefits. Companies in the chemical industry in Puerto Rico (mostly pharmaceuticals) enjoy average pre-tax operating profit rates seven times higher than in the U.S. mainland. By virtue of their high volume of net profits ($4.6 billion), U.S. chemical companies in Puerto Rico will continue to save a substantial amount of federal taxes—almost $400 million or more each year.

We thus strongly reject the view that the Clinton wage credit proposal will result in plant closings and massive layoffs in Puerto Rico. Such an argument is based only on the empty threats of those 936 companies which are bound to feel the largest impact of the Clinton proposal. These companies are also the most lucrative and will remain very profitable under the wage credit initiative.

We also reject the notion that Puerto Rico will bear an unfair share of sacrifice under the Administration's economic plan. A handful of profitable U.S. companies—not any resident or local business of Puerto Rico—will be the only ones asked to pay federal taxes on repatriated income.

ACTWU calls on those in Congress who are really concerned, as we are, with job losses and economic dislocation in Puerto Rico as well as on the mainland, to support the Administration's wage credit proposal. We also call Congress to help Puerto Rico face real economic threats like the relocation of companies to low wage Caribbean and Latin American countries, the lack of long term private and public investment, the economic slowdown and restructuring of the U.S. economy and the imposition of ill conceived U.S. policies such as the proposed North American Free Trade Agreement.

ALTERNATIVE ECONOMIC STRATEGIES FOR PUERTO RICO

Reform of 936 must go beyond concerns about increasing tax revenue for the Treasury or restoring tax equity. It must seriously deal now with the problem of economic development and job creation in Puerto Rico, and with issues such as runaway plants, infrastructure, working conditions, education, the environment and Caribbean economic integration. However, over the long term, even 936 reform as outlined here may not be enough to prepare Puerto Rico for the new world economy. An alternative economic model that looks at all aspects of the Puerto Rican economy, including its present economic and political relationship with the U.S. and its Caribbean neighbors is needed to attain real development for Puerto Rico. Such a model must be centered on the need to lift the wages and living conditions of Puerto Rican workers to a level equal to that of their mainland counterparts.

Preliminary Estimate of the Impact of Clinton's "Wage Credit Reform" on Section 936 Tax Benefits

(Key Manufacturing Sectors in Puerto Rico)

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
		No. of Mfg. Est	No. of Emps.	Estimated No. of 936 Emps	Taxable 936 Income (Thousands)	Federal Tax Before 936 Credit (Thousands)	936 Firms' Gross Wages (Thousands)	Current 936 Income Tax Credit (Thousands)	Proposed Wage Credit (Thousands)	Ratio of Current Tax Savings to Wages	Proposed U.S. Corporate Tax Rate	Estimated Tax Rate Under Wage Credit Plan	Estimated Tax Revenue From 936 (Thousands)
	All Mfg.	1,972	158,874	105,511	$8,109,975	$2,780,944	$2,167,244	$2,726,546	$1,300,346	108.9%	36.0%	18.3%	$1,426,200
Greatest reduction	Chemical	163	20,554	20,100	$4,586,846	$1,559,993	$610,151	$1,536,633	$366,091	217.2%	36.0%	26.0%	$1,170,542
in 936 tax savings	Food Proc. @	256	24,173	11,828	$942,414	$320,600	$222,883	$318,323	$133,730	120.3%	36.0%	19.8%	$184,593
	Electrical	131	20,863	20,700	$1,156,873	$393,748	$389,000	$390,600	$233,400	82.1%	36.0%	13.9%	$157,200
Reduced	Instruments	83	14,861	8,483	$568,446	$193,696	$175,823	$192,562	$105,494	97.5%	36.0%	15.5%	$87,068
936 tax savings	Machinery	87	5,887	3,303	$229,781	$78,129	$85,695	$78,113	$51,417	120.5%	36.0%	11.6%	$26,696
	Petroleum	26	1,696	939	$126,928	$43,160	$37,921	$43,008	$22,753	87.5%	36.0%	16.1%	$20,255
	Paper	166	5,637	185	$4,591	$1,561	$3,761	$1,561	$2,257	37.0%	36.0%	0.0%	$0
	Textile	16	3,839	329	$1,790	$610	$3,689	$610	$2,213	14.8%	36.0%	0.0%	$0
Unchanged	Misc. Mfg.	57	3,273	3,263	$97,870	$33,267	$54,557	$32,967	$32,734	50.5%	36.0%	0.0%	$0
936 tax savings	Fab. Metal	220	5,209	2,333	$57,785	$21,749	$40,511	$19,573	$24,307	43.3%	36.0%	0.0%	$0
	Leather	29	5,640	4,466	$44,069	$14,999	$51,463	$14,393	$30,878	24.9%	36.0%	0.0%	$0
	Apparel	269	32,187	19,611	$134,655	$45,748	$223,420	$45,662	$134,052	17.5%	36.0%	0.0%	$0
	Rubber	76	5,721	5,500	$62,491	$21,247	$209,289	$21,238	$125,573	8.4%	36.0%	0.0%	$0

@ In 1989, Pepsico and Coca Cola Company alone accounted for two-thirds ($195.3 million) of food processing tax savings while employing less than 500 people (only 4% of 936 employment in the industry). On average, the food processing industry in Puerto Rico would not pay any federal income taxes under the Clinton plan if both Pepsico and Coca Cola were excluded from the industry financial figures.

Source: Puerto Rico Census of Manufacturers; U.S. Treasury Department; Directory of Plants Promoted by the P.R. Economic Development Administration (FOMENTO).

(1-2) P.R. Census of Manufacturers, 1989

(3) ACTWU estimates based on data from the U.S. Treasury Department, 1989 Income Tax Data and the 1991 Directory of Plants Promoted by FOMENTO.

(4-7) U.S. Treasury Department

(8) Column (6) x wage credit of 60%

(9) U.S. Treasury Department

(10) Proposed corporate income tax rate in Clinton's plan

(11) [Column (5) - Column (8)] / Column (4). An income tax rate of 0.0% indicates that whenever the 60% wage credit is higher than the income tax credit, 936 companies will continue to receive federal income tax exemption. This calculation overestimates the actual tax rate for 936 companies since Clinton's investment tax credit is not included.

(12) Column (7) - Column (8). A tax revenue equal to $0 indicates that whenever the 60% wage credit is higher than the income tax credit, 936 companies will continue to receive full federal income tax exemption.

Statement of the American Horse Council, Inc.

INTRODUCTION

The American Horse Council (AHC) appreciates the opportunity to submit this testimony on President Clinton's economic proposals to stimulate the economy and reduce the deficit. The AHC is the national trade association for the horse industry in the U.S. and includes 191 equine associations, representing over 1 million individual horsemen and women and all breeds and types of equine activities.

The horse industry has been adversely impacted by several factors in the last eight years, including the downturn in the economy world-wide, changes made in the Tax Reform Act of 1986 and the expansion of other forms of gaming. Many racetracks and breeding farms have closed and many continue to struggle economically. Tens of thousands of jobs have been lost at racetracks, shows and breeding centers around the country. Hundreds of breeding farms, many a source of pride for their entire state, have been lost and along with them the beautiful open space that they provided.

Some of these losses can be reversed by changing the Internal Revenue Code to help the industry revive itself and produce more jobs, more revenue to the federal, state and local governments and a better balance of payments.

The President's economic plan gives Congress the opportunity to assist the industry and all it supports. We ask for that assistance and pledge that it will be repaid several times over in the form of more jobs, more farms and open space and more revenue to the federal, state and local governments.

President Clinton's economic plan proposes tax changes that could help the horse industry, provided we are included. The horse industry is not seeking special treatment, only fairness by including us in any provisions, such as the capital gains exclusion, investment tax credit and passive loss relief, that are intended to stimulate investment and produce jobs in other industries. There are also proposals that we oppose, such as the reduction of the deduction for business meals and entertainment, the denial of the deduction for club dues and the elimination of the deduction for lobbying expenses, because we feel they will chill any stimulus to jobs and the recovery.

U.S. HORSE INDUSTRY

The U.S. horse industry is a very diverse $15.2 billion industry that employs and supports hundreds of thousands of workers. Horse owners and breeders spend $13 billion in annual investment and maintenance costs. $200 million worth of horses are exported each year, far more than are imported. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban growth.

Parimutuel horse racing is legal in 43 states and involves the racing of Thoroughbreds, Standardbreds, Quarter Horses, Arabians, Appaloosas and Paints. Off-track and inter-track wagering is legal in 41 states. There are over 200 racetracks in the U.S. In 1990, over 79 million people attended the races, generating over $624 million in direct revenue to states from parimutuel taxes, track licenses, occupational licenses, admission taxes and miscellaneous fees.

Another 40 million people view equine sports each year at horse shows and rodeos. There are 7,000 sanctioned horse shows a year with thousands of local, unsanctioned additional shows. These shows contribute $223 million annually to our economy with rodeos contributing over $100 million. 27 million people over twelve ride each year, more than half on a regular basis.

On the state level, California's horse industry generates the most dollars with a total GNP of $2 billion annually, followed by New York's $1.3 billion and Texas' $1 billion. Many other states have very substantial breeding, racing and showing industries.

The equine industry is very labor-intensive. Machines can-not be used to breed horses, train horses, feed horses and properly care for and exercise horses. Hundreds of thousands of individuals breed, own, train, use and care for horses. These people, who work full-time in the horse industry, include owners, trainers, grooms, jockeys, drivers and riders, veterinarians, instructors, van operators, racetrack employees and the countless others who do not work directly with the horse but whose livelihood depends on it. Many of these jobs involve unskilled or semiskilled workers, who might be unemployable outside the horse industry.

What supports the horse industry, including the job base, the breeding farms and the revenue stream in the form of taxes to government, is the investment in the horses themselves. The horse industry relies on "outside" investments to operate, just as other businesses do. Without owners willing to buy, breed, race and show

horses, the hundreds of thousands who are supported by the industry suffer. Without such investment, jobs and revenue are lost. All of this has been put at risk because of the downturn in the economy and changes in the tax laws that have occurred since the mid-1980s.

EFFECTS OF THE ECONOMIC DOWNTURN IN THE INDUSTRY

The horse industry has been hurt by several events in the last few years. The industry, like others, realized substantial growth in late 1970s and early 1980s but peaked in the mid-1980s. Eight years later the economic climate has changed dramatically and so has the horse industry.

In the late 1970s to mid-1980s, the horse industry prospered and expanded. Capital was available and was being invested in the horse business. But then the economy took a bad turn, not only in the U.S. but throughout the world. Foreign owners cut back on their purchases of U.S. bloodstock and the Tax Reform Act of 1986 changed the rules on investing. The reduction of the tax rates, the elimination of the capital gains exclusion and the addition of the passive loss rules impacted substantially on the desirability of investing in what might be called riskier investments, including real estate, oil and gas programs, new, small businesses, and the horse industry. The changes made it economically wiser to put capital in safer investments, such as certificates of deposit or the stock market, rather than in activities, like the horse business which produce jobs and revenue to the states.

Demand for horses declined but the industry already had a supply of horses in production. It takes three years to get a foal from conception to the two-year-old sales. Thus, the demand fell quickly, but the supply did not. Many owners and breeders who had purchased horses or bred them at pre-1986 prices sold them at post-1986 prices for substantial losses. People who had gotten into the business then, and even some who had been in for some time, got out. Others have stayed away.

This affected the entire industry, because it relies on the owners, many of whom cannot be involved full-time, and their investments to remain viable and expand. The breeding farms, stallion managers, feed suppliers, veterinarians, van operators, farriers, trainers, jockeys, grooms, stable hands, race tracks and their employees and suppliers, all rely on the horse owner and breeder. And when there are fewer owners the entire industry suffers.

Since the mid-1980s, the number of horses bred and registered has decreased for all breeds, as the attached chart shows. The number of Thoroughbreds registered has declined 25%, Standardbreds 29%, Arabians 57%, Morgan Horses 37%, Quarter Horses 40% and Saddlebreds 31%. The affect of this decline on the industry has been dramatic.

For the eighth time in the last nine years total revenue from public auction of Thoroughbred horses declined. There has been a 50% decline in revenue since the 1983 peak, when 21,500 horses were sold for $682.7 million. In 1992, 16,118 Thoroughbreds were sold, the lowest number since 1979, for $332.4 million. The average sale price was $20,585, the third consecutive years of decline and the lowest since 1979. Obviously, fewer people are willing to invest in horses. Figures from the Horsemen's Benevolent Protective Association (HBPA), the association of Thoroughbred owners and trainers, also reflect this. The number of individuals registered with the HBPA fell to 32,561 in 1992, a decline of 4.1% from 1991 and 7% since 1985.

This has lead to fundamental changes in the industry, to losses in jobs and less revenue to the states and the industry. Horse trainers who once had twenty horses in their barn and grooms necessary to care for them now have three and four horses and fewer workers. Many have had to take part-time jobs outside the industry. Racetrack veterinarians, who once worked exclusively on the track, are now making visits to farms to care for horses and make ends meet.

A brief look at the horse show circuit illustrates the effect of this loss of owners and reduction in the breeding of horses. A nationwide research study by the American Saddlebred Horse Association found that there are fewer small horse shows in the U.S. than there were ten years ago. The number of entries at horse shows has decreased. As mentioned, there are 7,000 sanctioned shows in the U.S. These shows, particularly the larger ones throughout the U.S., provide a viable living for thousands and thousands of ordinary, middle-class taxpayers who work full-time behind the scenes in a sport sustained by those able to pay the bills. Farriers and grooms are needed to take care of the horses; veterinarians, riders and trainers must keep them healthy, in good condition and competitive; managers, organizers, ring crews, advertising, feed and supporting services are needed for the shows to go on. And the local area reaps the benefits of the money that the show brings into the local

economy, approximately $223 million per year. All of this is built on the horse owner and breeder who invests in the horse itself.

This may be brought into even clearer focus in racing, where several race tracks have closed and others continue to struggle economically. Those that have closed include Longacres in Washington state, Jefferson Downs in Louisiana, Roosevelt Raceway in New York, and Canterbury Downs in Minnesota. Garden State Park in New Jersey will cease operations on May 29 and Philadelphia Park may close. If this happens Philadelphia, the fifth largest population center in the U.S., will be without Thoroughbred racing for the first time since World War II. When these tracks closed, jobs were lost and revenue to the state and local governments stopped.

Those racetracks that continue to operate will experience a significant shortage of race horses this year and will have difficulty in filling races. Some tracks already have. Currently in New York, harness tracks are suffering from an acute shortage of horses to fill their regularly scheduled racing programs. Recently, Yonkers Racetrack was forced to cancel several races because of the shortage of horses. When races are cancelled, the lost wagering opportunities result in lost revenue to the tracks, the horse owners, the trainers, drivers and jockeys, and the state and local government.

This decline in the number of available horses has affected jobs and employment in the industry. It has affected revenue to the federal and state government. A review of the registered Thoroughbred and Standardbred foal crops over the last ten years illustrates the severity of the problem in racing:

	Thoroughbred	Standardbred
1983 foal crop	47,237	20,298
1984 foal crop	49,247	19,795
1985 foal crop	50,432	18,384
1986 foal crop	51,296	17,637
1987 foal crop	50,917	17,579
1988 foal crop	49,220	17,393
1989 foal crop	48,235	16,896
1990 foal crop	44,039	16,576
1991 foal crop	42,000	13,671
1992 foal crop (estimated)	38,500	13,029
1993 foal crop (estimated)	36,000	.....

The size of the Thoroughbred foal crop has declined for seven consecutive years and the Standardbred crop for eight with the sharpest declines coming in 1991. This has long-term implications for racing and the industry it supports.

It takes three years for a racehorse to get to the track; in other words, the foals of 1990 are the three-year olds of today. Few horses race past the age of five. Although some tracks have felt the pinch, the real decline and scarcity of race-horses, and all that it will bring with it, will be felt dramatically at our nation's race tracks this year.

By 1995 racing as we know it may not be able to exist. The large foal crops of 1987 through 1989, last year's 3-, 4- and 5-year-olds are beginning to retire. With the sharp decline in the Thoroughbred foal crops of 1990 and 1991, there is a corresponding decline in the number of this year's 2-year-olds and 3-year olds, and next year's 3- and 4-year olds, etc. By 1995 the number of 2-, 3-, and 4-year-olds will fall to 116,500 and even if the 1994 foal crop remains at 36,000, and this is unlikely, the total number of registered Thoroughbreds between two to four and possibly racing in 1996 will be 110,500.

While the number of foals declines, the number of available races is staying approximately the same. Thus, the supply of racehorses in 1995 and thereafter will not be able to fill the races run. It is anticipated that the number of starters per race will decline from the average of nine available from 1984 through 1988 to seven. This decline in the number of horses available for racing will have a profound effect on the industry because racetracks will have two choices: (1) either cut back on the number of races or on the days of racing; or (2) run races with fewer horses. Either alternative will exacerbate the industry's economic problems and result in less betting, less revenue to the states and a loss of more jobs.

This decline can be explained as follows. Every time a dollar is wagered at a racetrack a percentage is taken out of the betting pool. This "takeout" provides the revenue to the states, the income to the track, and the purses for the owners of the horses, the trainers, the jockeys and the drivers. The larger the amount bet, the larger the amount that is earned by the state, the track and the horsemen racing

there. If this betting pool goes down it affects the entire industry because it reduces state taxes and income to the track and owners.

The decline in the number of horses available for racing will affect the betting pools. If tracks reduce the number of races or the days of racing, as some have, obviously less will be bet. If they simply race with fewer horses in smaller fields less will also be bet. Bettors dislike small fields because they offer less betting opportunities and smaller payoffs. The industry fears it may lose some of its best patrons if fields are reduced.

Thus, either alternative will result in smaller handles and less revenue to the states and the racing industry. This will exacerbate the current situation.

The decline in the number of horses and the industry in general is shown in other ways. A 1991 census in Michigan showed that there were 130,000 horses in the state, down from 160,000 in 1984. The equine industry in Michigan, which is primarily made up of small farms in suburban areas, pumped $256 million into the states economy in 1990 and income of $122 million. This is at risk.

In Maryland, where the horse industry is estimated to be a $1 billion industry, employing 20,000, many farms have closed. Windfields Farm, in Chesapeake City, home of Northern Dancer, the greatest sire of all time, closed in 1988. Sagamore Farm, once one of the finest in the state and home of Native Dancer, closed last Summer. In 1986, 4,000 mares were bred to Maryland stallions. In 1989, only 3,000 mares visited Maryland. Last year, the number was close to 2,000. Maryland breeding farms and farms elsewhere are an endangered species.

What has happened in Maryland has also happened in Kentucky, California, New York, Oklahoma and other states that have large and important breeding and training centers. It has impacted on the economies of these states.

SPECIFIC COMMENTS ON ECONOMIC PLAN

Several of the President's specific plans to stimulate investment and generate jobs do not apply to the horse industry. We believe that we have explained how hard the economic downturn and tax changes have hit the industry. Leaving the industry out of the economic stimulus proposals not only continues to favor other forms of investment over us, for no explainable reason, but also perpetuates the untenable position that the horse industry is not a serious business, not a large industry, and not one that produces jobs and revenue for the federal government and the state governments, entertainment for millions and a livelihood for hundreds of thousands.

We have the following specific comments on the President's proposal.

Change Passive Loss Requirements.—The President's proposal does not change the passive loss limitations for horse owners and breeders. It does, however, provide for a special rule regarding passive losses and real estate. We do not oppose this relief, but suggest that limited relief also be afforded the horse industry, which has been hurt by the passive loss rules.

The horse industry is unique with respect to the material participation requirements. It is difficult for many owners to breed, train, ride, drive or show their horses because of the expertise and physical ability that is required. It is a specialized and dangerous activity requiring experienced, trained professionals. The owner of a broodmare who boards the mare at another's farm may find it difficult to satisfy the minimum hourly requirement during the eleven month gestation period of a foal. The passive loss rules, therefore, are often viewed as difficult for many to satisfy.

Our position is that the passive loss rules enacted in 1986 should be repealed. We believe that they have done far more economic harm than good by stifling investment in some activities, such as the horse business. Nonetheless, absent a repeal we suggest two alternative approaches for relief that would encourage investment in the industry. The first would provide that passive losses from an equine activity would not be limited in computing an individual's regular tax liability, unless the losses came from an investment in a limited partnership. Instead passive losses which are not from a limited partnership would be restricted under present law rules in determining an individual's alternative minimum tax.

The second approach would modify the passive loss requirements to make it less difficult for an individual who owns and breeds horses to be an active participant. Specifically, in determining whether an individual is an active participant, our proposal would allow an individual to count all management time, even if others spent more or are paid for management services, and eliminate any specific minimum number of hours required. This could be limited to businesses engaged in breeding or using livestock for sporting purposes, provided the business is closely held with at least 80% owned by five or fewer individuals.

Include Equine Businesses in Capital Gains Exclusion.—The President has proposed a lower capital gains rate for investments in small businesses, which are corporations with less than $25 million in capitalization. If stock in these small corporations is held five years, upon sale a taxpayer may exclude 50% of any gain and pay tax on the remaining 50%. The reasons for the change offered in the President's plan are that "small businesses are important to economic growth and job creation in this country, and contribute to America's edge in international competition."

The AHC suggests that the horse industry is ideally suited to accomplish the goals of this change. It is made up of hundreds of thousands of small businesses, is labor intensive and already has a favorable balance of payments and edge in international competition. Unfortunately, most horse businesses cannot qualify for the exclusion because they are not conducted in corporate form. More to the point, however, under the proposal, farming businesses are specifically excluded from this special capital gain treatment. Therefore, horse breeding operations, even if conducted through a corporation, could not qualify.

The AHC suggests that this special capital gains treatment be extended to include investments in the horse industry. It will result in additional employment and revenue to the states.

Include Horses in New Investment Tax Credit.—Under current law there is no investment tax credit for tangible property. The President's proposal calls for a tax credit for small and large businesses. It would provide businesses with revenue over $5 million with a 7% investment tax credit for two years and smaller businesses with a 7% credit for two years and 5% thereafter.

The proposal states that property eligible for the credit "would be defined in the same manner as under the regular investment tax credit prior to its repeal, except that used property would not be eligible." Prior to 1986, the tax credit was not available for the purchase of horses, but was available for other tangible property used in the horse business. Congress did not make the credit available to horses prior to 1986 because it did not see the need for an incentive to invest in horses.

As the earlier portion of our testimony sets out there is ample need today. The horse industry, particularly the racing industry which supports much of the job base in our industry, is in dire need of just such a stimulus. It would be grossly unfair to grant it to other industries while denying it to horses be-cause of antiquated prejudices and unfounded beliefs. If racing declines further, so will employment and the revenue that it provides to the federal, state and local governments. The AHC supports the tax credit and requests that horses be included in its benefits.

Don't Reduce Deduction to 50% for Business Meals and Entertainment.—Presently, 80% of the cost of business meals and entertainment is deductible provided it is an ordinary and necessary business expense. Meals and entertainment expenses include food, beverages, tickets for sporting events and similar activities. The President's proposal would reduce the deductible portion of otherwise allowable business meals and entertainment from 80% to 50% beginning in 1994.

This reduction in the meals and entertainment deduction from 80% to 50% will adversely impact anyone in the horse business who attends events or entertains at events and treats the cost as a deductible business expense. It will also affect the race tracks, horse shows and other events at which such money is spent.

Horse owners, trainers, veterinarians and others purchase tickets to race tracks, horse shows or other similar events in order to introduce new clients to the sport and entertain existing clients. This is a legitimate form of promoting the horse business, similar to advertising in other businesses. It is unfair and counterproductive to the President's purpose to single out one of the few important ways for the horse industry to promote itself.

More importantly, many of these individuals attend the races or horse shows in order to watch their horses run, look at other horses to purchase or just be informed and must purchase tickets in order to do so. Presently, 80% of the costs of these activities are deductible. The proposal would reduce the deductible portion to 50%. Reducing the business deduction for something that is so obviously an ordinary and necessary business expense is unfair. The AHC opposes this change.

Retain Deduction for Club Dues.—The President's proposal would also eliminate any deduction for "club dues" beginning in 1994. The prohibition would apply to all types of clubs, including business, social, athletic, luncheon and sporting clubs.

This could affect the deductibility of dues paid by horse owners and breeders for "clubs" at tracks, such as "turf clubs," and at horse shows and similar events. To the extent that people use such clubs less this would adversely affect the events themselves and the employment and revenue they produce. The AHC opposes this change.

Retain Deduction for Lobbying Expenses.—Under current law, expenses incurred for lobbying Congress or state legislatures are deductible as business expenses. This includes amounts incurred for direct communications with legislators, for communications through a trade association and for membership dues in an organization that lobbies.

Under the President's proposal businesses would no longer be allowed to deduct lobbying expenses, including costs to communicate with the executive branch as well as the legislative branch. No deduction would be allowed for the part of membership dues that is used for lobbying and trade associations would be required to report to their members the portion of their dues used for lobbying activities.

This will affect all individuals and organizations that represent members before government, or belong to organizations, like the AHC and many of its member organizations, that do. The change includes state or local organizations that lobby state legislatures. Lobbying elected representatives is an important right of people involved in an activity. The costs of such activities have correctly been considered an ordinary and necessary business expense. The proposal will deny the deduction of these costs, including dues paid to organizations that lobby. This is unfair and counterproductive to the purpose of government which is to hear from constituents. Membership organizations that lobby will have to keep additional records to be able to advise members of what portion of their dues are not deductible. This is an unnecessary and burdensome change.

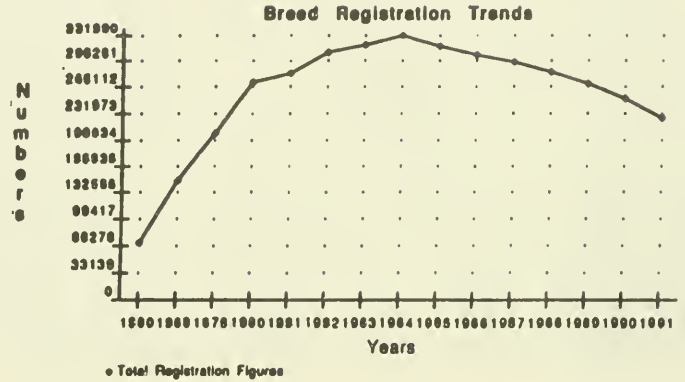
Reinstate Health Insurance Deduction for Self-Employed.—Under current law an incorporated business can deduct the full cost of any health insurance provided for its employees. A self-employed individual, however, operating as an unincorporated business can only deduct this cost for himself and his dependents to the extent it, together with other medical expenses, exceeds 7.5% of adjusted gross income.

Prior to July 1, 1992 a self-employed individual was allowed to deduct up to 25% of the amount paid for health insurance for himself, his spouse and dependents. The President's proposal would extend the 25% deduction retroactively through 1993. The AHC supports this change.

Many individuals in the industry are self-employed, such as trainers, jockeys, drivers, and veterinarians. It is unfair to allow those who operate in corporate form to deduct health insurance costs for themselves but not those operating as sole proprietors or partners. As the Administration is well aware the costs of health insurance are substantial. Having the cost, even just part of it, deductible could mean the difference between a person having health insurance or not. The AHC supports this provision.

BREED REGISTRATION FIGURES 1960 - 1991

	1960	1968	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Anglo & Half Arabian	3,200	9,600	11,361	10,017	9,752	8,247	9,052	9,200	9,654	9,646	9,200	8,600	4,776	4,276	4,251
Appaloosa	4,052	12,369	20,176	26,384	16,274	25,317	22,184	17,674	16,189	14,661	12,589	12,317	10,746	10,600	9,992
Arabian	2,064	9,974	16,658	16,726	20,281	24,937	16,391	26,176	30,004	28,263	26,421	24,689	21,723	17,975	12,996
Hackney	489	656	696	585	601	766	631	733	744	781	621	668	779	909	731
Miniatures	0	0										3,896	4,036	6,700	6,276
Morgan Horse	1,069	2,134	3,400	4,537	4,785	4,200	5,317	6,411	4,836	4,329	3,903	3,626	3,732	3,618	3,362
National Show Horse	0	0	0	0	0	1,470	1,018	762	866	927	1,011	676	916	793	694
Paint	0	2,200	6,696	9,654	8,411	13,863	13,626	12,034	12,662	11,275	10,816	14,629	14,960	16,163	16,548
Palomino	857	1,292	1,710	1,837	1,660	1,062	1,641	2,547	1,301	1,516	1,719	1,747	2,060	1,699	1,844
Pure Fine	0	0	380	645	859	712	993	1,166	1,336	1,323	1,246	1,484	1,463	1,556	1,468
Quarter Horse	36,607	65,326	87,176	137,090	148,785	155,401	166,346	166,676	167,360	163,773	147,007	126,362	123,294	119,697	101,200
Racking Horse	0	0										4,476	3,500	4,600	4,500
Saddlebred	2,329	3,566	4,064	3,666	3,621	3,132	2,767	5,164	4,361	4,363	3,618	3,611	3,706	3,560	3,570
Standardbred	9,413	10,662	12,630	16,219	17,432	20,066	20,298	19,795	18,384	17,637	17,679	17,393	16,066	16,676	13,017
Tennessee Walker	2,643	6,483	6,661	8,654	8,902	7,279	7,561	7,780	7,612	8,750	8,712	8,963	8,860	7,972	7,662
Thoroughbred	12,901	22,811	28,271	36,670	38,670	42,894	47,236	49,244	50,429	51,293	50,817	49,218	48,218	43,671	37,442
Total Registration Figures	78,334	148,656	208,694	279,723	281,233	319,960	317,961	331,396	316,949	306,456	287,864	283,116	269,699	249,037	227,237



Statement of the American Hotel & Motel Association

INTRODUCTION

The American Hotel & Motel Association is a federation of associations representing lodging's interests in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands. The Association federation has a membership in excess of 10,000 individual lodging properties which represents approximately 1,300,000 rooms. The lodging industry employs approximately 1,500,000 people, with close to one-third of that total involved in foodservice.

The hotel industry has been suffering from a downturn of epidemic proportions for the last several years. In 1990 alone, losses for the U.S. hotel industry were estimated to be $5.5 billion. For 1991, the losses were estimated at $2.7 billion. In 1990, limited-service hotels (those without foodservice) only posted a small loss and, in 1991, recorded a positive net income. This tells us that the burden of our industry's losses in 1990 and 1991 were borne by full-service hotels, i.e., those with restaurants, room service, catering departments and which host our nation's conventions, trade shows, business meetings and banquets. In addition, for the last several years the occupancy rate has been hovering around 60%, a 10% decline in business since 1986 and a direct cause of the billions in losses referred to above.

As a direct result of industry losses, across-the-board reductions in our labor force have been made, cutting, for example, in 1991 alone, over $1 billion in payroll and related costs.

The overall picture one is left with is of an industry in deep trouble which has had to take strong steps to stabilize its position. The fat is gone; now this Committee could be putting the muscle in danger. With losses for 1991 less that half of 1990 losses, there is a sense that we may have turned the corner and be on a gradual course taking the full-service segment of the industry back to a break-even point and eventual profitability. But changes in business consumer patterns may well work against our industry's recovery.

While our industry has suffered mightily over the last few years, we recognize that we aren't the only industry so afflicted. However, as other businesses economize, we suffer as a result. An article in the Wall Street Journal of December 16, 1992, discussed the subject of business travel and made some unsettling observations. First and, perhaps, most obvious is that corporate travel budgets have been reduced. In recessionary times that is to be expected, but a complicating factor is the massive number of white collar jobs that have been eliminated. That reduces the pool of business travelers. At the same time, corporations are adopting new communications technology, such as video conferencing, E-mail and the ubiquitous fax, to reduce even further the need for business travel. Corporations are saying they simply will not travel as much in the future. The Wall Street Journal article cites research sources indicating that business hotel room bookings were off for the third consecutive year and that there was a trend away from full-service hotels to limited-service, a trend verified by the loss statistics cited above.

BACKGROUND: THE TAX REFORM ACT OF 1986

In 1986, the deductibility of business meals and entertainment was reduced from 100% to 80%. This was an unprecedented action by the federal government. It was conceded that these expenses were "ordinary and necessary" as required by the Internal Revenue Code and below the threshold of "lavish and extravagant," the existing disqualification standard unique to Section 274 of the Code. So, despite being the same as other business expenses in the eyes of the Code, Congress determined to restrict deductibility. The justification used was that there was an element of "personal consumption" after all, a person has to eat, doesn't he or she?

A check of the record of the proceeding before this Committee at that time will show that we strongly opposed the reduction when we testified, predicting revenue loss and incorporating studies produced by the Hotel Employees and Restaurant Employees International Union as to job loss. When this change to deductibility was implemented in the late 80's, our country enjoyed a robust, growing economy and the assumption was that our industry could "take the hit." However, that was a false assumption. An independent and as yet unpublished study has recently been compiled by Professor Stephen Hiemstra of the Purdue University Hotel School dealing with the impact of the reduction in the deductibility of business meals and entertainment. The study determined that overall foodservice sales have been subjected to a permanent downward shift of 3.4% of sales. For example, in 1991 the drop was $6.5 billion attributable solely to the tax change, according to Hiemstra.

As the study points out, there are a number of factors which affect foodservice sales. Positive factors include increases in populations and growth in income. An-

other positive factor for the lodging industry was the inclusion of the "banquet exception." This was a 2-year transition rule on behalf of the lodging and foodservice industries, keeping deductibility at 100% on certain large meal functions which met certain criteria. It recognized the fact that these events were frequently scheduled long in advance of the actual date of occurrence; in many cases years in advance, in reliance on existing tax laws. We believe this exception also was a recognition of the unique "non-personal" consumption which takes place at large group functions. It was an appropriate exception and it helped delay for several years employment dislocation and revenue loss.

However, all factors exert an influence and the net result is total sales. The Hiemstra study isolated the loss attributable to the 100% to 80% reduction. The fact that this loss may have been masked by other factors does not mean that the loss did not take place, only that its visibility as a negative impact was clouded.

While predictions of job loss in 1986 covered a broad range and the "masking" effect discussed above made subsequent measurement difficult, it seems undeniable that if there is a permanent loss of sales, there will be a concomitant loss of employment (or failure to create jobs). While not primarily intended as a measurement of job loss, but rather one of revenue loss in the industry, Hiemstra has informally estimated that it would be reasonable to expect that the impact of lost revenue at the level he calculated could lead to job losses in the range of 150,000 or higher overall, with potential lodging losses contributing as many as 25,000 to that total. We admit that's history and we don't expect this Committee to undo that now. But, neither do we expect it to deny the reality of the loss in the past and the reality that loss will occur in the future.

It is important to note that not all foodservice was impacted equally. In fact, the study opines that foodservice in hotels could feel as much as twice the average impact, or 6% of their sales, which would be a sizable adverse impact, particularly when added to the negative impacts of business cutbacks in recent years. Food and beverage sales in hotels approximated $20 billion for 1992. lithe 6% estimate is accurate, our industry could today be enjoying sales of an additional $1.2 billion annually and could be supporting as many as 30,000 to 35,000 additional jobs.

The conclusion is inevitable: the 1986 change in deductibility had an impact on our industry, measured today by jobs not existing and people not employed in the hotel, motel and restaurant industries. Although initially obscured by the robust economy of the late 80's, the impact did and does exist

THE CURRENT TAX PROPOSAL: WHAT'S REALLY AT STAKE

The Finance Committee is currently considering whether it is appropriate to further reduce the deductibility of business meals and entertainment from the current level of 80% to an unprecedented 50%. The driving force behind this continued attack on business meals and entertainment deductibility seems to be one of perception. The easy characterization adopted by the popular press is that of two white upper class men dining at an elite restaurant. We all know what it's called, "the 3-martini lunch." Were that the totality of business meals and entertainment deductibility and the totality of the impact, we might well agree with you. But, this perception isn't the smallest part of the story. The range of business activities regulated by Section 274 of the Internal Revenue Code goes far beyond the business meal served in a restaurant.

In the country's full-service hotels the activities covered include:

- The business traveler's own meals, whether eaten in a hotel coffee shop or restaurant, or grabbed on the run from a food cart.
- Refreshments served by companies in convention hotel rooms where they display their particular goods in conjunction with a trade show. These rooms are generally known in the trade as hospitality suites.
- Banquets held in hotels as part of conventions or trade shows, as company-sponsored events for employees, or freestanding events for local businesses.
- Receptions-stand-up events either as a precursor to or in lieu of a sit-down banquet meal, again held at conventions, trade shows, by companies and independently, for local business attendees.
- Food service as part of an extended meeting. This includes the continental breakfast prior to the meeting; the mid-morning or mid-afternoon coffee break and the working lunch; and the sandwiches and salads served at the meeting table while the meeting continues. These activities take place frequently during conventions and trade shows, as an industry is gathered together by its trade association and breaks into component groups to conduct its business.

All of these foodservice activities, the majority of the food and beverage served in hotels, have two things in common. First, the business person consuming the food has no control over what is served (with the exception of the business traveler's own meals). This lack of choice is significant because one of the primary reasons currently offered to justify the reduction in deductibility is the element of personal consumption the idea that the person eating and drinking is satisfying personal desire. This option is lacking in the food and beverage events described above and, while hotels take justifiable pride in the quality of their food and its presentation, the actual business consumer "takes it or leaves it."

The second element common to these events is the predominance of the business content attending the food and beverage. When a business sponsors a reception for its customers, hosts a hospitality suite or conducts a working lunch, it does so because the event is conducive to promoting its image, creating an environment to sell its goods or services, or actually conducting its business. Also, a wide range of employees, from sales personnel through middle- and upper-management, are in attendance. These are working sessions and those producing the work are in attendance.

While many of these goals are met at a business meal, at the group events typically hosted in hotels as adjuncts to conventions, trade shows and business meetings, the business content is dominant. At these events it is clear, "there is no free lunch."

The second major driving force behind the constant attacks on business meals and entertainment deductibility is the promise of billions of dollars of revenue to the federal coffers if you just lower deductibility. We in the lodging industry have serious doubts about the reasonableness of this premise. Firstly, we have seen the revenue estimates and have found no supporting documentation from the Joint Committee on Taxation, the Congressional Budget Office, or the Office of Management and Budget to explain the assumptions made to derive the revenue estimates.

Secondly is the astounding statement offered by the Secretary of the Treasury before the House Ways and Means Committee concerning the impact of the proposal on convention business. He has stated that there would be no impact on our industry, no reaction on the part of the business community, and no change in consumption patterns as a result of a reduction by more than one-third in the deductibility of a legitimate business expense. We do not find that belief credible and we urge this Committee to reject that belief once and for all. A lowering of the deduction level will hurt our business.

Thirdly, if there were a desire to simply raise revenue, there are more broadly based and fairer ways to spread the cost over the business community without concentrating the impact on one industry in the economy. We do not believe it is our role to point the finger at anyone and target them for extra taxes, but we challenge this Committee to avoid burdening our industry a second time on expense deductibility without considering whether others should be burdened a first time in a similar fashion.

We believe it likely that revenue is not there at the levels predicted by Treasury for the simple reason that the patterns of consumption by the business community have changed and will continue to change, lowering the revenue expected by the Treasury.

JOBS IN AMERICAN CITIES WILL BE LOST

It is inevitable and, perhaps, unfortunate that any presentation to this Committee on the deductibility of business meals and entertainment will not be persuasive based on the legitimacy of these expenditures, the mundaneness of the settings in which these activities occur, the unreality of the revenue estimates bandied about or even the simple sense of equity that our industry has sacrificed as much as it should. In the final analysis, what really matters is how many working Americans you will displace from their jobs this time.

As we indicated earlier, the impact from a further reduction in deductibility will not impact all hotels evenly. Those hotels which are limited-service (i.e., that do not serve food) should feel little impact from the change. The impact will be felt most severely in the full-service segment of our industry and will be concentrated in those hotels catering to business travelers, typified by the large convention hotels found in all major United States cities. These hotels, many with in excess of 1,000 rooms, are major employers in their cities. They provide a broad range of jobs from entry-level through management and they provide entry into the job market for many young people, women and minorities and those without higher education. These jobs keep people off unemployment and welfare rolls or, in many instances, provide a supplement to income earned from a primary job. We are proud of the jobs our in-

dustry has created and the many talented individuals who have moved upwards from these beginnings. These employees are not faceless numbers to be totaled up and discarded as Congress and the Administration tilt at the windmill of personal consumption. They are tax paying, contributing citizens of our major cities and are entitled to this Committee's respect and compassion.

How many will you sacrifice? As stated earlier, there was an impact from the 1986 reduction. In order to determine the impact from the current proposal, the National Restaurant Association researched the issue of job loss and concluded an industry loss for foodservice with business meal clients of 165,000. We believe this is a conservative estimate of the impact across foodservice and we have no hesitancy in endorsing that amount of job loss. We would note, however, that the figure represents what is called full-time equivalents and the total number of real individuals, real people losing their jobs, will include part-time as well as temporary or seasonal employees. That means that the total number of people actually becoming unemployed will likely be well in excess of 165,000. Whether the job loss is full-time and the only source of income, or part-time and a needed supplement to meet expenses, the loss of that job will create economic pain. We further note that in this time of economic malaise, there is not likely to be the masking effect previously enjoyed. This time, job loss will be visible and countable.

Lodging's share of the job loss predicted by the National Restaurant Association can reasonably be expected to be in the range of 15% to 25% of the total, or 25,000 to 40,000 jobs lost. Again, that is full-time equivalents, and the actual number of full-time, part-time, seasonal and temporary employees actually dislocated will likely be at or above that 40,000-person level. However, this loss will not be spread evenly across the country. The bulk of the full-service hotels and certainly the large convention hotels are located in urban areas. They are big city hotels and many of the individuals who lose their jobs will be at the lower end of the economic spectrum, working because of the range of entry-level jobs created by lodging properties. When they lose their jobs, many may not have the ability to seek jobs in other industries. It will fall to the cities and states to provide their support through unemployment, Medicaid and welfare.

If you lower the deductibility from 80% to 50%, business will react in a number of ways. The individual business traveler will trim the number of trips taken and the level of expenses for those trips still taken. At conventions, banquets and the like, the number of attendees will shrink as companies allow fewer employees to attend these functions. The level of expenditures by event sponsors will decline and, as a result, the quality and quantity of food served will decline. These types of shifts will directly impact the revenue of the hotels and its remaining employees. When a banquet shifts from beef to chicken, for example, and the total meal cost is reduced, the income of the hotel is reduced, as is the earning of the waitstaff. This reduction of employee income will also carryover into tipped employees serving in restaurants, who will see tips reduced as checks decline and diners trim tips to get the most mileage out of their available travel budgets. This eventually reduces taxes paid to government at all levels.

Finally, it is generally recognized that there is a "multiplier effect" from spending in hotels. While the effect varies across the country, it is appropriate to estimate a doubling effect. That is, for every dollar spent in a hotel, a dollar in sales is generated in the city where the hotel is located. This money is spent, for example, on goods and supplies to serve the hotel's guests, as well as spending by employees. Every dollar lost to the hotel is two dollars lost to the city.

ELIMINATION OF SPOUSAL TRAVEL

Non-business spending by the business traveler, i.e., sightseeing, souvenirs and the like, whether by the traveler or accompanying spouse, is another source of revenue to our nation's cities. With regard to this type of spending, we decry the new strictures proposed by the Administration with regard to the business deductibility of spousal travel as still another unwarranted burden on the lodging industry and tourism in general. Existing law has strict tests which must be met by a spouse before expenses attendant to his or her travel are deductible by the employer of the business spouse. They don't allow a free ride.

The Administration's proposal to require the spouse to be an employee as well as provide appropriate service will only hurt convention-related travel. The employee standard creates a hurdle that many could not overcome due to corporate policy. It will create a chilling effect on spousal travel generally, as corporations view spouses as persona non grata and adopt employee-only policies at their business meetings. This is not a change to raise substantial amounts of revenue; the projection by the Joint Committee on Taxation is only $90 million for five years. We urge the Com-

mittee to simply drop this anti-family provision and enforce existing law. When spouses accompany a business traveler, local economies benefit from direct spending and the frequent tacking-on of a personal stay at the end of the business stay.

SUMMARY

In summary, we urge this Committee to retain the deductibility of business meals and entertainment at its current level. The Administration has committed itself to creating jobs through its stimulus package. We find it inconceivable that the Administration would undercut as much as 40% of its effort in that area by destroying at least 165,000 foodservice jobs and exacerbating the loss in major cities where job and revenue loss will be concentrated. The further reduction in deductibility will ripple throughout our economy, particularly in our major cities, causing discomfort and dislocation as spending is curtailed at all levels of business.

American business reacts and does so strongly when its costs of doing business are unfairly driven up. The City of New York recently relearned that lesson. Through a combination of levies, the total tax on a $100 hotel room in New York City is 21.25%. The final straw was an additional 5% hotel tax added to raise revenue for the State. The effect was a decline in business for the City estimated by City Comptroller and former Congresswoman Elizabeth Holtzman to exceed $1.1 billion over the last five years. Ms. Holtzman herself also estimated that thousands of jobs were lost; the number could be as high as 6,000 to 8,000 jobs. The refusal of business to go along with this expense is evident.

Congress itself is grappling with an unintended consequence in reaction to one of its own laws: that of the luxury tax on boats and other so called "luxury items." The parallel is compelling. Congress perceived a conspicuous consumption and thought it could simply tax it and reap the benefits. Instead, purchasers reacted and devastated an industry. Who lost? The Federal Government of course; because it did not gain revenues and, in fact, lost the various taxes on wages not earned. But, more importantly, the workers building boats lost—they lost their jobs. Now Congress is trying to repair the hurt it caused, but seemingly only on the "one hand," because on the "other hand" it is being led to believe it can simply tax business by reducing the deductibility of business meals and entertainment and reap the benefits of increased revenues. It didn't work with luxury boats, it won't work with business meals and entertainment. An 80% to 50% drop is a steep reduction and foodservice employees and others will lose their jobs as businesses refuse to accept the added expense.

Business will react to cost increase, whether directly as in occupancy taxes, or indirectly through reduced deductibility of legitimate business expenses. That reaction will hurt the lodging industry, among others, and stall our gradual comeback from recessionary depths. The effects of your actions will be permanent. A further reduction in the deductibility of business meals and entertainment should not be made.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

The American Petroleum Institute (API) represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. API members, many among the leaders in worldwide oil and gas exploration and production, are troubled by the increase of the U.S. tax burden on foreign operations under the Administration's Revenue Reconciliation Act of 1993 (the Proposal(s)); API appreciates the opportunity for these comments.

I. IN GENERAL

API shares the Administration's concern with the growing federal deficits and applauds the President's focus on the need to balance spending with revenues, as well as reducing the outstanding debt. However, API questions the wisdom and advisability of the proposed changes to the taxation of foreign source income. Any benefit from the expected revenue increases is greatly outweighed by the macroeconomic, adverse effect on the competitiveness of U.S. companies overseas.

Turning to the Proposal's premises, we first would like to challenge one of the principal rationales, *i.e.,* the postulated need to remove perceived tax incentives which under present law "make foreign investment more attractive" than the domestic deployment of capital. The Administration assumes that, where the Proposals discourage foreign investments, the same investments would then be made in the United States and create U.S. jobs.

With respect to a natural resources extraction business like oil and gas exploration and production, it is obvious that the choice of locations for the investment was determined millions of years ago and not by any of the revenue acts. Because of the continuing depletion of U.S. petroleum reserves and diminishing domestic prospects, coupled with the environmental moratoria and restrictions, API members have to look for reserve replacements outside the United States and maintain their foreign presence. If foreign exploration and production is eliminated as a viable choice, many companies may enter a slow liquidation mode.

Unfortunately, the Proposal would add another layer of tax cost to the most onerous foreign source income tax regime of which we are aware. If U.S. companies in the petroleum exploration and production business are slowly rendered noncompetitive in the foreign arena because of their foreign competitors' lesser home country tax burdens, the investment will be made by the foreign competition; but no additional U.S. investment will result.

Second, for foreign operations of U.S. companies in general, the Administration's assumptions, both the imputed U.S. tax reasons for foreign investment and the suggested adverse effect on the domestic economy, must be challenged. U.S. companies outside the natural resources industries locate operations abroad because of such factors as transportation and labor costs, tariffs and trade zones, local content requirements, market response capability, but not U.S. tax. The postulated adverse effect on the domestic economy ignores the U.S. jobs and domestic investment that support foreign operations. Not only will domestic manufacturing supply material and equipment, guaranteeing U.S. manufacturing employment, but high quality, "symbolic analysts'" jobs will provide the entrepreneurial and managerial guidance and, where manufacturing intangibles are utilized, the intellectual property (like know-how, patents, secret processes) for the foreign operations. If these foreign operations are run by foreign owned businesses, it would be accidental that segments of the U.S. economy remain employed in those functions.

Third, in the age of increasing globalization of trade and commerce, it appears anachronistic to attempt to use taxation as a barrier for the direction of the flow of investment funds. Tax policy should be guided by the goal of securing the proverbial "level playing field;" in the case of foreign income taxation this should mean removal of barriers to full foreign tax credit utilization and taxing only repatriated earnings, steps diametrically opposed to the Proposal.

Compared to the home country taxation of the foreign competition, the Internal Revenue Code exposes foreign operations to a significantly greater risk of double taxation because of such rules as the sourcing for interest, state income taxes, and research and experimental expenditures (R&E). Of the proposed changes, the new rules for royalty basketing, the repeal of the working capital exception, and the expansion of the current taxation of undistributed earnings, would exacerbate this exposure.

In a recent study the U.S. General Accounting Office reported for 1989 (the latest reviewed period) an effective corporate tax rate on the worldwide income of U.S. corporations of 37.1%, compared to a rate of 32.9% for domestic operations (GAO/GGD–92–111, *1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years,* at pp. 34 and 36). This rate differential is certainly not indicative of a tax appeal of foreign business investment.

As a final general observation, it must be noted that the Proposals add another layer of complexity, in direct conflict with the move towards simplification within the last legislative period. Of all areas of Federal income taxation, it should not be the already byzantine structures of foreign income taxation which are further burdened with new casuistic subregimes.

In 1986, taxpayers witnessed an unprecedented increase in the complexity of the foreign taxation provisions of the Code with, among other things, the proliferation of the separate foreign tax credit limitation baskets and an increase in the multiplicity of regimes targeting income of controlled foreign corporations (CFCs) for current taxation. Despite universal agreement that the foreign source income provisions are far too complex, that complexity has been compounded in subsequent legislation. The Proposal offers nothing in the way of simplification. In fact, with changes such as the quarterly testing of a taxpayer's investment in U.S. property (Bill section 2302, amending Code section 956), the Proposal further compounds the Code's complexity, increasing inordinate compliance costs with little, if any, benefit being derived in terms of revenues or fairness.

It is essential that simplification be accorded a higher priority. The present and proposed burdensome requirements lead to excessive tax planning and compliance costs, adversely affecting productive capital investment. Simpler rules would reduce those costs, encourage compliance, facilitate the free flow of capital, and improve the competitive position of U.S. multinational concerns.

II. REPEAL OF WORKING CAPITAL EXCEPTION FOR FOREIGN OIL AND GAS AND SHIPPING INCOME

(Bill section 2321, amending Code sections 904, 905, and 954)

The Proposal would eliminate the so-called working capital exception for foreign oil and gas and shipping income. Specifically, the proposed provision would eliminate the present law exclusion from passive income of interest on temporary investments of working capital in connection with foreign oil and gas extraction income (FOGEI), foreign oil related income (FORI), or shipping income.

According to the "Summary of Administration's Revenue Proposals," released by the Treasury Department on February 25, 1993, at p.52, the Proposal would eliminate the working capital exception because:

> . . . current law provides more favorable foreign tax credit treatment for income associated with foreign oil and gas or shipping activities than for income earned abroad by other United States industries. The Administration believes that there is no sound policy reason for this difference in treatment and that foreign oil and gas and shipping activities should be put on an equal footing with other industries.

This is erroneous. Foreign oil and gas income is subject to less favorable foreign tax credit treatment than income earned abroad by other industries. In particular:

- excess foreign tax credits on FOGEI cannot be applied against non-FOGEI income (Code section 907(a));
- foreign taxes on FORI cannot be credited in situations where the foreign government imposes higher taxes on FORI than on other income (Code section 907(b));
- the Treasury regulations for determining the creditability of foreign taxes are far more restrictive in the case of foreign extraction taxes (Treas. Reg. §§1.901–2 and 1.903–1); and
- in the calculation of the U.S. tax on foreign income, a significant portion of FORI is subject to loss of "deferral" under the subpart F provisions of the Code (Code section 954(a)(5) and (g)).

Similarly, foreign shipping income is subject to less favorable foreign tax credit treatment than income earned abroad by other industries. In particular, a separate foreign tax credit limitation is imposed on shipping income, with the result that shipping income cannot benefit from foreign income taxes paid on non-shipping income (Code section 904(d)(1)(D)); and in the calculation of U.S. tax on foreign income, shipping income is subject to loss of "deferral" under the subpart F provisions (Code section 954(a)(4) and (f)).

Enactment of the Administration's proposal would not put foreign oil and gas and shipping income on an equal footing with other industries. Instead, enactment of the proposal would only serve to further penalize the oil and gas and shipping industries relative to other U.S. industries. Also, increasing the tax burden borne by the U.S. oil and gas and shipping industries would lessen their ability to compete with foreign-based oil and gas and shipping companies. If the current discriminatory treatment of foreign oil and gas and shipping income is to continue, Congress should not "cherry-pick" by eliminating features of a discriminatory system which might be beneficial.

We believe that the present law exception properly treats temporary investments of working capital as a logical extension of the activities generating FOGEI, FORI, or shipping income, and, therefore, this tax treatment should be retained. Moreover, we believe that this current tax treatment should be applied to all businesses so as to bring about fairness. To suggest that business should be penalized because it attempts to obtain an investment return on working capital is unreasonable on its face. If a change is to be made, apply this sound rule to all taxpayers engaged in the active conduct of a trade or business, instead of eliminating the current rule as applied to oil, gas, and shipping operations.

Alternatively, if the policy to put foreign oil and gas activities on an equal footing with other industries is an appropriate one, then other adjustments to the treatment of FOGEI and FORI should follow. In particular, there is no sound basis for the continuation of Code section 907. The objective of limiting foreign tax credits for extraction taxes paid to foreign governments has been achieved through regulations promulgated in the 1980's (Treas. Reg. §§1.901–2 and 1.903–1). Furthermore, there is no sound basis for treating income from refining and marketing operations differently than income from other manufacturing operations (Code sections 907(b) and 954(a)(5) and (g)). In short, API shares the Administration's view that there is no sound policy reason for difference in treatment and that foreign oil and gas ac-

tivities should be put on an equal footing with other industries. Repeal of Code section 907 would be a good start.

III. ROYALTIES TREATED AS PASSIVE INCOME FOR PURPOSES OF SEPARATE APPLICATION OF FOREIGN TAX CREDIT

(Bill section 2312, amending Code section 904)

The Proposal would treat foreign source royalties derived in the active conduct of a trade or business and those received from a CFC as passive income. The Proposal would also allocate R&E to the place of performance (or, in the case of foreign R&E, according to gross sales). API believes that the scope of the Proposal clearly exceeds its apparent rationale.

First, the Administration reasons that the treatment of foreign source royalty income as general limitation income results in a "tax preference" because royalties may be subject to low foreign tax and, therefore, can absorb excess foreign taxes paid on other general limitation income. In contrast, royalties received from the use of intangible property in domestic production activities cannot be "similarly sheltered."

API believes that this argument is flawed. In enacting the Tax Reform Act of 1986 ('86 Act), Congress acknowledged that the overall limitation was consistent with the overall multinational aspects of U.S. operations abroad. At the same time, Congress focused on investments which could "quickly and easily be made in foreign countries rather than at home," and which bear little or no foreign tax. These latter concerns resulted in the inclusion in the passive income category of such items as portfolio stock dividends, passive rents and royalties, and gains from sales of stock and securities.

The Administration starts from the erroneous premise that a licensor of an intangible is free to manipulate the location of markets generating the license income. The natural resource industry typically locates a foreign manufacturing site based on an ample, reliable, and efficient supply of crude oil and related feedstocks; other factors are transportation logistics, availability of labor and access to markets. Moreover, statutory tax rates are typically higher in the host countries of foreign petroleum manufacturing sites which pay royalties than in the U.S., and the effective tax rates of those manufacturing companies are typically cyclical to investment patterns. Consequently, generation or use of general limitation foreign tax credits from royalty income can be just as high or low as it could be from any active business income.

Second, as part of the '86 Act, Congress determined that income earned through foreign branches of U.S. companies and CFCs should be treated similarly. Look-through rules were provided for interest, rents, and royalties received from CFCs to achieve neutrality with the other principal form of income repatriation, i.e., dividends. The Proposal to revoke the look-through rules with respect to royalties received from CFCs goes against this Congressionally intended branch/CFC equality. More importantly, it would introduce an inherent disparity among different forms of repatriation of earnings from CFCs. We believe that all payments, including royalties received by a U.S. company from a CFC engaged in active business, should be characterized according to the CFC's income. No artificial distinction should be made between the earnings of an active business paid into the U.S. as royalties vs. dividends. We wonder why the Administration would want to depart from this basic consistency principle introduced in 1986, without a *strong* reason to do so.

Third, as stated in our introductory comments, API believes that foreign manufacturing is actually beneficial and necessary to the creation of jobs in the United States. Tax proposals which threaten U.S.-owned foreign manufacturing will not protect U.S. jobs; rather, we believe that these jobs would transfer to foreign multinationals with lower costs. Foreign manufacturing by U.S. affiliated companies supports U.S. jobs either through retention of direct U.S. personnel "headquarters" type of employment, or indirectly through raw material exports to these foreign sites, and greater foreign market penetration which recycles back to additional U.S. exports. Therefore, increasing U.S. tax on royalties from active foreign business simply translates into an increased tax rate on foreign manufacturing operations and a decrease, rather than an increase, in domestic economic activity.

Fourth, in trying to directly connect the sourcing of royalty income to the sourcing of the R&E expense by means of the passive categorization, the Administration seems to be ignoring that the Proposal will not only affect royalties with respect to manufacturing processes (which appear to be the target), but will also affect all intangibles listed under Code section 936(h)(3), such as trademarks, copyrights, software, and other intellectual property which has no comparable R&E in the U.S. API suggests that the sourcing of R&E should continue to be studied independently

under Code section 861, and should not be coupled with all royalty income. If there is to be a rationale of income and expense symmetry, this opens up questions such as why the U.S. withholds on outbound royalties payments while the related foreign R&E is not deductible in the U.S.

In summary, API strongly urges the withdrawal of the Proposal to treat royalty income across the board as passive income.

IV. EARNINGS INVESTED IN EXCESS PASSIVE ASSETS

(Section 2301 of the Bill which would amend Code sections 951, 959, 1296, 1297, and add a new section 956A)

The Proposal would require 10-percent U.S. shareholders of certain CFCs to include in taxable income their pro-rata share of a portion of the CFC's current and accumulated earnings. In a further expansion of the U.S. taxation of undistributed CFC earnings, the U.S. shareholder would have to include in taxable income with respect to the CFC the lesser of (a) the accumulated earnings and profits, or (b) the excess, if any, of the value of the passive assets over 25 percent of the value of total assets.

The Administration's rationale is that present law concerning the taxation of undistributed earnings "creates a significant tax incentive to hold earnings offshore, instead of repatriating or reinvesting them in an active business." We disagree.

First, the Proposal increases current taxation of undistributed earnings while most countries do not impose such "anti-deferral" rules. Other countries generally do not tax the foreign income of their multinational companies until such earnings are paid as dividends to the parent company. Even in the U.S. this is the general rule, except in cases where subpart F (Part III of Subchapter N in Chapter 1 of Subtitle A) of the Code requires certain types of income to be taxed currently. In addition, under the passive foreign investment company (PFIC) rules, a U.S. shareholder of the PFIC must either include in income his share of the PFIC's earnings or pay U.S. tax and an interest charge based on the value of any "tax deferral" related to the PFIC's income.

Second, passive investments are unattractive from the opportunity cost perspective of a business; this is not changed by perceived tax advantages. Nevertheless, there seems to persist a misperception that U.S. companies maintain passive type assets for the purpose of avoiding U.S. tax. In reality, U.S. companies evaluate investment opportunities on a discounted cash flow (DCF), or on an alternative basis, such as expected return on assets or return on capital employed. Such evaluations measure the required rate of return. For businesses the required DCF "hurdle" rate typically is 15 percent or more. U.S. companies must invest in active business assets to achieve such returns because it is evident that such returns could not be achieved by passive type investments.

Third, there should be no further piecemeal changes in antideferral regimes without a comprehensive study and development of policy goals. The current PFIC rules were designed to "eliminate the tax advantage that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds." As described above, the definition of a PFIC is very broad, and many companies with active businesses and even some companies subject to a high foreign tax rate are PFICs, a result not within the quoted PFIC rationale.

Finally, the Administration's Proposal would force U.S. shareholders of a CFC to include in taxable income the income of the CFC even if accumulated prior to enactment. Thus, where the CFC has been in an active business for many years before enactment, the retroactive aspect of the Proposal will suddenly tax these active business earnings from those pre-enactment periods regardless of distribution. This is an unprecedented provision; in the past, when similar provisions—such as Code section 956, concerning investments in U.S. property—were enacted, the law applied prospectively only.

V. MODIFICATION OF ACCURACY-RELATED PENALTY

(Bill section 2322 amending Code section 6662)

The Proposal is twofold. It would lower the thresholds for the imposition of the misstatement penalties; for the 20% penalty to the lesser of $5,000,000 or 10 percent of gross receipts and for the 40% penalty to the lesser of $20,000,000 or 20 percent of gross receipts, respectively. Furthermore, the reasonable cause and good faith exception from the imposition of these penalties would be made contingent (i), if an "approved" pricing method is used, on the taxpayer documenting contemporaneously the reasonableness of such use, and (ii), if any "other" method is used, on the taxpayer documenting contemporaneously that, while none of the approved methods was "likely" to, such "other" method was "likely" to, result in a price that

would clearly reflect income. In either case, the required documentation must be provided to the Service within 30 days of a request.

The Administration proposes these changes (with considerable improvements in the draft of the statutory language, compared to the earlier releases of the Proposal) because of a perceived need for statutory guidance on the "reasonable cause and good faith" standard. The documentation requirements are an effort to respond to the Service's complaints (*e.g.,* 1993–7 I.R.B., at 79) of taxpayers' failure to provide meaningful documentation on audit. Finally, present law's thresholds are deemed too high; the reach of the penalty provisions should not exclude smaller businesses.

First, API questions that the criteria for the "reasonable cause and good faith" exception can be legislated because the test is the "facts and circumstances" of each case. This may be the type of criterion where "[o]ne struggles in vain for any verbal formula that will supply a ready touchstone. . . . Life in all its fullness must supply the answer to the riddle." (Mr. Justice Cardozo in *Welch* v. *Helvering,* 290 U.S. 111 (1933)). For the imposition of a penalty, the focus must be on the culpability, to be determined in each case. The Omnibus Budget Reconciliation Act of 1989 (P.L. 101–239) clearly envisioned a facts and circumstances oriented review when it codified the reasonable cause exception from the accuracy related penalty; the intent was to provide a uniform standard *with a greater scope of judicial review* which was expected to lead to greater fairness and minimize inappropriate impositions (H.R. Rep. 101–247, at 1393). When the Omnibus Budget Reconciliation Act of 1990 (P.L. 101–508) added the section 482 related penalty provisions in Code section 6662, the Conference Committee expressed the intent "that the same standard of reasonable cause and good faith apply . . . as would otherwise apply to the valuation misstatement penalty under section 6664(c)."

Based on this genesis of the reasonable cause and good faith exception, API opposes the contemporaneous documentation requirement because it is a mechanical criterion which ignores the subjective, culpability premise of a penalty. Contemporaneous documentation should be a safe harbor or shield for the taxpayer; its failure should not automatically result in a penalty imposition. Automatic imposition of such substantial penalties in case of insufficient documentation would be too draconian; it equals strict liability which is contrary to civilized penalty administration.

From the perspective of the Congressionally envisioned uniformity of standards, API opposes the introduction of a special "more likely" standard for "other" methods; this standard does not bring more certainty than the general reasonable cause and good faith criterion. It is akin to the "more likely than not" test of the tax shelter penalty exception of Code section 6662(d)(2)(C). Since "tax shelters" are arrangements where "the principal purpose . . . is the avoidance or evasion of Federal income tax" (Code section 6662(d)(2)(C)(ii)), this stricter measure was imposed because "taxpayers investing in tax shelters should be held to a higher standard of care in determining the tax treatment of items arising from the shelter or risk a significant penalty." (1982 Blue Book, at 217). Reviewed in this statutory framework, it would be chilling to find transfer pricing measured in a tax shelter context. The general "reasonableness" standard for all non-tax shelter penalties should be retained.

Finally, the documentation production period of 30 days is flawed, both from a policy standpoint and in light of compliance realities. Apparently, a failure to meet the document production dead-line would preclude the invocation of the penalty exception. This would seem to be a rather absurd and inequitable result. The understatement penalty was not intended as a penalty for presumed tardiness.

As to the length of time granted for document production, the unqualified 30 days production period is too short and must not be rigid. Even if the requested documents are under the U.S. headquarter's control, thirty days may often be too short a period to satisfy a document request which may relate to a year for which documents have already been sent to off-site storage locations. Furthermore, in light of the international character of the underlying transactions, the requested documents may have to be produced in cooperation with foreign affiliates, involving time consuming intercompany information transfers. Thus, a 60 day period (cf., Treas. Reg. §1.6038A–3(f)) would be more realistic. And, to be responsive to particular circumstances of a taxpayer, the District Director should be given the authority to extend any such period.

Statement of the Associated General Contractors of America

The Associated General Contractors of America (AGC) is a national trade association comprised of almost 33,000 firms, including 8,000 of America's leading general contracting companies. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tun-

nels, airports, water works facilities, multi-family housing projects and site preparation/utilities installation for housing development. Likewise, member companies in Puerto Rico are engaged in the construction of much of the island's infrastructure.

On behalf of the AGC of America, Puerto Rico Chapter, we welcome the opportunity to provide this statement on the proposed changes to Section 936 of the Internal Revenue Code and request that it be made a part of the record of the Committee's proceedings. The proposed changes are included in both the Administration's Revenue Proposal and in legislation (S. 356) recently introduced by Senator David Pryor. The benefits of "936" were and are intended to stimulate investment in Puerto Rico and to generate expanded employment on the island. To this end, it may be considered a success, especially in the creation of jobs on construction and related projects.

Like other industries in Puerto Rico, local construction firms have benefitted from Section 936. AGC of America, Puerto Rico Chapter is greatly concerned about the proposed changes to Section 936 and the dire consequences on Puerto Rico's construction industry. Senator Pryor's legislation, S. 356, and the provision contained in the Administration's Revenue Proposal, seek to repeal Internal Revenue Code (IRC) Section 936 (Puerto Rico and Possessions Tax Credit), replacing it with a new wage-based credit. Repeal of Section 936 would have a permanent negative effect on Puerto Rico's economy, crippling the construction industry. We estimate that by 1995, total job-loss on the island would be almost 102,000, with construction losing approximately 8,000 jobs, or 12 percent of its employment base.

If Section 936 is replaced with wage credits or capped as some propose, many "936" companies will cease expansions here—killing an important sector of the construction industry. AGC of Puerto Rico commissioned and recently received a study (dated April 1993) of the effect on Puerto Rico's construction industry of such a repeal. It found that continued economic development in Puerto Rico is at risk. In summary, the repeal by Congress of Section 936 would be a disaster.

The proposed changes in Section 936 would significantly increase federal taxes for many U.S. manufacturers currently operating in Puerto Rico (under that section of the Code) and thereby, do not now pay federal taxes. These changes could decidedly endanger the economic development of the island and cause severe damage to the economy in the near future.

The importance of Section 936 for the Puerto Rican economy cannot be emphasized enough, for example, since 1991 manufacturers have represented 39% of Gross Domestic Product (GDP); 23% of Gross National Product (GNP); 23% of personal income; 29% of government income; 24% of consumption; and support directly or indirectly, 19% of total employment in Puerto Rico.

Given the magnitude of these figures, it is not surprising that the overall level of economic activity, **upon which the construction sector depends,** has been driven by manufacturing for nearly four decades. In fact, manufacturing and construction together account for 42% of real GDP and 27% of total employment on the island. Amendments to Section 936 would result in economic stagnation, with construction taking a huge hit.

Amending Section 936 as is proposed, will dramatically change the performance of the manufacturing sector from an expected annual real growth of 0.5% to a declining annual real rate of 7% by 1995. According to the April 1993 analysis:

- Direct employment by "936" companies falls by 31,517, i.e. from 133,598 under a baseline scenario to 102,081 in a reduction scenario. The total loss of jobs in all manufacturing amounts to 45,537, most of it due to a reduction in "936" manufacturing.
- The impact of a reduction in manufacturing production as well as in the investment in construction by manufacturing (and, as a consequence, the negative to zero growth in the economy as a whole) **halts** the annual growth in construction from 3% in the baseline scenario to 0.1% in the reduction scenario.
- Construction generated a direct **employment** of 55,572 in 1991. But the employment it supported in the rest of the economy was even greater, at 67,252 additional jobs, for a total number of jobs supported by construction of 122,824 or 12.5% of total employment generated in Puerto Rico in 1991.

While the construction sector accounted directly for $2.3 billion in 1982 prices in **output** in fiscal year 1991, it supported an additional $3.7 billion of output in the rest of the economy. The study concluded that for each $1.00 spent on construction an additional $1.60 of output was generated in the rest of the economy. For every 100 persons employed in construction, 121 additional jobs are created in the rest of the economy and every $1.00 of payroll in construction generates an additional $1.68 in other sectors of the economy. Lastly, every $1 million invested by "936" manufacturing companies on construction **generates 9 jobs in construction and**

an additional 13 jobs in the rest of the economy. Not surprising, the industrial sectors that contribute most to construction are the pharmaceutical and chemical industries. Their loss is our loss.

The analysis also found that reduced bank lending, such as would result from the of "936" deposits, would have an enormous negative effect on construction. When considering the impact of a reduction in finance, a further 1,058 jobs could be lost in our industry—for a total job loss of 7,794 jobs. The reduction scenario also depicts four years of stagnation in the construction sector.

Until now, the "936" possessions tax credit has been viewed as an instrument of economic development for Puerto Rico. Over time, however, that notion has significantly altered—the proposed changes respond to a need to increase revenue for the U.S. Treasury. This policy change implies that economic development in Puerto Rico will be at risk without any assurance that, as a result, net additional revenues will be forthcoming from the U.S. Treasury.

The proposed changes to Section 936 entail significant increases in effective taxes for U.S. corporations operating in Puerto Rico under that section of the Code. The AGC Puerto Rico Chapter's study clearly shows that the proposed changes threaten the economic development and stability of the island, causing severe damage to the local economy in the near future. Further, it puts a disproportionate burden of reducing the federal deficit on Puerto Rico's local economy. Section 936 remains the only U.S. incentive to support Puerto Rico's continued industrialization and development.

While we agree that all businesses must bear their fair share of the tax burden, including construction companies in Puerto Rico, we respectfully urge you to drop this provision from the Administration's proposal.

STATEMENT OF DR. RICHARD L. BERNAL, AMBASSADOR OF JAMAICA TO THE UNITED STATES OF AMERICA

Mr. Chairman and distinguished Members of the Senate Finance Committee, I would like to thank you for the opportunity to provide Jamaica's views on the use of 936 funds. Indeed, this forum is especially welcome because the amendment to the Section 936 program -- which created the opportunity to use section 936 funds for Caribbean financing -- was initiated by this Committee in the Tax Reform Act of 1986.

Seven years later, we can see clearly that this amendment has worked very well. The Section 936 program has made a significant contribution to the economic development of the entire Caribbean basin and to the United States by providing financing to facilitate increased trade and investment. Originally envisioned as a tax provision designed to encourage U.S. firms to invest in Puerto Rico, specifically in manufacturing, the program has now become a major source of financing for projects throughout the Caribbean. Section 936 of the Internal Revenue Code allows funds to be invested in eligible Caribbean countries, i.e. countries which have a Tax Information and Exchange Agreement with the United States and are designated as qualified to participate in the Caribbean Basin Initiative. To date, the following countries have signed Tax Information Exchange Agreements: Barbados (1984), Jamaica (1986), Grenada (1987), Dominica (1988), Dominican Republic (1989) Trinidad and Tobago (1990), St. Lucia (1991), Costa Rica (1991), Honduras (1991), Guyana (1992). At the time these agreements were signed, the understanding was that 936 funds would be available for investments in the Caribbean. These tax agreements commit signatories to cooperate in sharing tax information with the United States, which is an important mechanism to fight money laundering and prevent U.S. tax evasion.

Overall, the impact of this provision has been considerable, as it has resulted in increased U.S.-Caribbean trade and investment and promoted economic growth and employment in both the United States and the Caribbean countries. The impact of this tax provision resulting from investment and trade has been considerable.

A. EXPANDS U.S-CARIBBEAN TRADE

Section 936 financed projects have expanded trade between the Caribbean and the United States by promoting investment, increasing production, exports, and economic growth. Given that Caribbean economies do not have a capacity to produce capital goods, investments require imports, approximately 70% of which are supplied by U.S. firms. As Caribbean countries experience growth and expansion, new opportunities for investment and trade are created for the United States.

Since the Caribbean Basin Economic Recovery Act (CBERA) was enacted in 1984, the U.S. has developed a growing trade surplus with CBI countries: from 1983 to 1990 U.S. imports from the region declined by 15.6% while U.S. exports to the region increased by 64.7% from $5.7 to $9.7 billion. Given that US$1 billion of U.S. exports to Latin America generates 20,000 new direct jobs in the U.S. The increase in CBI purchases of U.S. goods and services from 1983 to 1990 helped to create 80,000 new direct jobs in the U.S. Of every U.S. dollar of foreign exchange earnings by the Central American and Caribbean countries, 60 cents is used to buy American products, as compared to Asia which spends only 10 cents.

B. PROMOTES CARIBBEAN DEVELOPMENT

As the Caribbean economies undergo major economic changes and adopt private-sector led, export-oriented growth policies, the availability of funds for investment becomes acute. Countries in the Caribbean have been able to draw on this pool of capital, to promote growth through the expansion of private investment and to finance critical public sector development projects. Section 936 financing has helped to strengthen the economies of each of the eligible Caribbean basin countries. Section 936 funds have financed investments, which have been critical in the creation of jobs, the installation of productive capacity, and the production of goods and services. The specific ways in which 936 funds contribute to Caribbean development and thereby increase U.S.-Caribbean trade are:-

1. INCREASES INVESTMENT

Several Caribbean Governments have implemented comprehensive economic reform programs which involved the removal of all barriers and impediments to the operation of the market. This has resulted in the creation of a private-sector led, market driven economy. The process of accelerating and sustaining economic growth depends critically on the volume of investments in both public and private sectors. Section 936 funds have been important in funding public sector development projects and private sector investments since 1988, see Table 1. These funds have been particularly valuable because they are available in foreign exchange and therefore alleviate the foreign exchange constraint as well as expands the volume of investment. As Table 2 shows, 936 funds were the largest source of capital inflows in TIEA signatory countries, in 1991, accounting for 23.3 percent of total inflows.

These flows have been particularly important, given the reduced U.S. aid (development assistance and economic support funds) allocated to several Caribbean countries since the mid-1980s. In 1984, the Eastern Caribbean received US$104.6 million, but in 1992 this was US$21.7 million, a decline of 79.3 percent. In Jamaica, the amount was US$155.3 million in 1985, but fell to $68.8 million in 1992 a reduction of 55.7 percent. The inflow of 936 funds has offset the decline in US aid flows.

2. BUILDS INFRASTRUCTURE

The resources provided by 936 funds have made a substantial contribution to the rehabilitation and upgrading of infrastructure, which complements and enhances the efficiency and productivity of private investments, as well as improves export competitiveness. For example, the trans-Caribbean telephone cable project financed through Section 936 funds will enhance the region's communication links and provide the countries with state-of-the-art service and equipment.

To compete effectively in today's global economy, modern transportation and telecommunication are essential. Air Jamaica received $51 million in 936 funds to acquire two aircraft which it now uses on high density flights to and from the United States. A phone cable project that improves telecommunications services in Jamaica and expands the volume of international calls that can be dialed directly from the island was also financed through 936 funds. In Barbados, a total of US$35 million was spent to expand and upgrade infrastructure of the Barbados Telephone Company while Grenada Telecommunications Limited benefited from US$8 million, which was used in the expansion and upgrading of their facilities and equipment. Trinidad and Tobago received a total of US$210 million which was spent on infrastructure for natural gas exploration and construction of petroleum facility to separate butane and methane from natural gas, as well as a water flooding project.

3. PRIVATIZATION OF PUBLIC ENTERPRISES

Money from this program has helped to fund privatization programs, which reduced the drain of fiscal resources to public enterprises and transferred assets to the private sector. Hotel privatization programs such as the Wyndham Rose Hall in Jamaica, led to more efficient management, expanded employment and significantly increased revenue generated by that property.

4. INCREASES FOREIGN EXCHANGE EARNINGS

The 936 funds have provided foreign exchange inflow which has helped to stabilize the exchange rate and to generate additional foreign exchange earnings by expanding export capacity in the bauxite/alumina industry, in Jamaica, and improving the plant and efficiency of the tourist sector e.g. the refurbishing of Mallards Beach and Americana Hotels in Ocho Rios, Jamaica, refurbishing of Hotel Embajador and construction of Fiesta Bavaro Hotel, in the Dominican Republic. The wood and sugar processing industries in Honduras also benefitted from the 936 funding.

5. EXPANSION OF FOOD SUPPLY

The agricultural sector has been able to utilize 936 funds to expand its productive capacity e.g. expansion and modernization of broiler meat and hatching egg facilities, in Jamaica; development of banana plantations and related facilities in Costa Rica; establishment of a cardboard box factory in Dominica to supply that country's banana industry and manufacturing sector at a cost of $2.1 million.

6. EMPLOYMENT CREATION

The projects financed with 936 funds both in the public and private sector have directly, and through their multiplier effects, created thousands of new jobs across a range of skill categories. Job creation discourages legal and illegal emigration. Migration movements from the Caribbean and Central America have intensified in the last decade. From 1981 to 1988, emigration from Central America and the Caribbean to the United States amounted to 47 percent of total emigration into he United States.

The jobs created by investments, funded by 936 funds, are not at the expense of jobs in the United States. In fact, production and employment in the Caribbean and the United States are complementary. For example, the production of apparel in the CBI region is complementary to production in the United States. Of the apparel produced in Jamaica, 80 percent of the finished goods consist of U.S. raw material, machinery, and other inputs, most of which is made for U.S. firms. Without this complementarity of production between the U.S. and CBI countries, U.S. firms and Caribbean producers would not be able to maintain their market share or their competitiveness in the global market place.

7. DEMOCRACY AND SOCIAL STABILITY

Economic development is a necessary, but not sufficient condition to ensure democracy. Since development is the foundation on which enduring democracy can be built and maintained, U.S. foreign policy must aim at supporting economic development in the Caribbean as the basis for political stability and democracy in the region. These small countries are very vulnerable to narcotics and drug trafficking. Therefore, vigorous anti-drug trafficking programs will have to be pursued nationally and regionally. While focusing on destruction of crops and processing facilities, interdiction, public education, and against money laundering, more attention and resources must be devoted to providing jobs and economic activity as an alternative to involvement in drug trafficking. In Jamaica, through the 936 program, the construction of 750 low-cost prefabricated housing units, which were

manufactured in Puerto Rico and assembled and installed in Jamaica, added significantly to the housing stock, from which the lower income earner benefitted.

RECOMMENDATIONS

Section 936 has operated according to the original intent of the U.S. Congress and has brought about the desired results and its place in Caribbean development has grown more prominent and important each year. It is an essential program without which many important projects throughout the Caribbean would not have been realized.

The countries which have signed TIEA's recommend the retention, without modification, of the Section 936 tax incentive because the availability of Section 936 funds provide an invaluable source of financing for investments in the Caribbean economies and trade between the United States and the Caribbean. The development of the Caribbean economies and the other economies in the region contribute to the economic growth of everyone in the region, including the United States.

Changes in the tax incentive structure to the Section 936 of the Internal Revenue Code would adversely impact on investment and growth in the Caribbean and on U.S. exports and employment.

TABLE I

USE OF 936 FUNDS BY CBI COUNTRIES
Calendar Years 1988 - 1992
Millions of Dollars

	Disbursed	Pending	Total
Jamaica	275.1	60.0	336.1
Trinidad and Tobago	210.0	124.0	334.0
Dominican Republic	77.6	5.0	82.6
Costa Rica	52.7	5.2	57.9
Barbados	36.2	-	36.2
Grenada	8.0	-	8.0
Honduras	2.9	0.9	3.9
Dominica	2.2	0.5	2.7
Guyana		0.6	0.6
Total	665.8	196.3	862.1

TABLE 2

TOTAL LOANS DISBURSED BY FINANCIAL SOURCES IN TIEA SIGNATORY COUNTRIES DURING 1991

Millions of Dollars

Inter-American Investment Corporation	3.0
German Investment & Development Company	3.3
International Finance Corporation	20.1
Overseas Private Investment Corporation	22.8
Caribbean Development Bank	27.4
Business Advisory Services	37.2
International Development Association	50.7
European Investment Bank	71.9
Commonwealth Development Corporation	75.9
Overseas Economic Corporation Fund	94.9
International Bank of Development and Reconstruction	161.2
Inter-American Development Bank	201.9
Sub-total	770.3
SECTION 936	233.4
Total	1003.7

STATEMENT OF THE CARIBBEAN/LATIN AMERICAN ACTION

I. INTRODUCTION

Mr. Chairman and distinguished Members of the Senate Finance Committee, I would like to thank you for the opportunity to appear before you today and to present the views of Caribbean/Latin American Action on the Administration's proposal for Section 936. Caribbean/Latin American Action is a non-profit 501(c)(3) organization committed to promoting private-sector generated economic development in the countries of the Caribbean Basin.

Clearly, the countries of the Caribbean Basin are deeply concerned over the future of Section 936. A reduction in Section 936 tax benefits substituted for wage credits would jeopardize the pool of 936 funds available for development-oriented private sector projects in the Caribbean Basin.

Recent studies conclude that Section 936 funds have become one of the leading sources of project funding for new investments and business growth in eligible Caribbean Basin countries. In some countries, 936 funds are the primary source of loan financing. 936 funds are vital to the development goals of the Caribbean Basin, particularly as other sources of development assistance have declined.

In my testimony, I will argue that the Administration's proposal relating to Section 936 works at cross-purposes with U.S. policy in the Caribbean Basin. That policy aims to protect U.S. economic and security interests by fostering a stable democratic region through economic development. Furthermore, it works against the development goals and objectives of the Caribbean Basin and the many efforts underway to establish healthy free-market oriented economies.

II. BACKGROUND

Section 936 of the Internal Revenue Code of 1986 permits certain U.S. corporations to earn income that is in effect free of United States federal income tax if the income is derived either (i) in the active conduct of a trade or business in a possession or (ii) from qualified possession source investment income ("QPSII"). The Tax Reform Act of 1986, broadened the definition of QPSII to include income from investments of Section 936 funds for development projects in qualified Caribbean Basin countries.

U.S. subsidiaries operating under Section 936 may deposit their earnings in banks operating in Puerto Rico and receive interest free from U.S. and Puerto Rico income taxation. Because the interest earned is tax free to the depositor, the banks offer lower interest rates for these funds.

Without QPSII treatment and 100% credit on interest earnings, there would be little incentive to deposit funds in Puerto Rico and invest in qualified Caribbean Basin countries. The availability of funds and term resources would eventually dry up, interest rates would rise and the only source of U.S. concessionary loans to the small countries of the Caribbean Basin would be eliminated.

III. 936/CARIBBEAN PROGRAM SUCCESSES

Since implementation in 1987, the 936 Caribbean Development Program has achieved solid results and steadily gained momentum. Through mid-March 1993, $684.6 million worth of investments were funded by Section 936 funds in nine eligible Caribbean Basin countries representing 46 projects and approximately 13,000 jobs. It is estimated that an additional $800 million worth of investments are in the pipeline pending government approval. By year end 1993, total disbursement figures could amount to $1.5 billion.

Projects related to telecommunications, agribusiness, food processing, infrastructure, manufacturing and tourism are being financed with 936 funds. To cite some examples, 936 loans have been used to finance the expansion and modernization of Barbados' telecommunications infrastructure; the expansion of Trinidad and Tobago's airport facilities; the construction of low-income housing in Jamaica and the purchasing of equipment for Costa Rica's metal mechanic services for the power and telephone industries in Central America. These projects provide substantial benefits to the Caribbean Basin economies by creating new jobs, direct investment, technology transfer, foreign exchange earnings and other benefits in the form of indirect employment and related-support businesses. At a time when the program is flourishing and the Caribbean Basin is struggling with few advantages, reductions in the 936 development approach would seriously undermine the region's economic goals and aspirations.

IV. CARIBBEAN BASIN DEVELOPMENT IMPACTS U.S. ECONOMY

Caribbean Basin countries have embarked upon a historic path undertaking economic reforms necessary to stimulate private investment in the region. New leadership in the region is moving in the direction of genuine economic change committed to economic liberalization. Liberalization of trade, investment and capital

flows stimulate growth benefitting both the U.S. and the Caribbean Basin. We should not overlook the fundamental fact that when investment in the region expands, imports increase and additional U.S. exports and jobs are generated.

Presently, the U.S. has a trade surplus with the Caribbean Basin countries in the amount of $2.1 billion. Combined U.S. exports to the Caribbean Basin countries in 1990 totaled $9.7 billion, rising 5.6 percent over 1989. The Caribbean Basin was the 11th-largest export market of the United States, ranking before Australia and Italy. The consistently positive U.S. trade balance with the Caribbean Basin reflects a 64.7 percent growth in U.S. exports since 1983. In 1990, this $9.7 billion in U.S. exports supported almost 200,000 American jobs. Furthermore, it is estimated that for every dollar earned in the Caribbean Basin, 60 cents are used to buy American products; compared to Asia which only spends 10 cents on the dollar. Obviously, CBI industries have a strong propensity to purchase American raw materials, machinery and equipment. On average, over 45% of all CBI imports are sourced from the U.S., the highest percentage in Latin America. Furthermore, most of the construction and procurement for 936 loan sourcing is from the United States.

The United States benefits when the economies of the region are healthy and strong. Economic growth in the Caribbean Basin creates markets for U.S. services and products. "Improved economic growth in the Caribbean Basin is in the direct interest of the United States. It helps to create jobs and exports for the U.S. It helps to promote the ideals of democracy, which are important for us not only in our own nation, but throughout this hemisphere," said President Clinton during the 1992 Miami Conference on the Caribbean. In this light, any measures to increase the flow of 936 funds to the region should be encouraged and enhanced; especially at a time when the region is so committed to the continuation of free-market oriented macroeconomic policies.

V. REVISITING THE CARIBBEAN BASIN INITIATIVE

Economic and political stability in the Caribbean Basin has always been important to the United States. As a result, the U.S. has promoted economic growth and economic stability embodied in two major U.S. programs, the Caribbean Basin Initiative (CBI) and Section 936. The CBI has provided a unique impetus to the development of trade and investment between the U.S. and the Caribbean Basin. The result has been an increase flow of trade and investment both ways. Perhaps most significantly, the new opportunities for trade and investment which were created within the CBI framework have inspired creative free-market oriented economic thinking in the region.

Notwithstanding, the CBI has not met all its goals of generating employment and private-sector led investment opportunities, and broadly based economic growth has not been realized. One of the major problems, from the inception of the CBI program has been the limited amount of investment incentives. To a degree, Section 936 has served this function in eligible Caribbean Basin countries. In this regard, we should seek ways to preserve and enhance those programs that stimulate trade and investment in the region and find ways to build upon the fundamental principles of the CBI.

VI. EROSION OF PREFERENCES

Although the Caribbean Basin countries positively view the North American Free Trade Agreement (NAFTA), there is deep concern that the erosion of the market access advantages enjoyed by CBI

countries will adversely impact the competitive situation of Caribbean Basin economies. NAFTA, the Single European Market, the extension of trade preferences to Eastern Europe and the Andean nations and other global trade developments can threaten the economic progress that the Caribbean Basin countries have made under the CBI. The region faces a difficult transition period from an environment of special trade treatment to a future environment ruled by principles of free trade and reciprocity. The Caribbean Basin recognizes what the future holds and is taking measures within its means to meet the challenge.

The public and private sectors of the Caribbean and Central American have expressed their concern that Mexico's preferential access to the U.S. market would divert investment and trade away from the Caribbean Basin region. As NAFTA becomes a reality and Mexican products benefit from duty-free and quota free treatment, the margin provided by 936 interest rates may become as important a factor as CBI tariff preferences in maintaining U.S. investor's interest in the Caribbean Basin. Against this background, it has become now more important than ever to identify and preserve the unique advantages that the Caribbean Basin has to offer in this rapidly changing global trade environment. At this juncture, 936 funds are critical to the development goals of the Caribbean Basin.

VII. UPHOLDING TREATY COMMITMENTS

Another issue that I would like to raise today is related to Tax Information Exchange Agreements (TIEA) with the United States. Signing a TIEA was a precondition for eligibility to receive 936 loans. TIEAs are important to the United States because they provide the mechanism to obtain evidence against tax evaders. In order to enjoy the benefits of accessing 936 funds, these countries have had to enact amendments to their legal codes in order to permit access by the U.S. to confidential information. TIEAs are valuable in the war against drugs and they are effective in deterring drug money-laundering by creating effective tracing instruments.

To date, Barbados, Costa Rica, Dominica, the Dominican Republic, Grenada, Guyana, Honduras, Jamaica, St. Lucia, and Trinidad and Tobago, have concluded TIEA's. Without the recent developments on 936, it was anticipated that other countries would have signed by year end 1993. The reduction of 936 tax credits would limit the pool of funds available for 936 Caribbean Development projects and hence erode the linkage between signing a TIEA and accessing 936 funds. This undermines the credibility of the U.S. to uphold commitments and agreements which it has requested.

VIII. REDUCED LEVELS OF U.S. ASSISTANCE

Given events in the former Soviet Union, the Middle East and Eastern Europe, aid levels to countries in the Caribbean Basin will decline from previous levels or even be eliminated in some countries. In recent years, total USAID levels have decreased in the Caribbean Basin. In Central America, USAID levels dropped from $827.189 million in 1991 to $633.818 million, the amount which has been allocated for Fiscal Year 1993. In the Caribbean, USAID levels have also been slashed from $205.405 million to $180.558 million. Total U.S. Assistance to the region is also dropping. The availability of 936 funds reduces the region's need for U.S. aid and compensates for the lack of direct assistance from the United States. These loans buttress free-market private-sector oriented policies which enable economic growth.

Recognizing the need to improve the flow of funds to smaller regional projects, the Caribbean Basin Partners for Progress (CBPP) was established. The CBPP is a financial institution created by U.S. corporations operating in Puerto Rico under Section 936. CBPP loans are designed for small businesses which are the engine of economic growth in the Caribbean Basin. To date, the CBPP has a pipeline of 35 projects in place amounting to approximately $30 million. Most loans range in the amount of $300,000. Approximately, 65% of these loans are in agricultural projects. This type of credit replaces loans which in another day might have been provided by USAID.

Furthermore, 936 funds represent approximately $100 million in foreign exchange savings as a result of lower interest rates to eligible Caribbean Basin countries. This substantial savings has offset the decline in direct U.S. aid.

IX. REDUCING DRUG EXPORTS AND MIGRATION FLOWS TO THE U.S.

Lastly, numerous studies demonstrate that the incentive to migrate and to enter into drug production are directly linked to slow growth, low investment, poverty, and overall lack of opportunities in the countries of origin. Migratory movements from the Caribbean and Central America have intensified in the last decade. From 1981 to 1988, emigration from Central America and the Caribbean to the U.S. amounted to 47% of total emigration from Latin America, which represents 20% of total immigration into the United States. This is a staggering number for a group of countries that represent less than 15% of the total population of Latin America.

Countries which experience social degradation are prone to consume drugs and enter into drug production and trade as a source of income. The region is also concerned that the removal of trade and investment preferences to CBI countries not only dampens government efforts for economic reform and modernization but also has the undesirable side effect of increasing drug trafficking, notwithstanding their best efforts at intervention. This production and trade is usually targeted at the most profitable and closest market--the United States.

X. DEMOCRACY AND ECONOMIC GROWTH

In the past decade, there has been a remarkable shift towards democracy and free markets in the Caribbean Basin region. Assisting developing countries to a successful transition to pluralistic democratic government and economic liberalization has always been an overriding objective of the United States. An economically thriving and politically democratic Caribbean Basin benefits the U.S.; an impoverished and chaotic region only creates serious economic, social and security problems for the United States. The essential remedies to the latter are always more costly than preventative measures that rely on the resourcefulness of the particular country. The 936 program was designed to assist that effort and it is succeeding more dramatically than anyone envisioned in 1987.

Perhaps it is useful to note that the 936 Caribbean program, as it was born in the mid-1980's, focused particularly on the rebuilding of a politically and economically devastated Grenada. In 1993, use of these funds as an incentive for creating investment and jobs in Haiti would not only be consistent with the principles of the 936 Caribbean Program, but could be an important incentive to the establishment of new business ventures in that beleaguered island. As with Grenada, the task of reconstructing Haiti will need special measures. The 936 Caribbean program could be central to restoring the economy.

To conclude, 936 funds are an important catalyst for investment and economic development in qualified Caribbean Basin countries. The reduction of 936 tax incentives or the gradual elimination of the program undermines an important instrument of U.S. foreign policy. At a time when the region is so committed to the continuation of free-market oriented policies and democratic reform, changes to Section 936 will jeopardize an important program that is working well and helping the region realize its economic potential.

Statement of the Electronic Industries Association

I INTRODUCTION.

Committed to the competitiveness of the U.S. electronics industry, EIA has been the national trade association representing American high technology companies for over 68 years. Its 1,000 members manufacture 85% of the U.S. production in components, parts, systems and equipment for communications, industrial, governmental and consumer-end uses.

EIA supports the President's goal of reducing the federal deficit, and agrees on the necessity of mutually shared sacrifice. However, we question and are deeply concerned about the balance between taxes and spending cuts in the President's Economic Proposal, and have serious reservations about a number of the specific tax components in the package.

Two such provisions affecting international taxation are the reasons for EIA's testimony today—the proposal to place foreign source royalty income in a separate "passive income" category for purposes of the foreign tax credit, and the proposal to eliminate deferral of current taxation of active income earned abroad. EIA believes that even if these provisions do raise some revenue in the short-term, their collateral and long-term effects will weaken U.S. companies by reducing their global competitiveness. These proposals will increase costs, result in an ultimate loss of U.S. jobs and will impair the ability of U.S. firms to pay taxes in the future. These results are the very opposite of President Clinton's goals of harnessing technology to drive economic growth and job creation.

These two provisions are so significant with respect to the ability of our members to compete in the global marketplace, and will have such a disruptive effect on the operations of our members, that EIA would be willing to forego the enactment of the President's investment tax credit proposal to eliminate them.

II TREATMENT OF ROYALTY INCOME.

A. *Background.* The royalty proposal will treat all foreign source royalty income as income in a separate foreign tax credit limitation category for passive income, even if the income reflects the earnings from a taxpayer's active trade or business. (Currently, U.S. companies can aggregate active royalty payments from overseas subsidiaries with active income earned from foreign businesses, i.e., service income, dividends.) The proposal will affect not only royalties with respect to patents and manufacturing processes, but will also adversely affect trademarks, copyrights, software and other intellectual property rights crucial to the success of modern enterprises.

The royalty proposal—which constitutes a major change from current global marketing practices—is "coupled" in the President's Revenue Package with a proposal to amend the Section 861 rule to allow allocation of all R&D expenses to the place of performance of the R&D. No explanation is given for combining these two very different provisions.

EIA strongly believes that there is no justification for coupling these two proposals. In fact, the two proposals will create opposite results. The allocation proposal makes U.S. R&D spending more attractive; the increased taxation of the royalty income such R&D earns abroad makes it less attractive. The royalty provision and the rules for allocating R&D should individually stand on their own merits. And on the merits, the royalty proposal is so anti-competitive that we do not believe it should be considered.

On a separate but related note, EIA has long advocated and continues to support an approach that will allocate 64% of R&E expenses to the place of performance and allow the remainder to be allocated based on either sales or gross income. See Code § 864(f) and Rev. Proc. 92–56, I.R.B. 1992–28. EIA believes that while a 100% allo-

cation can be justified, EIA will not support the proposal to allocate all expenses to place of performance if the "price" of such a rule is allocation of all foreign source royalty income to the passive income basket.

B. *The royalty proposal will substantially increase costs and thus seriously erode our members' competitiveness in the global marketplace.* The economic future of many of our members, and the jobs for many of their U.S. employees, depend heavily on the ability of our member companies to compete in the global marketplace. As the Clinton Administration has recognized, the ability of our companies to compete, and for American workers to compete, "depends less on traditional factors such as natural resources and cheap labor. Instead, the new growth industries are knowledge based." *Technology for America's Growth: A New Direction to Build Economic Strength,* at 7.

Given the standard of living that we all believe should be the right of the American worker, we cannot look to compete on a per-hour wage cost with companies operating in countries with low wage and benefit levels. As a result, the future of our industries and our workers depends upon our ability to compete with the new patents, trademarks, software, and other intellectual property that are the basis of high wage jobs. EIA's historic strength has been its members' ability to develop new ideas and to use innovative processes to create and manufacture technologically superior products and services to meet the needs of the global marketplace.

The royalty proposal will hamstring those efforts by penalizing the worldwide commercialization of our members' technological creations. Our nation's leadership in the electronics industries is constantly challenged from aggressive and well-financed international competitors. We can retain superiority in this field only through a consistent effort and only if the competitive playing field is level. Domestic tax, trade or other government policies that discourage the development or increase the cost of developing intellectual property (upon which breakthrough technology products and services depend) will erode our ability to compete in the global market and to maintain American jobs.

As such, the royalty proposal's increased "tax" upon our companies will create a real barrier to our ability to compete with foreign companies that are not similarly disadvantaged. Moreover, if we lose in the overseas marketplace, we will surely lose in the U.S. market as well.

C. *The royalty proposal will disrupt operations of U.S. companies in the global marketplace.* The current United States tax system recognizes that intellectual property is integrally tied to the active conduct of a trade or business. Indeed, recent U.S. tax policy has consistently focused on ensuring that royalties reflect the true value of the intangible assets to which they relate. The tax code, under section 367(d) and section 482, has been strengthened to encourage U.S. companies to accurately price the royalties that they charge to affiliates.

This proposal will change this method of operation. Fairly-priced royalties will be faced with a *penalty.* Current agreements with affiliates, with unrelated parties, and with foreign governments, all based on a fair royalty price, will be disrupted and will need to be reevaluated. At a time when American businesses should concentrate on making better products and improving customer service, additional attention to the costs and benefits of royalty agreements will be necessary.

D. *The royalty proposal will dilute America's technology base.* This proposal makes the development of intellectual property in the United States less attractive by increasing its cost. As a result, the increased costs of this proposal can and will affect decisions that will be made in the future regarding the manner and locale of a company's business.

Companies have a variety of possible responses if this proposal is enacted. As noted above, at the margin, a company might be tempted to increase foreign manufacturing or foreign R&D. [NOTE: Appendix A provides an example illustrating the incentive for foreign manufacturing that the proposal could create.]

As an alternative to increasing foreign manufacturing, a company might also have an incentive to give up American ownership of certain intellectual property to a foreign competitor or a joint venturer. A company might even be forced to withdraw from certain foreign markets and cede them to competitors.

We believe that there is no justification for a tax policy that will likely result in both a dilution of America's technology base and a transfer of R&D efforts and employment abroad. It does not make sense for U.S. tax policy to disrupt the current system for a proposal that has only marginal utility and will, in essence, hurt the competitiveness of U.S. industries and provide further disincentives for U.S.-based research.

Indeed, if any revenues are raised from this proposal, it is because the provision will create excess foreign tax credits. Although tax policy alone may not be a sufficient incentive to manufacture abroad, a company with such excess credits will have

a marginal incentive to manufacture in a low tax jurisdiction abroad rather than in the United States. That further erodes the ability of the electronic industries to create good U.S. jobs for U.S. citizens.

E. *The royalty proposal could result in a loss of U.S. jobs.* The decisions as to where to own and develop intangibles generally are driven by concerns other than tax motivations. These decisions are based primarily on the need for proximity to customers and suppliers, the existence and availability of a highly skilled workforce, and the overseas market involved. As the Wall Street Journal recently reported, "company officials say that they located abroad not to dodge U.S. taxes, but to take advantage of the same low labor rates and raw material prices that their European and Asian rivals have access to." *Clinton Plan for Foreign Operations Draws Complaints from U.S. Companies.* Wall Street Journal, Thursday, March 25, 1993, at A–3.

However, the increased costs of doing business that are bound to result from the royalty proposal will only hurt U.S. companies' competitive position in the global market. To the extent that U.S. companies will be unable to compete, contracts will be lost, business will decrease, and there will be fewer job opportunities for Americans. Since exports increase the high wage/high benefit jobs found in the U.S. electronics industry, they should be encouraged, not discouraged.

F. *The royalty proposal will not raise significant revenue in the long run.* The proposal will have some short-term revenue raising effect, but as discussed above, companies in excess credit positions can and will adjust their operations to deal with the proposal—and such adjustments will have adverse economic effects on U.S. companies and their workers.

G. *The royalty proposal is not based on sound tax policy.* There are no sound or compelling tax policy reasons for this proposal. Generally, the Tax Code has required separate "baskets" for passive income only when the nature of the income was that it was fungible and easily movable. Royalty income is not in that category. The source of such income depends on the country in which the use (or right to use) the intangible arises. This proposal is an indirect method of changing that fundamental rule. In addition, the royalty proposal appears to make an argument that royalty income should be in a separate basket because it is not heavily taxed. This argument is overbroad, and if taken to the extreme, can lead to infinite transactional basketing.

Finally, under the proposal, royalties will be arbitrarily treated differently from other types of income, such as dividends and interest, received from related parties. Moreover, such a rule will distinguish between branches (which can acquire intangibles as tax-free capital contributions) and subsidiaries of related corporations.

H. *The increase in reported royalty income is not due to tax avoidance.* The Administration defends its proposal by arguing that after 1986, taxpayers reacted to extra foreign tax credits generated in part due to lower U.S. tax rates by establishing foreign subsidiaries and having these subsidiaries make royalty payments for intellectual property developed in the U.S. EIA believes that this increase is due to a number of factors, in particular a growth of U.S. business abroad and compliance with the U.S. tax law. These include the general increase in software and software-related exports (which rely heavily on royalties), a rise in joint ventures in order to penetrate the global market, increased franchising overseas by U.S. companies, as well as the fact that U.S. firms have increased their royalty charges as affiliates as a matter of compliance with the super-royalty provisions of the Tax Code (section 367(d)) and increased scrutiny under section 482. The Administration should not use taxpayers' attempts to increase their global business and a legally mandated requirement such as the super-royalty provision to argue that the increase in royalty income illustrates tax avoidance.

I. *The royalty proposal is unsound economic policy.* It is incorrect as a matter of economic policy to tax royalty income as passive income. Research and development activity by U.S. based companies must be encouraged rather than discouraged. The ability to transfer the fruits of that research easily has helped to create and maintain jobs in the United States and has strengthened the economy of the U.S. and of its corporate citizens.

As noted earlier, the royalty proposal in its current form not only places royalties from technology in the passive category but also covers royalties from trademarks, copyrights, and software. In addition to all the other reasons cited above for abandoning the proposal, the lack of any conceptual reason for imposing a penalty on these other classes of intellectual property must also be considered. Many U.S. companies license their trademarks to foreign licensees to gain entry to, or retain market share in, a foreign market. This is good for U.S. exports and good for the overall economic health of U.S. multinational companies. Imposing another layer of tax on this activity, as the royalty proposal will do, will make it more difficult for U.S. com-

panies to compete and over the long term will reduce market share of U.S.-based multinational corporations.

J. *Summary.* Any tax proposal must take into account the fact that U.S. companies compete in the global marketplace. Indeed, studies have repeatedly shown that exports contribute significantly to job growth in the United States. For example, the Department of Commerce estimates that for every $1 billion in exports, 19,100 jobs are created. U.S. Jobs Supported by Merchandised Exports, Office of Macroeconomics Analysis, Series 1–92, April 1992. Rather than penalizing international operations, EIA believes policymakers must make the United States the world's best place in which to manufacture and from which to export. A fundamental part of this effort is the avoidance of policies like the royalty proposal which impair the ability of U.S. firms to compete and operate in the global market.

Concern with "runaway plants" or other tax sheltered foreign income should be addressed carefully and directly. Blunt tax policy changes should not be adopted when they will disrupt the sectors of the American economy that produce competitive products and high wage employment. The royalty proposal is an overkill to any perceived problem, in that it affects not only manufacturing royalties, but all kinds of intellectual property, and increases the cost of business activity to such an extent that it hampers the ability of American companies to compete abroad.

III CHANGES TO DEFERRAL

A. *Background.* The deferral proposal will require 10 percent shareholders of certain "controlled foreign corporations" ("CFCs") to include in income currently their pro rata shares of a specific portion of the CFC's current and accumulated earnings. The proposal will apply to a CFC that held passive assets representing 25% or more of the value of the CFC's total assets.[1] In essence, the deferral proposal eliminates to a large extent the concept of "deferral" in our foreign tax system. The U.S. tax system already puts U.S.-based multinational companies at a competitive disadvantage with their foreign counterparts; the deferral proposal will increase that disadvantage.

Most foreign competitors operate under a system (a "territorial system") which does not tax any foreign income. By contrast, U.S. multinationals are taxed on their worldwide income. The foreign tax credit, far from being the special tax preference that some policymakers seem to view it, is really just an adjustment mechanism that prevents double taxation of U.S. income by the United States and by foreign jurisdictions.

The concept of deferral in our international tax system prevents multiple taxation of the same items of income, and also respects the tax sovereignty of nations that use a territorial system. It is an important concept not only for these tax policy reasons, but as a means of ensuring that U.S.-based multinationals remain competitive in the worldwide tax system. For the reasons discussed below, the EIA believes that the complete or partial repeal of deferral—as a means of preventing a perceived export of jobs, fixing a perceived "unfairness," or as a pure and simple revenue raising measure, is, in its operational effect, counter to the goal of enhancing U.S. competitiveness and growing domestic high wage employment.

B. *The deferral proposal will harm U.S. companies.* The deferral proposal will increase the costs to U.S. companies doing business abroad—either by increasing taxes or forcing these companies to alter their operations. Thus, the proposal will have a detrimental effect on the benefits of international economic activity. We view this as shortsighted, since the overseas operations of and sales by American companies preserve U.S. jobs by increasing the overall activities and financial strength of U.S.-based corporations.

Indeed, other nations recognize the importance of the global marketplace and provide incentives to their corporate citizens with worldwide operations. Our members compete with foreign multinationals who have the advantages of tax enterprise zones and additional tax or treaty advantages, such as *tax exemption* for foreign subsidiary dividends. In short, the United States currently provides one of the least favorable rules for the taxation of offshore income. Clearly, if deferral is eliminated the competitive gap will widen, benefiting our international competitors.

C. *The deferral proposal will not create U.S. jobs; it will slow U.S. economic growth.* Although taxes are a factor in the determination of where businesses decide to locate, they are clearly not the only nor the predominant factor. We believe that

[1] The portion of current and accumulated earnings subject to inclusion is the lesser of the CFC's (1) total current and accumulated earnings and profits, or (2) the amount by which the value of the CFC's passive assets exceeds 25% of the value of its total assets.

in the electronic industries, the primary reason for a decision to locate manufacturing abroad has been the need for daily access to customers and suppliers.

Because the economic factors discussed above will remain the same even if deferral is wholly or partially eliminated, few, if any, business enterprises will relocate their plants inside the United States solely because of a tax change. Instead, the additional tax cost of operating abroad will make American multinational business less competitive and thus reduce its market share and profitability. And while we reject the claims of American decline in high technology, we caution that both the recent macro-level and individual product-level achievements of the U.S. high technology sector are by no means guaranteed and that the pressures associated with international competition will remain intense for the domestic economy. The imposition of a large new tax increase will most assuredly have an adverse affect upon their progress and will harm the President's plan to boost U.S. high-tech leadership in world markets.

D. *The deferral proposal will not produce significant revenue.* We must seriously question whether the proposal will generate the kind of revenue predicted by the Administration, particularly in the longer term. The Staff of the Joint Committee on Taxation estimates that the deferral proposal will raise between $600 million and $800 million in tax revenues in the first two years, diminishing to $100 million after three years.

These estimates indicate to us that even at its most "optimistic" the revenue effects of such a change are short lived. Moreover, these estimates do not appear to take into account the likely changes in the actions of both foreign governments and multinational corporations which will occur if deferral is wholly or partially repealed. For example, foreign governments will be expected to increase foreign taxes. Indeed, the reaction of foreign governments to the Tax Reform Act of 1986—many of whom lowered taxes to reflect the change in the U.S. tax system—illustrates that foreign taxes are likely to rise again if the U.S. tax system again changes course.

If foreign taxes increase, U.S. companies will merely be paying more to foreign jurisdictions. Moreover, repeal of deferral means that companies will not have the same incentives to minimize taxes paid to foreign governments, and indeed, could change their tax planning to accelerate the payment of foreign income taxes which are postponed, such as foreign withholding taxes.

E. *Sufficient rules exist to prevent abuses.* Finally, we believe that the deferral proposal is unnecessary because sufficient rules exist to prevent abusive situations. For example, the foreign personal holding company rules (secs. 551–558 of the Code) prevent the use of offshore corporations as "incorporated pocketbooks," where dividends, interest and similar forms of passive income were realized by U.S.-owned corporations located in countries with low or no income taxes. Subpart F itself prevents tax avoidance by treating all items of foreign-base company income as a constructive dividend to the U.S. shareholders that must be reported currently.

F. *Summary.* In summary, we believe that the deferral proposal will impair the competitiveness of the U.S. electronics industry abroad without increasing domestic employment or providing a domestic economic stimulus. It will create a tax system that is unfair and competitively disadvantageous, and which invites retaliation by foreign countries and a shift of activities of U.S. companies abroad. This proposal runs counter to the goal of strengthening U.S. exports and domestic employment, and will only weaken our industry's attempt to increase its share of the global electronics market.

IV. CONCLUSION.

The President has stated that "the United States must . . . ensure that its tax, trade, regulatory, and procurement policies encourage private sector investment and innovation. In a global [economy] where capital and technology are increasingly mobile, the United States must make sure that it has the best environment for private sector investment and job creation." *Technology for America's Growth, supra,* at 12.

The royalty proposal and the proposal on deferral will frustrate these important goals by increasing the costs of U.S. business operations in international markets. They have no tax or economic policy justification, and will likely lead to an export of U.S. manufacturing, R&D activities and jobs. These are not the items we want to export. Rather, we want to continue to export the best products and services that our people and our technology can produce. We therefore strongly urge that these two proposals be rejected.

APPENDIX A—EXAMPLE

Assume a U.S. company has a foreign subsidiary with manufacturing operations in a foreign country which imposes a tax of 50% on the foreign subsidiary's income.

Assume further that the foreign subsidiary earns $100 in income per year but pays its U.S. parent $30 per year in royalties under a license for intellectual property from its U.S. parent. Finally, assume the foreign subsidiary dividends 100% of its annual after-tax earnings to the U.S. parent. In this case, the total income to the U.S. parent (before foreign and U.S. tax) would be $100.

Assuming no dividend withholding tax, the foreign subsidiary would pay $35 in foreign taxes ($100—$30 deduction for royalties paid to its U.S. parent) x 50% tax rate). Under the proposal and at current tax rates, the U.S. parent would pay $10.20 in U.S. tax ($30 royalty income from its foreign subsidiary x 34%). There would be no U.S. tax on the dividend income from the foreign subsidiary because of the foreign tax credits brought up with the dividend income. In fact, the U.S. parent would have $11.20 in excess foreign tax credits [$35 foreign tax credits—($70 "gross-up" dividend income from its foreign subsidiary x 34% U.S. tax rate)]. Thus, total tax on the $100 of foreign earnings of the U.S. company and its foreign subsidiary would be $45.20, for an effective tax rate of 45.2%.

In this situation, if the U.S. parent is considering investing in a new plant, either in the U.S. or a foreign country, the proposal would provide an incentive to the U.S. parent to seek a low-tax foreign country. For example, if the U.S. parent earns $100 of taxable income from a new plant located in the U.S., its total tax bill will increase by $34 ($100 from its new U.S. plant x 34%). Combined with its income from its foreign subsidiary in the country with the 50% tax rate, the U.S. parent would earn $200 of pre-tax income, and would pay $79.20 in tax, for an effective tax rate of 39.6%.

However, if the U.S. company establishes a new foreign subsidiary in a country which, via statutory rates or tax holidays, imposes a tax rate of only 20% on manufacturing profits, it will pay a lower total tax bill. In this case, the new foreign subsidiary would pay $20 on its income before dividending to the U.S. parent. The U.S. parent would be faced with a residual U.S. tax of $14 on that income. However, $11.20 of this residual U.S. tax would be offset by the excess foreign tax credits the U.S. parent has with respect to the dividends it received from its other foreign subsidiary operating in the country with a 50% tax rate as a consequence of the President's royalty proposal. The net result is that the U.S. company would earn $200 of pre-tax income, and pay worldwide tax of $69.00, for an effective tax rate of 34.5%.

STATEMENT OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

The members of ECAT appreciate President Clinton's attention and proposals to reduce the burgeoning federal budget deficit. It is the nation's number one economic problem. We can and do argue with some of the deficit reduction proposals. What we do not argue with is the necessity to get on with the deficit reduction task.

President Clinton's tax proposals single out U.S. firms with overseas business operations for payment of an unduly heavy share of the additional tax burden called for in the deficit reduction package. For reasons later cited in connection with an ECAT study of the impact of U.S. overseas business on the U.S. economy, we think this an unwise course of action.

While the business community recognizes that the new Administration needs time to develop a set of consistent foreign economic policies, we hope that the chosen path will be toward opening such competitive opportunities as those that will follow successful completion of the long-stalled Uruguay Round and the NAFTA rather than a path of placing U.S. business in less favorable competitive situations such as would follow enactment of the foreign tax proposals before this Committee. If the United States is to prosper in the modern global economy, we cannot afford to see our streams of income diminished, as would be our foreign income stream with enactment of President Clinton's foreign tax proposals.

The rhetoric of the 1992 Presidential campaign and the early months of the new Administration depict the U.S. tax code as somehow or other unduly encouraging U.S. firms to invest abroad rather than at home. Were reality coincident with the rhetoric, we would find it difficult to disagree with proposals intended to make taxes a neutral factor in regard to where investments are placed.

But the rhetoric does not fit the facts. The U.S. tax code does provide investment neutrality. In order to avoid double taxation of the same income, the foreign tax credit provides that income earned abroad by U.S. citizens shall pay the higher of either the U.S. tax rate or the foreign tax rate. If the foreign rate is higher, then no tax is owed the United States. If the foreign tax is lower, then the difference between the foreign and the U.S. rate is owed the United States.

When U.S. taxes are owed on foreign income, they are payable on receipt of the foreign earnings. In this way, U.S. taxes are paid on foreign income when it is realized just as U.S. shareholders pay tax on corporate profits only after dividends are received.

This practice of the United States is generally mirrored in the tax practices of other countries. As a result, there is an approximate international tax neutrality insofar as investment is concerned. To the extent that the United States tax practice diverges from the international norm, there is a competitive disadvantage to U.S. firms. Several of President Clinton's foreign tax proposals move the United States away from the international norm and would, if enacted, be anticompetitive for U.S. business.

Anticompetitive measures cannot be afforded by the U.S. economy, which is more closely intertwined with the economies of our trading partners and our global competitors than is generally realized. We in ECAT, for example, are about to publish a study demonstrating the enormous benefits to the U.S. economy flowing from U.S. foreign direct investments.

The principal author of our study is Dean Peterson who is a respected and well-known international economist with extensive government and private sector experience. Dr. Peterson worked in close consultation with economists from a number of ECAT member firms. Our study has also been reviewed by other nationally known economists to help ensure that it contains no glitches.

We conducted our ECAT study to examine the effects of the foreign operations of U.S. multinational corporations on the U.S. economy. A similar ECAT study in the early 1970's had shown that the foreign direct investments of U.S. firms had a most positive effect on the U.S. economy. We wanted to see, in light of the relative deterioration of the U.S. international competitive position during the 1980's, whether this positive effect might have changed since the original study was published in 1973.

Our study, therefore, focuses on the decade of the 1980's. It in very considerable depth explores the effect of U.S.-based multinational companies on the health and competitiveness of the U.S. economy. The study is based on an examination of U.S. government statistics, and demonstrates that U.S. multinational corporations continue to be a source of enormous strength to the U.S. economy in every measurable respect.

We believe it critical for national policy that the findings of the study that are summarized below be clearly understood for they establish a factual framework against which policy proposals such as foreign tax proposals can better be weighed to see if they advance or detract from the national interest.

The ECAT study shows that U.S. multinational corporations (USMNCs) made strongly positive contributions to the U.S. trade, payments and financial positions throughout the 1980's, a decade characterized by a massive deterioration of the U.S. trade balance, international payments balance, and global financial position. In fact, USMNCs are now the single most positive factor in the U.S. balance of payments. Had it not been for the positive performance of USMNCs during the 1980's, the economic position of the United States would have been much worse, given the weaker performance of corporations oriented primarily toward the domestic market.

The report's principal findings are:

- USMNCs contributed surpluses to the U.S. balance of payments— consisting of positive trade flows and earnings net of reinvestment—*averaging $83 billion annually* in the period 1982 to 1990.
- USMNCs balance of payments surpluses rose steadily from an average of $74 billion during 1982—1984 to $130 billion in 1990.
- USMNCs surpluses on trade account alone rose from $46 billion in 1984 to $80 billion in 1990. By contrast, the overall U.S. trade balance for manufacturers deteriorated steadily through 1987 and hit a deficit of −$73 billion in 1990. Absent the enormous balance of payment surpluses of USMNCs, the state of the U.S. economy and balance of payments would have been truly calamitous.
- USMNCs have consistently achieved trade surpluses in most industrial sectors.
- Real U.S. export growth averaged 14 percent annually from 1986–1991, the highest for any five-year period in U.S. history.
- Total U.S. exports accounted for 89% of U.S. economic growth during 1989–91.
- USMNCs accounted for approximately two-thirds of U.S. manufactured exports.
- U.S. firms and industries that have been most aggressive in expanding global investments have also been most successful in expanding both their U.S. exports and global market shares.
- Industries with the highest proportionate levels of foreign investment achieved the highest rate of export growth. Significantly, U.S. exports to overseas affili-

ates accounted for a steadily rising share of total exports by USMNCs and were strongly and positively correlated with growth in foreign affiliate sales. This demonstrates the importance of foreign investment by USMNCs. *In effect, exports follow investment.*

- While returning substantial trade and balance of payments surpluses to the United States, USMNCs continue to build their operations abroad *primarily through reinvestment of overseas earnings.*
- Investments overseas enable USMNCs to achieve global economies of scale, to assure access to foreign markets, and to sustain the worldwide research and development activities indispensable to maintaining competitiveness in an increasingly global environment.
- The higher the share of U.S. direct manufacturing investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country.
- The relative paucity of U.S. direct investments in Japan, for example, is a major reason why U.S. exports to that country are relatively small.
- U.S. foreign affiliates predominantly serve foreign markets. The underlying motivation for foreign direct investment is to penetrate markets otherwise inaccessible to U.S. firms and then to protect or expand market share. *Excluding Canada, only 8 percent of sales by U.S. foreign manufacturing affiliates were to the U.S. market in 1989.*
- Financial transactions by USMNCs have consistently been positive. Indeed, they are now the most positive single factor in the U.S. balance of payments.
- *Gross* balance of payments investment income generated by USMNCs rose from $30 billion in 1982 to $72 billion in 1992.
- *Net* of reinvested earnings, the average contribution of positive investment flows, climbed from $19 billion annually in 1983-84 to $56 billion in 1992.
- The dramatic deterioration of the U.S. merchandise trade balance in the first half of the 1980's was driven by clearly identifiable macroeconomic forces.
- The most important factors were the overvaluation of the U.S. dollar, up 37 percent in real terms against 40 leading international competitors from 1980 to 1985, and rapid growth in U.S. domestic demand in 1982–85 relative to other industrialized countries. Similarly, the subsequent recovery in U.S. exports and dramatic improvements in the merchandise trade balance can be traced to a reversal in these macroeconomic trends. Had U.S. multinational firms not made foreign investments, the trade balance would have been much worse.
- USMNCs have been and continue to be the source of significant employment in the U.S. economy—much of which is generated by foreign investment.
- During the 1980's, manufacturing USMNCs had a better record on employment than the typical large U.S. manufacturing firm. Because of the economic downturn and increased pressure from foreign competitors, employment by USMNC parents did decline slightly from 1982 through 1989. That decline, however, was substantially smaller than the decline in employment by Fortune 500 companies as a whole. Furthermore, manufacturing employment by foreign affiliates of USMNCs is declining, belying the belief that USMNCs are shifting U.S. jobs abroad.

The above findings factually contradict the conventional wisdom that USMNCs are harming the U.S. economy by shifting jobs abroad and importing cheaper products into the United States. In fact, the opposite is true. Investment by USMNCs abroad provides the platform for growth in exports and creates jobs in the United States.

These findings lead to important policy conclusions, including:

- An open system of global trade and investment is a necessary condition for assuring long-term prosperity of USMNCs and the U.S. economy;
- Foreign direct investment is indispensable as the means for gaining access to overseas markets and as a source of capital and technology dissemination;
- Multilateral approaches to international trade and investment problems are preferable; and
- The link between domestic policies and international economic performance is of critical importance to maintaining competitiveness and jobs.

However, there are clouds on the horizon. Foreign multinationals have overtaken USMNCs as leading sources of new foreign direct investment. Proposals have been put forward to limit the economic activities of foreign multinationals in the United States.

Likewise, as the U.S. economy continues its halting recovery and unemployment rates continue to be a concern, proposals have been put forward to limit the flexibility of USMNCs to invest abroad, such as President Clinton's foreign tax proposals.

Enactment of such limiting proposals could produce tragic results for the competitiveness of the U.S. economy. The proposals would curtail needed foreign capital for the U.S. economy and would limit the ability of U.S. firms to compete with global firms from Japan, Germany, and elsewhere, who are increasing their global market share at the expense of domestic U.S. firms.

It is with the benefit of the ECAT study in mind that we conclude that enactment of the President's foreign tax proposals would be harmful to U.S. firms who do business internationally. This, incidentally, includes many thousands of firms who supply materials and components and services to other firms who export goods. Many or most of these supplier firms are unaware that they are participants in U.S. international business.

In the case of many ECAT member companies, for example, the increasing costs and burdens of government laws and regulations, among other things, makes it economical for them to contract with outside firms—most of whom are small—for goods and services. Out-sourcing saves large companies mandated costs, for example, that in many cases do not apply to smaller firms, and is a very major reason for small business growth.

A principal stated objective of Prlesident Clinton is to encourage the growth of small businesses, as witnessed by his proposal for an investment tax credit. The President's proposals to target U.S. multinational corporations for disproportionate tax increases, however, will work very much in the opposite direction. To the extent that the largest U.S. firms are hurt, so will be their outside suppliers.

The President has proposed six changes in the foreign tax area that together would increase taxes on U.S. multinational firms by an estimated $15.8 billion over a period of six years. The late Senator Everett Dirksen once said that a billion here and a billion there and soon you have some real money.

For the firms that would have to pay the $15.8 billion in increased taxes on their foreign income as proposed by President Clinton, that is an awful lot of real money—money that otherwise could be invested in job creation for large numbers of workers and that could prevent the loss of business opportunities to our foreign and domestic competitors.

As stated at the outset of this testimony, such possible consequences trouble many American businessmen at a time when they are all struggling to become more competitive and to maintain their standings in the dynamic global economy.

Here are brief comments on the six proposed changes in the taxation of foreign source income. The three most troublesome to the members of ECAT are those that would:

- treat royalties as passive income for foreign tax credit limitations
- amend Section 936 to limit the possessions corporation credit to 65 percent of wages paid, and that would
- eliminate foreign tax "deferral" for accumulated earnings that are greater than 25 percent of total assets.

While for a number of members of ECAT the Section 936 proposed changes treated below are of the greatest consequence, the proposed changes concerning royalty income are either at the top of the list for a large number of ECAT companies or are a close second.

What is proposed by the Clinton Administration is to treat royalty income as passive income, thereby disallowing low-tax royalty income to be averaged with high tax income as currently provided under the overall limitation method of calculating the foreign tax credit. This will very substantially increase the tax costs of conducting foreign business for large numbers of U.S. firms who license technology to their overseas affiliates as well as to non-related firms.

Royalty income is an important component of U.S. international competitiveness. To illustrate, in 1991 royalty and licensing income from abroad totaled $17.8 billion. This large amount is not only vital to the profitability of the parent U.S. firms, but to the U.S. balance of payments.

The United States is fortunate in being a high-technology economy. Licensing this technology to overseas subsidiaries is important to the international competitiveness of both the subsidiary and the U.S. parent firm. To raise the tax costs of licensing technology seems inappropriate and unfair to high-technology firms who are doing their best to compete with the high-technology industries of other countries. To so penalize the licensing of technology as proposed by President Clinton will raise U.S. taxes on foreign source income at a time when U.S. industries are under siege from abroad. It might cause some to review whether it might not be more economical to conduct R & D in overseas facilities. Indeed, many countries offer incentives to attract the conduct of R & D in their jurisdictions.

It is interesting that the proposal to place royalty income in a passive basket is one part of a two-pronged proposal. The other prong is to provide that under the allocation provisions of Section 861 of the Internal Revenue Code, R & D expenses can be allocated solely to the locus of the R & D expenditure. While this is desirable, it in no way compensates for the substantial added tax burden connected with the royalty income prong.

The dual nature of this particular two-pronged proposal is troubling. While the Section 861 part is designed to keep R & D in the United States, the other part that would increase taxes on royalty income would do exactly the opposite, i.e., it would encourage U.S. firms to explore the possibilities of conducting R & D activities abroad.

Those members of ECAT who have made considerable investments in Puerto Rico in large part on the basis of Section 936, are particularly distressed at the proposed changes in that Section. We would hazard a guess that if enacted, there will be no federal budgetary saving or deficit reduction since it can be expected that in place of the private sector Section 936 investments there will be the need for increased direct federal transfer payments to meet a minimal level of societal benefits in Puerto Rico.

Local, state, and federal government transfer payments in the United States also might increase with the proposed drastic cutback in the Section 936 credit to the extent that there would be further migration from Puerto Rico to communities on the mainland that might not offer sufficient numbers of job opportunities, thus resulting in increased government transfer payments to the unemployed.

In addition to the increased federal, state, and local transfer payments that could be expected to follow from cutbacks in Section 936, it is also reasonable to expect that the government of Puerto Rico would exact a tax on Section 936 funds remitted to the mainland so that the estimated tax revenue estimates would likely be smaller than surmised. Also, if a truncated Section 936 causes U.S. firms to move their operations from Puerto Rico, they likely would go to other Caribbean or Pacific Rim countries.

The third most objectionable foreign tax proposal is to eliminate so-called "deferral" for retained earnings abroad that are in excess of 25 percent of the asset value of the foreign subsidiary. For many ECAT companies this is perhaps the most objectionable of the foreign tax proposals. It is but another attack against the "deferral" provisions in U.S. tax practice.

"Deferral" over the years has continually been whittled away by such measures as recharacterization of active income into passive income—such as is similarly now being proposed for royalty income.

No other countries go through these kinds of excesses. They either practice "deferral" as the United States used to, or they don't use "deferral" since they do not levy national taxes on income earned overseas by their citizens.

What "deferral" simply does is to postpone the payment of taxes until the income has been received by the taxed entity. We follow the same practice domestically. Shareholders in U.S. firms do not pay personal income taxes on the non-distributed earnings of the corporations in which they hold shares.

Of the other three foreign tax proposals included in the President's deficit reduction plan our views are as follows:

- the "stripping" rule proposal is not of any significant interest to ECAT members
- on the proposal to eliminate the working capital exception for foreign oil and gas and shipping income, ECAT members believe that interest earned on necessary amounts of working capital should not be deemed to be passive income, and
- on the proposal to improve enforcement of the Section 482 arms-length pricing mechanism, there is ECAT agreement that improved enforcement is certainly non-objectionable.

We would hope, however, that any new enforcement rules for Section 482, or for any other measures, will not further complicate the enormous and stifling burden of compliance. The 1986 tax bill added such technicalities and administrative burdens as to be nearly non-administrable. For many ECAT members, the cost of compliance is often greater than the resultant tax payment.

To conclude, we would ask that the proposed increases in taxes on foreign source income be weighed not just against possible revenue loss if they are not enacted, but also against their anti-competitive effect on U.S. firms engaged in foreign business. As our soon-to-be released ECAT study shows, these firms and their foreign business operations contribute most positively to the economic well-being of the United States. Their positive contributions far overwhelm any possible marginal tax revenues.

We would urge you to place these contributions uppermost among your considerations of the national economic interest in deciding on your deficit reduction legislative package. Prospering U.S. companies will pay more taxes than will diminishing ones.

STATEMENT OF THE EMPLOYEE RELOCATION COUNCIL

Mr. Chairman and members of the Committee, I am Cris Collie, Executive Vice President of the Employee Relocation Council, or E-R-C.

E-R-C is a professional membership association of 1,000 major corporations and governmental agencies and more than 10,000 relocation service companies concerned with the transfer of employees for job-related reasons. Our members move more than 220,000 American workers every year, many of whom are compelled to move to retain or obtain employment. We appreciate your giving us the opportunity today to present our views on the Presidents proposal to change the deduction for moving expenses and we look forward to working with the Committee.

We offer our support to this Committee as it drafts legislation to implement all of the tax and many of the spending provisions in the Presidents economic plan. The Presidents package—and his timetable—are ambitious. We realize you face a June 18 target date for approving your part of the budget reconciliation bill with its focus on jobs, education, investment incentives, and health care as well as with the proposals to reduce the deficit.

We wish you well as you develop this package.

Without question, the deficit is a serious problem that the American public wants solved. But the solution has not and will not come easy; the inevitable spending cuts and tax increases will require everyone to contribute to deficit reduction. We hope, though, that the final product from this Committee reflects its concern with sound tax and economic policy.

When President Clinton introduced his economic plan to a joint session of Congress in February, he lauded American companies as the promise of new economic health and stressed the integral role they would undertake with government in reversing the difficulties of the last two decades. We are in concert with the President in recognizing the significance of corporate America in the development of job opportunities and the rebuilding and strengthening of our workforce. However, we also are concerned that a general objective of the economic package—to create jobs—is undermined by the specific deficit reduction provision to restrict deductions for work-related moving expenses.

Our major interest today is the deduction for job-related moving expenses. Current law already includes so many restrictions on the moving expense deduction that many job-related moves are not deductible. We are concerned that additional restrictions on this business expense will hurt people in the job market and counteract some of the jobs incentives in other parts of the Presidents economic package. Our concern deepened with the recent announcements of massive job dislocation due to the cutbacks in military bases.

THE MOVING EXPENSE DEDUCTION IS A JOBS ISSUE

One of the main reasons President Clinton won the November election is his commitment to put people first by restoring our competitive position in the world economy. His economic package reflects his concern that our improving economy still needs help in the form of incentives to make it easier for the unemployed to find jobs. Moving expenses can directly affect the nations employment picture. A study (The Tax Treatment of Moving Costs: The Economic Impact on a Growing Economy) prepared for us by Eugene Steuerle (former Deputy Assistant Treasury Secretary) and Joseph Cordes (Chairman of the Economics Department of George Washington University and former Deputy Director of CBOs tax division), which has been separately submitted to be printed in the record, finds that in an ideal world there would be no restrictions on the moving expense deduction. Any restrictions, according to Steuerle and Cordes, can affect the mobility of labor and, therefore, can affect the ability to match the right worker and the right job to create the most productive economy.

This study indicates that any restrictions on deducting moving expenses can slow economic growth; the tax laws already include substantial restrictions. Our position is that no additional restrictions should be adopted. We want the economic recovery to continue. And we believe additional restrictions would discourage, not encourage, economic recovery.

Moving Helps Individuals and the Economy

In work-related moves, people move out of self-interest to increase their incomes or improve their standards of living, or retain their jobs. But it also is in the nations economic self-interest for people to move freely. Labor mobility facilitates matching the right people with the right jobs. It means people with the right training and education can be matched with jobs that use that training well. Additionally, some economic studies conclude that workers who move may increase not only their own income and the productivity of their employers, but also the output of other parts of their new community. Consequently, there is a positive link between labor mobility and productivity. Artificial barriers to this matching process should be avoided.

Restrictions on the Deduction Discourage Labor Mobility

Labor mobility helps improve economic productivity and can provide the U.S. with a competitive advantage over other nations. Historically, the American work force has been more mobile than workers in other countries. A few years ago, The Economist reported that American manual workers are 18 times more likely to move to a different state to find or keep a job than Britons. If we can preserve labor mobility, we will preserve a very important competitive advantage over countries where workers are less willing to move and government policies do not encourage mobility.

In an ideal world, there would be no restrictions on the deduction of work-related moving expenses. The Steuerle-Cordes study indicates that any restriction on the deduction is a barrier to the mobility of labor and, necessarily, is a barrier to the process of matching people and jobs. Maintaining such barriers is against the economic interest not only of American workers but also of the nation. Such barriers slow economic growth. For the individual, denying the deduction for work-related moving expenses substantially increases the costs of the move. The increased tax costs hamper labor mobility by adding to moving costs and, thereby, reduce the benefits of moving.

Denying the deduction also hurts the productivity of employers. Limits on the deduction discourage workers from moving when they would be more productive in another job. This makes it harder for employers to hire the best person for the job simply because that worker may not be able to afford to make the move.

Job-Related Moving Expenses are a Necessary Cost of Earning Income

Congress' first action on the moving expense deduction began with the premise that moving expenses are a business expense. The congressional report on the 1964 legislation that codified the moving expense deduction explains that moving expenses are treated essentially the same as business expenses.

We agree that moving expenses basically are a business expense. They are a cost of doing business and earning income and, as such, generally should be considered fully deductible. However, some moves do involve a personal consumption element; for example, moves into better houses, moves to take advantage of better schools, etc. The costs of these moves should not be deductible. We accept the policy position that expenses should not be deducted unless the move is work-related. To achieve this end, many restrictions already limit, and in some cases prevent, deducting the costs of moving from one location to another. However, current restrictions already rigidly limit the deduction to work-related moves. That is why we oppose further restrictions on the deduction.

Undue Restrictions Under Current Law

Current law already includes restrictions that unduly prevent deductions for moving expenses. Arguably, the restrictions were adopted to make sure that the moving expense deduction is only available for work-related moves and not for personal moves. Unfortunately, those restrictions already go too far. They sometimes inappropriately limit or deny deductions for what actually are job-related moves. They discourage a result—labor mobility—that we should encourage. Some of those restrictions are outlined below.

Full-time Job. One restriction intended to limit the deduction to job-related moves focuses directly on the individuals employment status after the move. It requires the individual to be a full-time employee for at least 39 weeks in the 12 months following the move. If the individual meets this test, he or she qualifies for the deduction.

Mileage Requirement. Another restriction—a mileage requirement—tries to carve out moves that presumptively are for personal, as opposed to work-related, reasons. This restriction presumes that job-related moves add at least 35 miles to the individuals commute from their old home to their new job. If the move does not add at least 35 miles to the individuals drive to work, then the moving expenses are not deductible. Congress increased the original mileage limit in 1969 over some members objections that the increase would deny the deduction for many job-related moves. In 1976, Congress decided that the mileage limit had been raised too high and cut it back to its current level: 35 miles. The reasons for the reduction in 1976 are equally relevant today: the congressional tax committees found that mobility of labor is important to the economy; job-related moving expenses are a cost of earning income; and the higher mileage restriction leads to longer commutes with higher commuting costs when we need to conserve energy.

Househunting Expenses. Current restrictions also limit the amount of a deduction available for expenses of looking for a new home and selling or renting an old one. The limit for househunting and temporary living quarters is $1500 and the limit for selling, buying, or settling leases is $3000, less the amount claimed under the $1500 cap. These are the same amounts adopted in 1976, and are obviously outdated. Despite Treasury's recommendation in 1986 that they be increased, the caps have never even been indexed for inflation.

Below-the-line Deduction. The moving expense deduction also is restricted by the overall limitation on itemized deductions. Before 1986, the moving expense deduction was an above-the-line adjustment to gross income—making it available to a larger number of individuals. The decision to make the deduction a below-the-line deduction effectively eliminates it for a large number of individuals, even if they move solely because of a new job and they meet all other restrictions

Rules on Spousal Business Expenses Should Not Affect Moving Expense

In addition to E-R-C's concern with the Administrations proposal to directly restrict the moving expense deduction, I would like to bring to your attention what could be an indirect and unintended restriction on the deduction. The Administration has proposed enacting a provision from last years tax bill (H.R. 11) that includes additional restrictions on the deduction of business travel expenses for spouses. The proposals objective is to deny a business expense deduction if there is not a clear business purpose for the spouses presence on the trip. That concern does not exist with moving expenses attributable to a spouse. However, if the spousal travel restrictions are drafted as in H.R. 11, they could be interpreted by IRS to deny a deduction for moving expenses attributable to spouses and dependents.

The spousal travel expense proposal in H.R. 11 amends IRC section 274 which determines when spousal travel expenses are sufficiently related to business activity that they can be deducted. However, the provision states that no deduction shall be allowed under this chapter. Both section 274 (in this case, governing spousal business travel) and section 217 (governing moving expenses) are in the same chapter of the Internal Revenue Code. Consequently, the provision could be construed to affect the portion of section 217 moving expenses attributable to spouses and dependents.

Nothing in the legislative history of the provision indicates it should apply to moving expenses. In H.R. 11, the provision refers specifically to a spouse who accompanies the taxpayer on business travel, which clearly distinguishes it from moving expenses. And, in the past, Congress has carefully clarified provisions that could affect both section 274 business expenses and section 217 moving expenses. For example, the 1986 Tax Reform Act Bluebook explanation of the reduction in the section 274 deduction for meals carefully explained that the reduction also would apply to meal expenses incurred under a section 217 move.

As you can see, neither the language of the proposal nor its legislative history indicate an intent to affect moving expenses. However, we think the proposal should be clarified to indicate that the restrictions under section 274 on business travel by spouses do not affect the moving expense deduction under section 217 if the section 274 provision is going to apply to all deductions under this chapter.

CONCLUSION: NO ADDITIONAL RESTRICTIONS SHOULD BE ADOPTED

E-R-C wants to see the economic recovery continue. Our position is that the current restrictions on moving expense deductions are more than adequate to limit this deduction to work-related moves and that additional restrictions would be inappropriate. Additional restrictions would discourage, rather than encourage, the economic recovery. Restrictions would hamper firms, industries, and regions that depend on mobile workers and would simultaneously help competing firms that rely on workers who are not affected by mobility. As Congress considers the Presidents economic package, it also is important to remember that we have no other policy in this country to help people move where the jobs are. Any change that further restricts the deduction will only discourage work-related moves and economic growth.

We recognize that the moving expense deduction was considered in this Committee and on the Senate floor last year along with a host of other potential revenue raisers. We hope this year the Senate recognizes the importance of the deduction to the economic recovery and jobs, and that the scenarios from last year are not repeated.

Nevertheless, we understand the need for deficit reduction and dealing with budgetary problems. And we understand that everyone will be expected to contribute if we are to meet this important objective. So, if the Administration and Congress agree that further restrictions on the deduction for moving expenses are necessary, we are prepared to do our part.

The proposal under consideration by this Committee, suggested by the Treasury Department in its February Summary of the Administrations Revenue Proposals and approved by this Committee last year, denies the deduction for real estate closing costs and meals. If further restrictions are necessary, E-R-C believes this is the most palatable approach. We feel strongly that further restrictions would be inappropriate and counterproductive. We also feel that any changes to the section 274 restrictions on spousal travel expenses should clearly indicate that they are not intended to affect the deduction of moving expenses attributable to spouses or dependents.

Tax Treatment of Moving Costs: The Economic Impact on a Growing Economy

A Paper Prepared by
Joseph Cordes and Eugene Steuerle
for the American Movers Conference and the Employee Relocation Council

INTRODUCTION

A hallmark of American society is its mobility. Census data show that in the course of a single year, almost one-fifth of the total population changed their place of residence.[1] The Survey of Income and Program Participation (which significantly understates the number of movers) indicates further that over one-fourth of the population moved within a single 2 1/2-year period.

When Americans move, economic considerations play an important role. One study, for example, estimated that between 70 and 85 percent of those who move to a different Standard Metropolitan Statistical Area (SMSA) or county did so for economic reasons.[2] The search for new employment opportunities figures prominently in the decisions of many movers. The aforementioned study, for example, also reports that between one-third to one-half of all moves were motivated by a decision to change jobs. Those looking for work also are significantly more apt to move than those not looking for work and those who are retired. For instance, among those 45-54 years of age, 28.1 percent of those looking for work moved over a 2 1/2-year period, whereas movers comprised only 12.2 percent of those with a job and not looking for a job and 13.9 percent of those not in the labor force.[3]

This movement has been a major source of dynamism in the American economy. The nation is mainly one of immigrants, and the descendants of those immigrants have moved from east to west, from south to north and back again, in search of a better way of life.

Although ideally one might wish that movement would not be required for improvements in economic well-being, individuals are often compelled to move by circumstance, opportunity, barriers to progress in one area, and other dynamic aspects of the economy. Seen in this context, mobility of workers plays an important role in helping market economies adapt to changing circumstances. This point has not been lost on some observers from Europe, where workers are generally less mobile than in the United States. The respected international weekly The Economist, for example, notes that American manual workers are 18 times more likely to move to a different state to find or keep a job than Britons, and goes on to suggest that the United Kingdom adopt a series of policies to facilitate labor mobility, including, among others, allowing moving expenses to be tax-deductible.[4]

Moving, of course, can involve significant costs. There is limited information on out-of-pocket moving expenses paid by individual workers, but when firms relocate employees, they often reimburse employees for some of their expenses. These reimbursements provide some indication of the costs of moving. According to 1991 data collected by the Employee Relocation Council for participating firms, the average cost for moving a homeowning transferee was $46,667; for moving a homeowning new hire, $33,467; for moving a renting transferee, $12,290; and for moving a renting new hire, $8,227. It should be noted that these costs do not include other costs to the employee that might not be reimbursed by the firm, either because of limits on total reimbursable expenses or because some expenses do not qualify for reimbursement.

TAX POLICY TOWARD MOVING EXPENSES

Tax policy has always been fairly restrictive in allowing moving expenses to be deducted. During the latter half of the 1980s, however, the general thrust of tax policy has been to reduce even more severely the extent to which moving costs are deductible in computing taxable income. These changes have come about because of both tax legislation and the failure to adjust limits on some moving expense deductions for rising costs.

Despite the large number of moves in the United States, only a small percentage of those moves have ever qualified for a moving expense deduction. Even before the passage of the Tax Reform Act of 1986, for instance, no more than 1.74 percent of returns filed for moving expenses.[5] The requirements of the law for any deductibility at all have been fairly strict and designed to insure that a move was mainly for work-related purposes. Thus, the law requires that the distance between an individuals new place of employment and former residence must be 35 miles greater than the distance between the individuals former place of employment and former residence.

The individual must be a full-time employee for at least 39 weeks in the 12-month period following the move (although this could be waived if the employee is transferred or separated from work, and in certain hardship cases).

These restrictions have been sufficiently stringent to insure that only a small fraction of moves actually received a tax deduction, as is evident by comparing the small fraction of households receiving a tax deduction with the much larger fraction of households which move in a given year. The cautious approach to deductibility of moving expenses taken by the tax code is underscored by the fact that other costs of moving, that are not deductible, could easily be considered to be costs partially or wholly related to work. Students who move for educational purposes pay costs that offset later gains in earnings. Households, such as single heads of households who spend part of the day caring for children, sometimes move to take part-time work. Finally, the 35-mile limit can be rather restrictive, as the additional commuting costs of going to a job even a few miles further away could be substantial. Moving closer to a new place of work, even if only a few miles, is a reasonable response to the increased cost associated with the new job.

This is not to argue that some restrictions are unnecessary. Some moving expenses are not related to the cost of work, and therefore, should not be tax deductible. The point is simply that mileage and full-time work restrictions prevent many taxpayers from deducting any expenses of moving, even when some or all of those expenses may be work-related.

Statutory Changes

Prior to 1986 legislation, taxpayers meeting most of the aforementioned work-related conditions were generally allowed an unlimited deduction for direct costs of moving household goods, as well as indirect moving costs up to a limit. These deductions were taken above-the-line, which means that taxpayers were able to deduct moving expenses without regard to whether they itemized other deductions. In 1986, these provisions were changed to recharacterize moving expense from an above-the-line deduction to one taken "below-the-line." Thus, taxpayers who make use of the standard deduction -- principally, those who rent and do not have itemizable mortgage interest and property tax deductions -- were no longer able to deduct moving costs. When these taxpayers were compensated by their employers for the cost of moving, therefore, they were required to treat such compensation as fully taxable income without any offsetting deduction. By itself, changing moving expenses to a "below-the-line" deduction increased (after-tax) moving costs for almost 900,000 taxpayers per year.[6]

Inflation & Movement Away from Proposals Made in Treasury I

In 1984 the Treasury Department recommended that increases in the cost of moving justified an increase in the overall dollar limitation on the deduction for indirect moving expenses from $3,000 to $10,000. In addition, it proposed that the dollar limitation applicable to temporary moving expenses and round-trip travel expenses be increased from $1,500 to $3,000. For moves outside the United States, the overall dollar limitation would be increased from $6,000 to $10,000 and the dollar limitation applicable for temporary moving expenses and round-trip travel expenses would be increased from $3,000 to $8,000. These costs also would have been indexed as of January 1, 1986.[7] From 1988 to 1993, inflation has increased consumer prices by more than one-fourth, implying that the $10,000 limit suggested by the Treasury Department would have been increased to more than $12,500. Other limits would have received corresponding increases.

Data supplied by the Employee Relocation Council imply that even larger increases may have been in order. Between 1986 and 1991, average relocation costs for employees of their surveyed companies increased by 7 percent per year. Extrapolating that data to 1993 implies an overall cost increase of about 60 percent since the beginning of 1991. This increase, of course, could be due to several factors, including an increased willingness of firms to cover additional costs of moving to attract employees. The index proposed by Treasury, nonetheless, was probably too low. Moving costs might be expected to grow in line with income and asset growth in the economy, rather than simply inflation. As average home value increased, for instance, so might sales costs associated with buying and purchasing those homes.

Regardless of what would be the correct index, the limits now applying in the law are neither indexed nor raised to the amounts suggested by Treasury even for 1988. Hence, many legitimate costs of work are not deductible.

The Response of Companies

As moving expenses have become less deductible, companies have responded in part by developing assistance programs to compensate employees for the additional federal tax liability that employees pay on their reimbursements for moving expenses. About 90 percent of the nearly 500 firms who participated in the Employee Relocation Council survey reported such programs.[8] Most firms also indicated that they had a separate assistance program for nonitemizers.

THE ECONOMICS OF MOVING

As noted, some moving expenses might be thought of as motivated mainly by desires of households to choose new surroundings, lifestyles, and perhaps bundles of local public goods, such as schools. To deal with these types of consumption-related moving expenses, the tax code restricts greatly the number of movers who might even be eligible to deduct moving expenses and tries to insure that they are job-related.

Moving Expenses as Costs of Investing in Human Capital

Clearly, however, a principal reason for moving is to increase earnings. Going back to the work of Nobel laureate economist Sir John Hicks, economists have argued that differences in net economic advantages, chiefly differences in wages, are the main causes of migration. [9] Drawing on the work of T.W. Schultz and G.S. Becker[10], L. Sjaastad formulated a model in which the migration is affected not only by earnings differentials, but also by factors such as moving expenses, job search costs, psychological costs, and uncertainty.[11]

The key insight of these migration models is that people move as a means of maximizing the potential earnings that they can acquire through their particular mix of skills and talents -- e.g., their human capital. Under this view, costs of moving become costs of earning income. Economists who have analyzed migration have found the human capital model to be quite useful in explaining the behavior of movers.[12] Among the findings of research on the determinants of migration:

- o Income opportunities at the destination are an important determinant of the decision to move. One study, for example, found that a ten-thousand dollar expected increase in the present value of husbands earnings increases the probability of interstate migration by 6 percent. [13]
- o Jobs attract migrants, but migrants do not appear to substitute fully for local workers, implying that the net gains from migration include not only the additional productivity from hiring the best worker for the job, but also spillover effects to other parts of the community;[14]
- o Moving costs are a barrier to migration. Many studies, for example, find that higher costs of living at the destination discourage migration, as does increased distance, which is correlated with increasing costs of moving.[15]

Implications of the Economic Model

The economic model of migration suggests there are several ways in which migration/moving enhances productivity and economic performance.

Long Run Economic Efficiency. Over the long run, migration/moving enhances economic efficiency by facilitating the match between the wages and salaries paid to workers and their productivity. An important condition for production efficiency in a market economy is that earnings of workers and returns to capital correspond to the value of the output produced by these factors of production. If labor and capital are mobile, the private interests of workers and their employers provide enough incentive for this to happen.

There are a variety of reasons why the productivity of workers may vary by location. Skills developed at one job may be worth more to another employer located in a different city. Within the same company, skills developed in one location may be worth more elsewhere in the company. (This would be mirrored by a company's decision that the person best qualified for a particular position needs to be transferred). In each of these cases, the efficiency of labor requires that workers move and relocate.

Responding to Economic Shocks and Technological Change. In the short run, unforeseen shocks to the economy, as well as technological change, will affect the productivity and the demand for labor in different geographical regions. Workers whose skills commanded a relatively high wage in a particular area may find those skills diminished in value as an everchanging dynamic economy adjusts to cyclical and technological shocks. If workers respond by refusing to accept employment at wages below what they expect, the unemployment rate in the region affected by the shock will rise. Migration from relatively low to high labor demand areas helps mitigate this effect, thereby helping the economy to operate as close to its full-employment potential as possible.[16]

Preventing barriers to mobility is also important for insuring that human resources not be underemployed. Being employed somewhere is not enough. Again, when technology, shifts in demand, and other economic shocks increase the value of a workers product in a different area (or decrease her productivity in an existing one), deterrents to mobility will act as barriers to the full employment of that persons skills. Productivity and national income decline along with the decline in her output.

TAX POLICY IMPLICATIONS

The (simple) human capital model of moving has fairly direct implications for the tax treatment of moving expenses. To see this, we first establish the properties of a well-functioning set of labor markets in the presence of moving costs, but in the absence of taxes.

Worker-Movers Choice

Consider the case of a worker who is trying to decide whether to accept an offer of a job that requires a move. Assume for simplicity that the worker must pay moving expenses. (It is easily shown that the same conclusions would hold if, instead, the prospective employer paid the workers expenses).

Define E_{mj} to be the present value of the earnings that a prospective mover would receive if she were to move to location j, and E_{mi} be the present value of the earnings she will receive if she stays at location i. Let M_{ij} be the cost of moving from location i to location j.

Then the human capital model of migration/moving implies that if the worker is to move, the present value of earnings at destination j must equal or exceed the sum of the present value of earnings at origin i plus the costs of moving.

$$E_{mj} \geq E_{mi} + M_{ij} \qquad (1)$$

Employers Choice

Prospective employers face a choice between hiring local workers and movers. From the employers perspective, the compensation package that it is prepared to pay someone to move from destination i to destination j, which determines the present value of the earnings the worker can expect to receive if she moves, E_{mj}, will equal the compensation package it would have to offer the best qualified local worker to accept the job at destination j, E_j, plus the difference in productivity between a mover and a local hire.

$$E_{mj} = E_j + (P_{mj} - P_j) \qquad (2)$$

Note that in this simple case, if there is no gain to the employer in the form of greater productivity from hiring a mover, the compensation package the employer is willing to offer a mover will be the same as that which would be offered to a local worker.

Equating the right-hand sides of (2) and (1) yields the condition under which a market comprised of rational workers and employers will result in a worker moving from location i to accept employment at location j:

$$E_j + (P_{mj} - P_j) = E_{mi} + M_{ij} \qquad (3)$$

That is, the compensation package the employer is willing to offer a potential mover to relocate to destination j must equal the compensation package the potential mover is earning at the origin i plus moving costs.

In a well-functioning, competitive labor market, wages will reflect the value of worker productivity so that $E_j = P_j$, and $E_{mi} = P_{mi}$. Substituting these expressions into (3) yields the condition at the margin under which employers are willing to hire movers and at which workers are willing to move:

$$P_{mj} = P_{mi} + M_{ij} \Longrightarrow (P_{mj} - P_{mi}) = M_{ij} \qquad (4)$$

This condition expresses the sensible, but important result that in a well-functioning labor market, in the absence of taxes, moves take place at the margin when a move increases a workers productivity by an amount at least equal to the costs of moving the worker.

Note that this means that some moves will not take place even though the workers productivity would be greater at another location.

When the increase in productivity is less than the real costs of moving the worker, the movement is uneconomical. This is as it should be in a well-functioning market. Moving requires the use of scarce resources. If these costs are not offset by added productivity gains, the economy does not benefit from having workers move to change jobs.

Labor Market with Moving Costs and Taxes

The principle of tax neutrality holds that a tax will be neutral when it does not interfere with the choices that consumers or businesses would make in the absence of taxes.

In the case of labor markets with moving costs, neutrality obtains when (a) income is taxed, and (b) moving costs are treated by the employee as costs of earning that income. An income tax can be neutral with respect to the moving decision in one of two ways. If workers pay moving expenses out-of-pocket, neutrality requires that workers be allowed a full deduction for these expenses. If employers reimburse workers for moving costs, these costs must be fully deductible as a legitimate expense of doing business to the employer, and should <u>not</u> be included in the taxable income of the employee.

In a tax regime in which moving expenses are treated neutrally, workers and employers will compare after-tax gains in earnings and productivity with after-tax moving expenses. (The tax rate may vary depending on whether moving expenses are borne and deducted against income by the individual or by the employer). In that case, if the tax rate is T, expression (4) becomes:

$$(P_{mj} - P_{mi})(1-T) = M_{ij}(1-T) \Longrightarrow (P_{mj} - P_{mi}) = M_{ij} \qquad (5)$$

The important feature of expression (5) is that moves that would take place in the absence of an income tax would also take place in the presence of an income tax that allowed full deductibility of moving expenses. That is, moves would take place when the added productivity exceeded the real costs of moving. Thus, full deductibility of moving expense maintains the economic incentive to move provided by the market place.

Incomplete Deductibility

Suppose, however, that moving costs are not allowed to be treated for tax purposes as costs of working. In this case, it is easily shown that moves will take place when condition (6) is satisfied:

$$[P_{nj} - P_{oj}] (1-T) = M_t (1-aT) \quad (6)$$

where a is the effective fraction of moving expenses that can be deducted. If we rearrange (6) a little, we have:

$$[P_{nj} - P_{oj}] = M_t [(1-aT)/(1-T)] \quad (7)$$

Note that in comparison to condition (5), moves will only take place if the gain in productivity exceeds moving costs by a factor greater than 1. This factor rises as a (the fraction of moving expenses that is effectively deductible), falls. For example, if moving expenses were not deductible at all, productivity at the destination would have to be 1/(1-T) times as large as moving expenses in order for moving to make economic sense. Intuitively what happens under incomplete deductibility is that the government claims its full share of the economic gains that result from moving, while bearing only a partial share of the costs.

From the perspective of workers and companies, denying deductions for moving expenses has the same effect as would an increase in the real cost of moving to workers and businesses. It is difficult to calculate precisely the extent to which existing limits on deductions for moving expenses have served to effectively increase the cost of moving. Nonetheless, some clue can be obtained by the amount by which companies pay additional expenses to employees to compensate for the taxes they now have to pay for reimbursed moving expenses. In 1992, the Employee Relocation Council estimated that when current employees received moving assistance payments from a company, they received an average of $4,020 to compensate them for federal tax liability owed on company-provided moving assistance payments.

When one particular method of payment is used -- the flat percentage method -- these tax gross-up factors ranged from 20 to 50 percent, with a median of 28 percent.[17] That is, the employee reimbursement would be treated as taxed at a 28 percent rate. Many companies, however, relied upon computations that were more specific to the taxpayers circumstance. In addition, most companies report providing additional reimbursements for the tax on the tax reimbursement, that is, on federal tax liability payments made by the employer as part of the assistance package. For example, if a taxpayer is in the 28 percent tax bracket, a typical formula would gross up actual moving costs by 39 percent, thus accounting for the taxes on the additional compensation paid to cover taxes on reimbursed moving expenses. (Some companies also include state and local and FICA taxes in their gross-up).

ECONOMIC COSTS OF LIMITING DEDUCTIBILITY

Though moving costs increase for tax reasons when they are not fully deductible, there is no increase in the underlying economic costs of moving. Thus, failure to allow full deductibility of moving expenses causes workers and employers to perceive moving costs to be higher than they actually are. In the parlance of tax economics, less than full deductibility of moving expenses creates a tax wedge between the cost of moving faced by workers and employers, and the true economic cost of moving.

Costs of Fewer Moves

Because less-than-full deductibility creates a tax wedge, some moves that would otherwise be economically beneficial to workers and employers will not take place. It is well-established in the public finance literature that when this happens, there will be a reduction in overall economic well-being, the size of which is determined by how responsive markets are to a tax-induced change in the price or cost of the activity affected by the tax wedge.[18]

Some economic choices may be relatively unresponsive to the introduction of tax wedges, because either the demand or the supply of the activity is fairly unresponsive to changes in its price. There is, however, no reason to believe that moving decisions should fall into this category. Goods and services that are often considered unresponsive to taxes are those that tend to be demanded in the same amount or supplied in the same amount no matter what the tax. For instance, some minimal amount of food may be demanded no matter what the tax rate, or the supply of land or other factor may be fixed even if a property tax is imposed on the land.

The economic model of migration, however, suggests that moving should be responsive to wedges created by the tax system for several reasons. First, the difference in net after-tax income plays an important role in the decision to move. Many companies also act as if the after-tax cost of moving matters to workers when they gross-up such reimbursements to reflect taxes. The supply of moving services should also be quite responsive, as there are few fixed factors involved. The costs of moving are largely the labor costs associated with paying for the services of moving companies, realty companies, lending institutions, and similar organizations.

Differential Treatment of Industries and Companies

Additional economic costs are imposed when tax wedges fall unequally on different sectors of the economy. Increases in moving costs resulting from less-than-full deductibility fall more heavily on workers who face the largest costs of moving, and on companies who rely relatively heavily on hiring new employees and/or on transferring existing employees to adapt their labor force to changing demands. As a consequence any tax wedge resulting from limiting deductibility may unintentionally discriminate among different industries -- to the extent moving is more important in some industries than in others -- and among firms in the same industry -- to the extent that some firms depend more on hiring movers than do other firms.

Differential Treatment of Industries. Imposing a moving tax wedge could affect different industries in several ways. Suppose that the ability to relocate workers within the firm plays a more significant role in the production function of some goods and services than others. In that case, failure to allow full deductibility of moving expenses has effects similar to those of taxing factors of production more heavily when employed in some activities than in others. This has effects quite similar to selective excise taxes.

Similar observations apply to industries that might be concentrated in certain regions of the country. To the extent such firms and regions need to import skilled workers from elsewhere, anything less than full recognition of the costs of moving would make it harder at the margin for such enterprises to attract the workers they need.

Differential Treatment of Firms. At the level of the individual firm, imposing a moving tax wedge could be expected to have differential effects depending on the size and the age of the firm. There is some evidence that smaller companies pay more for relocations than their larger counterparts, apparently because of differences in pricing clout in negotiating moving costs with moving companies themselves.[19] If this is correct, the denial of tax deductibility exacerbates the problem and discriminates against smaller companies.

At another level, the issue is more one of competition among firms, whether or not in the same industry or of the same size. If firms differ in the extent to which they rely upon mobile workers, the denial of appropriate deductions can serve to reduce competition -- in somewhat the same way as if the government randomly picked firms or employees of particular firms to pay different tax rates.

This anticompetitive aspect of the tax law may especially hit new firms that depend initially upon hiring workers from different areas. Suppose a new firm believes it has a more efficient production process, or it has an invention it wants to develop, or it believes that existing firms have grown stagnant. Then denial of tax deductibility of legitimate moving expenses operates as a barrier to increased market competition. The economic literature makes it clear that such anticompetitive policies are harmful to the economy. When such behavior is exhibited in the private sector, it is often fought through such devices as antitrust policy. When resulting from the tax code, however, there is no government response available.

SUMMARY AND CONCLUSIONS

Historically, American workers and companies have benefitted from a high degree of worker mobility. U.S. tax policy has attempted to avoid interfering with market incentives for mobility by allowing moving expenses to be deducted under some conditions. In recent years, however, the combined effects of changes enacted in the Tax Reform Act of 1986 and of inflation have been to place limits on deductions for moving expenses, even though the Treasury Department recommended that limits on moving expenses actually be raised in its comprehensive report on tax reform.

Economic models of migration imply that moving facilitates the formation and the allocation of human capital. These models suggest that allowing full deductibility of legitimate moving costs would be sound tax policy, especially at a time when policymakers are considering ways of deepening the human capital of American workers.

Footnotes

[1] Source: U.S. Bureau of the Census, Current Population Reports, Series P-20.

[2] Ann P. Bartel, The Migration Decision: What Role Does Job Mobility Play? American Economic Review, December 1979, v. 69, pp. 775-787.

[3] Diana DeAre, Longitudinal Migration Data from the Survey of Income and Program Participation, Current Population Reports Special Studies, Series P-23, No. 166. Washington, D.C.: U.S. Bureau of the Census, 1990.

[4] Wage Sclerosis, The Economist, August 19, 1989, pp. 12-13.

[5] U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, Washington, D.C.: Superintendent of Documents, various years.

[6] According to the Statistics of Income, in 1986, 1,790,938 taxpayers claimed moving expense deductions on their returns. In 1987, the number fell to 960,651; and in 1989 fell further to 898,825. (Note that the change in the tax deduction could also have reduced the number of returns with a deduction for moving expenses by creating a disincentive to move).

[7] U.S. Department of Treasury, Tax Reform for Fairness, Simplicity and Economic Growth, November 1984, pp. 122-123. Washington, D.C.

[8] Employee Relocation Council, 1988 Relocation Trends Survey, 1989. Washington, D.C.

[9] John R. Hicks, The Theory of Wages, London Macmillan Press, 1932.

[10] Theodore W. Schultz, Investment in Human Capital, American Economic Review, March 1961, v. 51, pp. 1-17; Gary S. Becker, Human Capital, New York: National Bureau of Economic Research, distributed by Columbia University Press, 1964; and Larry Sjaasted, The Costs and Returns of Human Migration, Journal of Political Economy, Supplement, Oct. 1962, v. 70, pp. 80-93.

[11] L. Sjaasted, ibid.

[12] For useful surveys of economic models of migration, see Michael J. Greenwood, Research on Internal Migration in the United States: A Survey, Journal of Economic Literature, June 1975, v. 13, pp. 397-434; Michael J. Greenwood, Human Migration: Theory, Models, and Empirical Studies, Journal of Regional Science, Nov. 1985, v. 25, pp. 521-544; and William J. Kahley, Population Migration in the United States: A Survey of Research, Economic Review, Jan./Feb. 1991. Atlanta: Federal Reserve Bank of Atlanta.

[13] Solomon W. Polacheck and Frances W. Horvath, A Life Cycle Approach to Migration: Analysis of the Perspicacious Peregrinator, in Ronald Ehrenberg (ed.), Research in Labor Economics. Greenwich, Ct.: JAI Press, 1977, pp. 103-49. Frank W. Porell, Intermetropolitan Migration and Quality of Life, Journal of Regional Science, 1982, v. 22, pp. 137-158, finds economic factors to be more important in explaining migration than quality of life factors. William Kahley, op. cit., p. 19, finds that both a states income growth and expected pay have a positive effect on in-migration.

[14] Michael J. Greenwood and Gary L. Hunt, and John M. McDowell, Migration and Employment Change: Empirical Evidence on the Spatial and Temporal Dimensions of the Linkage, Journal of Regional Science, May 1986, v. 26, pp. 223-35.

[15] Theoretical analyses include A. Schwartz, Interpreting the Effect of Distance of Migration, Journal of Political Economy, Sept./Oct. 1971, pp. 1012-1031; Ian P. King, A Natural Rate Model of Frictional and Long-Term Unemployment, Canadian Journal of Economics, Aug. 1990, v. 23, pp. 524-545; and Simon M. Burgess, A Search Model With Job Changing Costs: Eurosclerosis and Unemployment, Oxford Economic Papers, Jan. 1992, v. 44, pp. 75-88. Empirical evidence is found in Janet C. Hunt and James B. Kau, Migration and Wage Growth: A Human Capital Approach, Southern Economic Journal, Jan. 1985, v. 51, pp. 697-710; Mark C. Berger and Glenn C. Blomquist, Geographic Mobility and Quality of Life, Paper presented at the annual meeting of the Population Association of America, March 1989; and Richard Kahley, op. cit., p. 19.

[16] See King, ibid., and Burgess, ibid., for theoretical analyses. Empirical studies include: Julie DaVAnzo, Does Unemployment Affect Migration, Review of Economics and Statistics, 1978, v. 60, pp. 504-514; and Donald R. Haurin and R. Jean Haurin, Net Migration, Unemployment, and the Business Cycle, Journal of Regional Science, May 1988, v. 28, 1988, pp. 239-254.

[17] Employee Relocation Council, op. cit., p. 16.

[18] For discussion of how tax wedges lower economic well-being, see Harvey S. Rosen, Public Finance, 3rd Edition. Homewood, Ill., 1991, Chapters 13 and 14.

[19] Source: Nations Business, August 1990, Small Firms Pay More for Relocations, p. 8.

STATEMENT OF THE EUROPEAN-AMERICAN CHAMBER OF COMMERCE

INTRODUCTION

The European-American Chamber of Commerce in Washington, DC is pleased to provide the Senate Finance Committee its views on the Administration's tax proposals. Our remarks are focused on those provisions in the international section which have a particular impact on our member companies, specifically the proposals on earnings stripping and transfer pricing. Since the Chamber was formed a few years ago, most of our tax concerns have centered on proposals which would treat U.S. companies with European parents differently from other U.S. companies. For that reason, we would also like to take this opportunity to provide the Committee with information on the contribution European-affiliated U.S. companies make to the U.S. economy.

The European-American Chamber of Commerce is a joint endeavor of the European and American business communities to promote and sustain a healthy, open and mutually beneficial business climate in both the United States and Europe.

The Chamber seeks to advance policies that foster greater economic growth in the trans-Atlantic trade and investment relationship. This economic partnership is substantial and mutually beneficial, involving $400 billion in cross investment, $220 billion in two-way trade, and total investment-related employment of nearly 6 million workers.

European-affiliated U.S. companies pride themselves on being good corporate citizens and clearly make an important contribution to the U.S. economy. Because of their positive impact, the Chamber believes that European-affiliated companies should not be discriminated against in terms of investment, tax or trade policy.

IMPACT OF EUROPEAN AFFILIATED U.S. COMPANIES—INVESTMENT AND JOBS

European based investment in the U.S. provides a steady flow of funds and jobs to the American economy. The bulk of all U.S. investment from abroad comes from European firms. These companies' U.S. investments now exceed $400 billion and benefit the American economy through:

- **Job creation**—European firms provide jobs in every state of the U.S. European subsidiaries employ 2.9 million U.S. workers—more than all other nations combined—and supply 7 percent of U.S. manufacturing jobs. They provide at least 3% of the manufacturing jobs in each state.
- **High wages**—European subsidiaries pay wages that are almost 20 percent higher on average than those of U.S. firms as a whole, reflecting these firms' demand for highly-skilled and well-educated labor.
- **Increased spending**—Payroll, capital, operating and R&D expenditures by European firms in the U.S. boost domestic demand for business-related goods and services. The above-average salaries European subsidiaries pay their workers also stimulate the economy indirectly by sustaining increased consumer demand for goods.
- **Skill and technology transfer**—Alliances with European firms—which are world leaders in their field—enable American companies to tap into global resource-and-skills networks that are on the cutting edge of technology. This helps keep U.S. production methods competitive globally.
- **Philanthropic contributions**—Realizing that businesses prosper when communities prosper, European firms have started numerous programs that foster education, improve neighborhoods, support the arts and preserve the environment in the regions where they operate.

Many European-affiliated U.S. firms have maintained domestic production facilities for decades and believe their ongoing investment in the U.S. market reflects a clear commitment to manufacturing for the United States in the United States. Communities and workers clearly benefit from the open investment relationship the United States has historically enjoyed with Europe. States have long realized the contribution these companies can make to local economies, and actively recruit new investment.

U.S. business has benefited as well. The United States' open investment relationship with Europe has meant that American companies have been able to share in the benefits of European integration. In fact, U.S. multinationals sell more in the EC than any where else, including North America. Europe is also the United States' most important trading partner, with the U.S. enjoying a nearly $9 billion trade surplus in 1992.

TAX POLICIES AFFECTING EUROPEAN-AFFILIATED U.S. COMPANIES

The Chamber believes that the collection of taxes from international companies in any jurisdiction should be applied regardless of the companies' affiliation with a parent company abroad. Non-discriminatory tax treatment of international companies helps and encourages firms to compete around the world. The Chamber believes that tax issues should be guided by the following principles:

- *National treatment.* Tax rules should not discriminate against corporations with nonresident shareholders. U.S. affiliates of foreign corporations should be taxed in the same manner as U.S.-owned corporations. Similarly, U.S.-owned foreign corporations should be taxed in the same manner as foreign-owned foreign corporations. National treatment is the central principle of international trade law and bilateral income tax treaties. Countries that depart from national treatment in the pursuit of their self-interest, inevitably provoke retaliation that leave all countries worse off.
- *Reduction of tax barriers to cross-border investment.* The interaction of U.S. and foreign income and withholding tax rules frequently cause cross-border investment to bear a higher tax burden than domestic investment. Such rules are the equivalent of tariffs on export capital and impede the investment flow and efficient worldwide allocation of capital.
- *Expansion of tax treaty network.* Bilateral tax treaties have proved to be one of the most useful tools for advancing national treatment and reducing barriers to cross-border investment. The Chamber strongly opposes unilateral abrogation of tax treaty commitments.
- *Increased harmonization of tax systems.* Harmonization of national tax systems has been recognized as a critical element for achieving the free movement of goods, services, and capital within the European common market. Similarly, harmonization of U.S. and European tax policy objectives is a desirable, though clearly a long-term objective.

IMPACT OF THE CLINTON ECONOMIC PACKAGE ON EUROPEAN-AFFILIATED U.S. COMPANIES

The Chamber believes that the Clinton economic package advances tax proposals that directly target U.S. affiliates of European companies. These proposals ignore the fact that the net contribution of European-affiliated firms to the U.S. economy is no less than other U.S. companies. U.S. companies of European parentage are proud of their positive contribution to the U.S. economy, in terms of the number of jobs they support, the higher wages they provide to U.S. workers, and the value added to the technology base.

Discriminatory and burdensome policies contained in the Administration's proposals on transfer pricing and earnings stripping work against companies which clearly contribute to the U.S. economy. They also run counter to the Administration's goal of creating jobs and improving the overall economic health of the United States.

ENHANCED EARNINGS STRIPPING PROPOSAL

This proposal is intended to address the two kinds of perceived abuses wherein a subsidiary borrows from a parent company abroad (where it is assumed they pay lower tax rates [See Exhibit 1.1]), and then deducts interest paid to the parent instead of paying out dividends on earnings, which are subject to U.S. tax. A variation of this perceived abuse could occur when a parent company issues its guarantee to a bank, which in turn lends money to the subsidiary. If that subsidiary is perceived as being "thinly capitalized," the alleged abuse is that the parent may pay more interest expense (and less tax) in the U.S., than in the home country (which again is assumed to be a lower tax location). Also under suspicion are so-called "back-to-back" loans and other "conduit" type arrangements. A "back-to-back" loan occurs when a parent company makes an interest-bearing deposit with a bank, which in turn lends the money to the U.S. affiliate. The U.S. affiliate would receive a tax deduction for interest paid to a bank, while the same bank pays interest to the affiliate's parent overseas, less a "spread" or commission for its assistance.

Currently, Section 163(j), which the Administration proposes to "enhance," was enacted in 1989 over the strong objection of the Treasury Department. Under Section 163(j), and proposed regulations issued on June 12, 1991, a deduction for interest paid or incurred by a U.S. subsidiary to an "exempt related person is disallowed if the interest is deemed "excess interest expense," and the subsidiary's debt-to-equity ratio exceeds 1.5 to 1. A U.S. subsidiary is deemed to have "excess interest expense" when the interest paid to an "exempt related person" exceeds 50 percent of the subsidiary's "adjusted taxable income." "Excess interest expense" can be carried

forward. The debt-to-equity ratio operates as a safe harbor, but must be satisfied each year.

The legislative history to Section 163(j), and the June 1991 regulations, anticipated further regulations to address the perception of abuses due to guarantees, "back-to-back" and other "conduit" loans noted above. With regard to the date of the regulations, the legislative intent behind Section 163(j) also specified: "The conferees expect that any such regulations would not apply to debt outstanding prior to notice of the rule if and to the extent that the regulations depart from positions the Service and the Treasury might properly take under analogous principles of present law that would recharacterize guaranteed debt as equity."[1]

In the "Summary of the Administration's Revenue Proposals," Section 163(j), and the June 1991 regulations would be "enhanced" by treating any loan from an unrelated party that is guaranteed by a related party as related party debt for the purposes of the earnings stripping rules. That is, no distinction is made as to the deductibility of interest in situations where the lender would make the loan even without the parent guarantee. This directly conflicts with the 1989 legislative history which contemplated that the regulations would be issued distinguishing "ordinary course" guarantees from "nonordinary course" guarantees, and that only the latter would be attacked. In addition, the new proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993, without grandfathering interest paid or due under existing obligations.

The Chamber believes that currently Section 163(j), even without "enhancement" of the Code is discriminatory in that it treats foreign-owned U.S. companies with owners abroad less favorably than domestically-owned businesses. This is an affront to the U.S. bilateral income tax treaty standard which obligates the United States to treat subsidiaries of foreign companies fairly. None of the member states of the European Community have enacted rules similar to the Administration's provisions, with the exception of France, which has promulgated minimum debt-to-equity rules which apply to domestic French firms as well. The Administration's proposal to enhance these provisions also enhances the kind of discrimination that the government has historically opposed.

Unilateral legislation which violates non-discrimination clauses in tax treaties sets a bad precedent in dealings with U.S. trading partners. It comes at a time when the Administration needs to encourage, not discourage, investment in the U.S. in order to strengthen the economic recovery and create jobs. This is important because foreign direct investment supported U.S. economic growth throughout the 1980s. Investment in the U.S. appears to have declined in 1992.

Section 163(j) and the Administration's "enhancements" are largely based on the assumption that U.S. affiliates actively use earnings stripping because they enjoy lower tax rates in their parent countries. However, parent companies based in European countries, which account for $258 billion and 63% in 1991 of total foreign investment in the U.S., actually tend to incur corporate tax rates in their home countries that are equal to or higher than U.S. corporate tax rates. In 1991 countries accounting for 85.8% of total European investment in the U.S. subjected these parent companies to corporate tax rates equal to the current U.S. rate or higher (See exhibit 1.1); The suspected motive for earnings stripping simply does not exist for European businesses.

The Administration's proposal to "enhance" earnings stripping legislation comes three years after Section 163(j) was enacted, but before guarantee regulations could be issued and commented on by taxpayers. The delay of three years in adopting regulations to enforce Section 163(j) is evidence of the difficulty in writing regulations for a flawed underlying statute. Loans have often been made to U.S. affiliates of European companies that would be made "in the ordinary course" of business without a parent guarantee. Furthermore, debt-to-equity ratios appropriate for one particular industry are totally inappropriate for other industries. Regulation writers faced the task of devising fair, mechanical tests which would allow interest deductions for loans obtained "in the ordinary course," while disallowing interest on "bad" loans.

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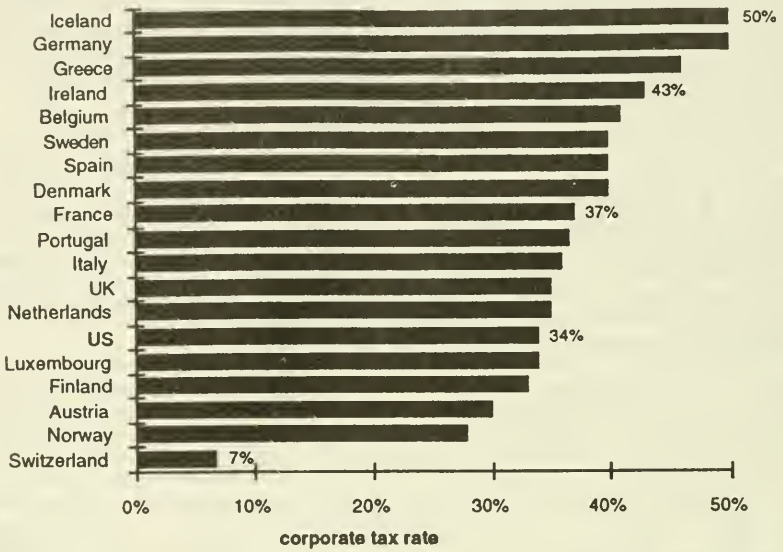
[1] See Conference Report of Omnibus Budget and Reconciliation Act of 1989, H. Rep. No. 386,101st Congress, 1st Session at 567(1989).

Exhibit 1.1

INTERNATIONAL CORPORATE TAXATION RATES



Notes:
Rates shown are for federal government only. Several countries apply lower rates to corporations with profits below a certain threshold. Ireland taxes the manufacturing sector at 10%. Switzerland uses a progressive tax rate schedule, with rates ranging from 3.63 to 9.8 percent; 7 percent is an average. The Netherlands taxes the first GLD 250,000 of profits at a higher rate (40 percent).

Source: "Taxation in OECD Countries," Paris, 1993, p. 66 (1990 data)

In the face of these difficulties, the Administration is attempting to "enhance" the rules by characterizing all guaranteed debt as "bad," and allowing no transition period for guaranteed debt that is already on the books. This approach includes loans made by U.S. banks, where earnings stripping is impossible since interest paid by a borrower to a U.S. bank is subject to U.S. tax.

Should the Administration's legislation apply against interest paid or accrued after December 31, 1993, it would disregard the legislative intent of existing law. Retrospective treatment is fundamentally unfair to debt negotiated before that date. It will result in expensive renegotiation of guaranteed bank loans and repurchase of guaranteed public debt where the terms of the debt, in most cases, do not allow the borrowers to call the debt based on a tax change which denies interest deductions. This kind of higher expense will result in less income, and less tax. Yet this is only one revenue losing aspect of the proposal.

The Treasury Department estimated in its February 1993 proposal, that its "enhanced" earnings stripping rules would raise revenues by almost $600 million. The Joint Committee on Taxation has lower expectations of only $165 million. However, a strong case can be made that the new proposals will actually reduce tax revenues.

Banks in the U.S. and elsewhere, underwent a period of serious loses in the late 1980s. As a result, banks tightened credit requirements encouraged by authorities, which raised banks' capital requirements as part of these tightened credit policies. They now look very carefully at the credit worthiness of a U.S. subsidiary before they lend, and they also require guarantees from foreign parent companies, mainly

in startup situations where the U.S. affiliate has no credit history. Optionally, for larger loans, they may ask for a parent guarantee in return for a lower borrowing rate. Given these developments, the impact of "enhanced" earnings stripping is easy to predict. The results are exactly the opposite of those intended.

Large borrowers, who used parent guarantees to negotiate slightly lower interest rates, will now have to renegotiate their loans at slightly higher interest rates without parent guarantees. The higher interest expense will translate directly into lower tax revenue. The other effect will be that companies who want to invest in the U.S., finding that they cannot guarantee the debts of their startup operations, will move elsewhere. New investment, new jobs and new economic activity will be discouraged. The Chamber believes this is not the Administration's intent.

Another change in lending behavior has occurred since the passage of Section 163(j). In the three years since this provision was implemented, loans have been renegotiated. Discussions with our Member financial institutions lead us to believe that parent companies have been afraid to renew guarantees or set up new guaranteed loans. Our discussions with investment officials of European governments indicate that while they still view Section 163(j) as discriminatory, they have not considered retaliation, because companies have changed their debt structures and are not complaining about it. It is arguable that any earnings stripping. abuses which may have existed no longer exist.

Where no advantage for earnings stripping exists, there is no need for earnings stripping regulation. As pointed out above, countries accounting for 85.8% of total European investment in the U.S. subjected these parent companies to corporate tax rates of 34% or higher. An important modification would be to allow the deductibility of interest on loans which are guaranteed by parents residing in countries having tax rates comparable to the U.S. Additionally, startup operations from any country should be allowed to deduct interest on loans when backed by parent guarantees for a limited period of time, such as three years. Finally, grandfathering provisions should be made for guaranteed loans which are already on the books.

Passage of "enhanced" earnings stripping proposals will probably result in less, not more revenue. Many believe that Section 163(j) has already had negative impact on investment and growth. Necessary modifications can be accomplished through regulation, rather than enacting additional complex legislation.

TRANSFER PRICING INITIATIVE

This proposal appears aimed at perceived problems in applying penalties that were enacted in Section 6662(e) of the Code in 1990 and the general provisions under section 482. The Administration's proposal, new, temporary regulations applying to Section 482, and the 1990 law, attempt to address a situation in which multinational firms import goods and services from affiliated companies abroad at an artificial price, and that this "transfer price" (the transfer price being the price charged between the affiliated firms) allows them to reduce the amount of tax they pay in the U.S.

It is alleged that by raising the price of some goods and services international companies can shift income out of the United States to a lower tax jurisdiction abroad. This concept presumes that a motivating factor exists, and that the foreign jurisdiction imposes less tax on income than does the U.S. As noted above, in the case of the majority of European countries, this is not true (see Table 1.1).

Current law requires that companies prove that the transfer price of a good or service is similar to a transaction with an unaffiliated company. This is commonly referred to as the "arms length standard."

On January 13, 1993, the Internal Revenue Service provided new, temporary Section 482 regulations that affirmed the "arm's length standard," but would replace current rules applicable to inter-company transfers of intangibles and modifying current rules in regard to tangible property. The new regulations also provide new methods which may be used to account for profits and pricing. In terms of penalties, the proposed regulations for substantial valuation misstatements would carry a 20% of misstatement penalty, and gross valuation misstatement would carry a 40% penalty in Sections 6662(e) and 6662(h).

The Administration's proposal on transfer pricing would only apply the "reasonable cause and good faith exclusions" to the 6662(e) penalties if companies provide the IRS with contemporaneous documentation to justify the methodology used by the taxpayer, demonstrating that the application of one or more reasonable transfer pricing methodologies was applied to the transaction. In order to qualify, companies must also document and observe all requirements imposed by Section 482. However, if a taxpayer chooses to pursue "other" methods than those prescribed, they must "establish that, at the time of the controlled transactions, the prescribed methods

would not be likely to lead to such a result." This would override the "best method" rule of the temporary Section 482 regulations referenced above. Under the "best method" rule, companies would only be required to prove the efficacy of the chosen method in establishing an "arm's length standard," without the onerous task of proving the negative neglected methods. The Chamber perceives a number of problems in this transfer pricing proposal:

- The Administration's proposal does not make clear when the taxpayer is required to provide its "contemporaneous" documentation: at the time of the related party transaction, or at the time of the tax return for the year in question. The work involved in documenting and analyzing a transfer that meets the "arm's length standard" is difficult. It strikes us as impossible to do at the time of the transaction.
- The applicability and justification of "other" methods, should the taxpayer choose a methodology outside one of those "specifically prescribed" in the 482 regulations, creates a serious and onerous task for companies. It results in a situation in which the taxpayer will have to defend the "reasonableness" of its methodology by using an unprescribed method. Trying to prove a negative, in that none of the "prescribed" methods produce an "arm's length transfer price," is an enormous burden and likely unattainable.
- The documentation requirement is excessively broad. Aimed at ensuring the accuracy of the "arm's length method," the requirement is crafted to capture too wide a number of transactions given the low threshold for application of the penalty for large corporations. For aggregate Section 482 adjustments of more than $10 million per year, a 20% penalty will apply, and a 40% penalty will be imposed on adjustments above $20 million per year. Such limits could be easily exceeded by a large corporation, even if the adjustment is relatively small: Consequently, the comprehensive documentation requirement of the "arm's length requirement" will apply to a very large number of inter-company transactions for large international companies. This Section could require an extremely large documentation burden on thousands of products.
- "Reasonable Cause," under Section 6662, applies an inappropriate test under this Section. It requires that the documentation of a taxpayer's chosen methodology must show that the methodology produced a result that was more likely than not to be sustained on the merits as "arm's length method." This "more likely than not" standard is one that is usually reserved for evaluation of a legal opinion, rather than evaluation of the reasonableness of a pricing analysis.

The penalties and requirements in this Section are coupled with a transfer pricing enforcement initiative. We appreciate that this is aimed at those taxpayers whose current transfer pricing practices are not sufficiently focused on compliance with the arm's length standard. The Chamber does not oppose such an initiative, but hopes that the Committee will insure that this endeavor results in expedited review of returns rather than simply an expansion of invasive and time consuming investigations.

The Chamber appreciates that the proposal is applied on predominately a non-discriminatory basis, although we would note that it will create a heavier documentation burden on foreign affiliated U.S. firms. We also appreciate that the proposal intends to maintain the "arm's length standard" and does not resort to protectionist, discriminatory ideas such as "formulary apportionment," "unitary" or minimum taxes. Such proposals would establish a huge disincentive for investment in the United States and could erode the healthy economic environment that European-affiliated U.S. companies have enjoyed for decades. Additionally, our U.S.-owned Member companies fear that such proposals would result in retaliatory measures abroad that would reduce their international competitiveness. These concerns have already been expressed numerous times within the Congress.

In a February 11, 1993, report entitled *Reducing the Deficit,* the Congressional Budget Office stated that such proposals would "discriminate against foreign owned companies, in violation of U.S. treaties, by taxing their income more heavily than the income of their domestic competitors. The minimum tax would be especially onerous on foreign-owned companies starting new businesses in the United States because new businesses are seldom profitable initially." The report adds that "Other countries are likely to treat the minimum tax as a protectionist measure and retaliate with similar taxes on U.S. owned companies conducting business within their borders. If so, then the minimum tax would stifle international trade and reduce economic welfare throughout the world."

CONCLUSION

It is clear that European-affiliated companies are good U.S. corporate citizens. They want and deserve to be treated like any other U.S. company. The earnings stripping and transfer pricing provision of the Clinton economic plan do not give full appreciation to the contribution of these firms and clearly place them in a secondary category of corporate citizenship. We trust that the direction of those proposals will be reversed during the process of Congressional consideration of tax legislation, and we would be pleased to cooperate with this Committee in any way to achieve that end. We thank the Committee for the opportunity to share our views and hope that you will take them under consideration.

STATEMENT OF THE EXECUTIVE INTELLIGENCE REVIEW

We propose that some form of nominal but otherwise significant universal tax be placed on individual derivative transactions not only in the U.S., but abroad. The included purpose of this taxation is not merely to derive a new source of revenue--much needed tax revenue, from a source whose taxation will be harmless to the real, that is physical economy, but also to bring into the light of day under penalties of law for non-payment of this tax, the magnitude and structure of the derivative bubble as a whole.

It is clear that the derivative bubble by the very nature of these transactions is a financial bubble in the tradition of the more primitive, more rudimentary and far less dangerous bubbles of the 18th century such as the John Law bubble in France and the South Sea Island bubble in England at the same period of time.

Today's derivate bubble is the John Law Bubble gone mad. The vulnerability to the entire financial system, the chaos and destruction of actual physical processes of production, distribution, employment and so forth is incalculable, and therefore this thing must be brought under control promptly. Otherwise all fine plans of stabilization of financial markets and economies, and budget management, go out the window as empty pipe dreams.

We must bring this under control and the best way to do it, we believe, is to impose a universal tax on each individual transaction as a percent of the nominal value of the matters which are traded in these credit, interest, swaps, options, index and other similar derivatives. That is the only way that we'll bring the magnitude and structure of this into the light of day and force some rationality into the situation and thus prepare ourselves to be able to take competent moves in order to bring the market as whole under control.

Moving to tax this runaway speculation is a prerequisite for taking the economy-building measures of infrastructure repair and expansion, job creation, and so forth, whose result will be a healthy expansion of the tax base--the foundation for restoring control over the federal budget.

The Magnitude of the Bubble

The magnitude of values traded in derivatives transactions, and related forms of specualtion in currencies, etc., is multi-trillions of dollars annually, and growing. Daily derivatives trading is estimated to be in the one trillion dollar range. Daily trading in foreign currencies is one trillion dollars. One aspect of this was shown in the report released this month by the Bank for International Settlements (BIS,) the Quarterly BIS study, "International Banking and Financial Market Developments." The BIS data shows the scale of the wild currency speculation last September. BIS member country banks recorded some $400 billion upswing in international lending in the 3rd Quarter 1992, followed by a $400 billion decline as speculators paid back currency loans the following 4th Quarter.

A Potential $150 Bil Per Year Revenue

What we propose is a tax at the rate of one-tenth of one percent of the notional value of the instrument traded, which on an annual basis, we estimate would result in the United States in a potential tax revenue of $150 billions. This compares most favorably with the size of the current budget deficit. It is to be noted, however, that in the process of implementing the tax, the market itself will tend to evaporate fast--the margins in trading are slim, and the nature of a bubble is to expand, fizzle or pop. However, equal to revenue benefits, the benefit of the tax on derivatives transactions is the restoration of control over outlaw financial activities, for purposes of the public good.

Who Proposes Regulations?

There are several voices raised to warn that action must be taken. Since 1978, Dr. James Tobin, now Sterling professor emeritus at Yale University, has been calling for an international uniform tax on spot transactions in foreign exchange--including the derivative forms of options and also deliveries on futures contracts. The Bank for International Settlements is calling for some form of regulation to "bleed" some hot air out of the Bubble, in hopes to keep it afloat without a Grand Pop. This month, the U.S. Securities and Exchange Commission has also called for a period of public comment on what actions can be taken to regulate the derivatives market.

The derivatives transactions tax we propose here was advanced this March by economist Lyndon LaRouche, the political prisoner most known for his advocacy of emergency measures to rebuild the U.S. economy, and for his role in advancing the strategic defense initiative policy and technologies in the early 1980s.

What If the Bubble Pops?

In summary, unless we bring this derivatives market under control and begin to shut it down at least to a significant degree promptly, we're going to have the biggest financial blowout in history--bigger than the John Law-type bubbles of the early 18th century. We better bring it under control fast.

Instead of going the route of trying to find an acceptable tax on the shrinking remainder of the real physical economy and the beleaguered population--the proposed BTU tax, Value Added Tax, health care tax, Social Security tax, etc., the alternative is to tax derivatives speculation, not people.

STATEMENT OF THE GENERAL AVIATION MANUFACTURERS ASSOCIATION

Mr. Chairman. Thank you for the opportunity to appear before this committee. I am Edward W. Stimpson, President, General Aviation Manufacturers Association (GAMA). Our association represents United States companies that manufacturer business, commuter, and personal aircraft, engines, avionics, and component parts. The aircraft our companies manufacture have 19 or less seats. They are an important part of our national air transportation system, carrying over 120 million passengers per year.

STATUS OF THE INDUSTRY

In terms of airplanes produced, 1992 was the industry's worst year since World War II—only 899 aircraft were delivered. This is in contrast to nearly 18,000 airplanes which were shipped in the late 1970s. Industry billings for 1992 were down seven percent from 1991 levels and shipments were down 12 percent. Clearly, our industry has never experienced economic recovery and we anticipate 1993 will be a challenging year.

In spite of a sluggish U.S. economy, our export market has remained active. In 1992, over 40 percent of the aircraft shipped were exported, and we foresee the export market as being important in the future.

Despite these difficult economic times, the U.S. general aviation industry has continued to invest in new products and new technology. Within the next five years alone, over one billion dollars will be spent on new aircraft development. However, the most important element for the health and vitality of our industry is a growing and expanding domestic and global economy.

We welcome and support President Clinton's goals to stimulate the economy and to reduce the federal deficit. Our industry is committed to cooperating with the Administration and Congress in achieving this goal.

REVITALIZATION PROGRAM FOR GENERAL AVIATION INDUSTRY

GAMA believes that a four-point program could reinvigorate the general aviation industry: (1) reenactment of the investment tax credit (ITC), (2) repeal of the luxury tax on airplanes, (3) product liability reform, and (4) continued improvement of the aviation infrastructure. Today, however, I will emphasize the tax issues.

REENACTMENT OF THE INVESTMENT TAX CREDIT

We were encouraged by President Clinton's statements about the investment tax credit being a key element of the stimulus package. However, we fear that the President's tax package, as it applies to business, will not realize the goals intended.

In light of the budget deficit, Congress must carefully balance the value of tax incentives against additional government "spending." Nevertheless, business tax increases, added to the complexities and limitations of the two investment tax credit proposals, greatly mitigate the effectiveness of the ITC as an incentive to buy a business aircraft.

Historically, the investment tax credit has stimulated growth in our industry and has been an important incentive for our customers to invest. After the ITC has been enacted (or reenacted) on average, sale of new aircraft have gone up by 30 percent the first year and 50 percent in the second year. As a result, thousands of jobs have been created. A chart showing the historic impact of the ITC is attached.

Why has the ITC been so successful in the past? We would suggest two important criteria: (1) the potential buyer must understand the ITC, and (2) the buyer must see the ITC offers significant value.

The "incremental" aspects of the proposed ITC does not meet the first criterion. It is too complex, and has too many qualifications to be easily understood by most of our customers. Even for those who may choose to use the incremental ITC, it's real economic value is only about one and one half percent, rather than seven percent. Thus, it is difficult for customers who could qualify for the ITC to see any significant value.

On the other hand, the proposed small business ITC could provide a more meaningful benefit because it is simpler to understand and has a greater economic value.

We urge this committee to improve the Administration proposal and make both ITC proposals simpler and of greater economic value. This will make them more effective sales tool and economic stimulus along the lines of former ten percent ITCs.

LUXURY TAX

Although the luxury tax was not included in the Administration's proposal, we are heartened by statements that the President supports repeal. We urge you to use the

language included in H.R. 11 last year. As you know, this repeal language was passed by the Congress twice last year and was vetoed each time for reasons unrelated to its merits.

The luxury tax has depressed sales of new business aircraft, as it has sales of other types of equipment. Instead of buying new aircraft, customers have bought used aircraft. There are certain provisions in the luxury tax which limit its impact, however, the fact is that potential customers the tax *may* apply, and they do not want to keep the additional records necessary to prove the tax *does not* apply. Businesses that otherwise would be our customers can simply buy used aircraft and avoid the luxury tax. As a result, millions of dollars of new aircraft sales have been lost.

The tax revenues generated by this tax are small compared to the negative impact of lost sales and jobs. In calendar year 1991, this tax brought in merely $119,000. For the first three quarters of 1992, only $139,000 was raised.

We are losing potential sales every week. It would be very helpful if Congress would assure our customers that repeal of the luxury tax will be effective on January 1, 1993.

BTU TAX

Obviously, any increase in operating costs is not welcomed by us or our customers. Our calculations show that if the tax is applied according to the published formula, seven or eight cents per gallon would be added to the price of aviation fuel. This could equate to as much as a $100 million dollar per year burden on general aviation users.

Our primary concern is that the BTU tax should apply uniformly to all types of transportation. We ask the Congress to ensure general aviation users do not bear more than their "fair share." In other words, the tax should be based on actual BTU consumption of each transportation mode. Price elasticity should not be allowed to transfer tax payment to other modes.

General aviation is currently paying a federal fuel tax of 15 cents per gallon for aviation gasoline and 17½ cents for jet fuel, plus state and local taxes and fees. Federal taxes go to the Airport/Airway Trust Fund. We recommend that the proceeds from this new BTU tax be placed in the Airport/Airway Trust Fund, and that general aviation users be given credit for this contribution as part of our financing the airport/airway system.

AIRCRAFT REGISTRATION FEE

The proposal to enact an annual federal aircraft registration fee of $270 is punitive and unfair. As it is unrelated to use of the airport and airway system, it is simply a property tax on aircraft owners which is already applied by many state governments. A combined registration fee and BTU tax would certainly be an onerous burden. The registration fee is a bad idea that should be forgotten.

STATEMENT OF THE MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. Chairman and members of the committee, my name is Clyde D. Batavia, president of Joe Clar and Sons Inc., Oakland, California. I am writing today as president of the Machinery Dealers National Association (MDNA).

Founded in 1941, MDNA is a national trade association representing nearly 500 corporations which sell used metalworking and other capital equipment in virtually every state.

MDNA does not have the resources to retain economists, consultants or other experts to debate whether the Congress should reinstitute the investment tax credit. However, if, in the wisdom of this committee, it proposes that an investment tax credit be enacted, I can tell you why it should be extended to used capital equipment.

In the machine tool industry today the vast majority of manufacturers are no longer American, but Japanese, German and Italian. By making the investment tax credit apply only to the purchase of new equipment, you are encouraging the purchase of foreign made goods with U.S. dollars, which, needless to say, will have a negative effect on the balance of trade.

In addition, it is simply not necessary in industry today to purchase and spend the millions of dollars it takes to buy new machine tools when there is a large quantity of very high quality used machinery available on the market which will accomplish the same task of improving and enhancing production.

Two common factors in the decision to buy used equipment are cost and availability. Market and/or production conditions strongly influence capital investment decisions. When smaller manufacturers have the opportunity to increase sales it often requires an immediate increase in production capacity. Most newly produced U.S. manufacturing equipment takes from 18 to 30 months to deliver—and this time lag would probably cancel the additional sales.

Because they are not highly leveraged, some smaller manufacturers are not able to acquire newly manufactured equipment because they don't have adequate financing to purchase highly expensive replacement machines.

There *is* a demand for late-model used machinery. In many instances, later year domestic used machinery and newly manufactured foreign machines are price competitive. Under President Clinton's proposal, new foreign machines have the advantage of tax credits. Industries seeking to retool then face three choices: Make do with inadequate equipment, purchase imported new machine tools or acquire more efficient used machinery.

If manufacturers retain their inadequate machinery, there is no increase in productive capacity and the goal of economic growth is frustrated. Retooling with imported machine tools is obviously undesirable, both in its ultimate effects on the domestic machine tool industry and in its adverse effect on the balance of payments. Only by retooling with more efficient used machinery can the maximum economic benefits to our nation be realized.

In other words, improving productivity does not necessarily require acquisition of newer machines. Often small manufacturers can increase their productivity by purchasing used equipment which is newer and more efficiently designed for its particular production needs. When small businesses are denied incentives to replace current equipment with used machines that are either more sophisticated or more appropriate for their operations, our economy loses.

What are the alternatives? Make do with existing equipment, merge. be acquired or close up shop.

Because tax credits generate additional investment in newly manufactured machinery, they improve productivity at one level and also make late-model used equipment available for another level of the economy. MDNA members believe that such credits can increase additional investment in used—as well as new—equipment. and also that they will generate economic growth to the extent this replacement equipment is more productive than older equipment.

By excluding used capital equipment you also dilute the ability of small business—which, as you know, represents the majority of jobs—to compete with larger corporations.

It's also important to note that the purchase of used machinery usually results in the hiring of additional employees; whereas, the purchase of new machinery frequently eliminates employees. Small companies are the ones that create jobs. Statistics show that, while the 500 or so largest corporations were—and still are—shrinking their payrolls. small businesses added some 12 million jobs.

The purchase of used equipment is not exclusively the domain of small businesses either. If you exclude used equipment from eligibility for the investment tax credit, you also penalize major manufacturing companies, as well.

For example. our members' customers often include such firms as General Motors, Chrysler, the U.S. Government. and several of the Fortune 500 companies. Even they cannot afford the millions of dollars that it costs for a new machine tool when there are used machine tools which will accomplish the same goal and are readily available for a fraction of the cost of new equipment.

IN SUMMARY

- Improving productivity does not necessarily require acquisition of new machines.
- By excluding used capital equipment new foreign machines have competitive advantages, cheating the domestic machine tool industry and adversely affecting the balance of payments.
- By limiting the availability of such an investment tax credit to new equipment investments, the government dilutes the ability of small business to compete with larger corporations. The difficult problems small businesses face acquiring capital are compounded when necessary used equipment investments are then denied allowances available to newly manufactured equipment investments.

Extending tax allowances to used equipment helps modernize *all* of America and not just the small minority which can afford new equipment.

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STATEMENT OF THE MICROSOFT CORP.

Mr. Chairman, Members of the Committee, my name is Mike Brown. I am Vice President, Finance for Microsoft Corporation. I greatly appreciate the opportunity to testify before the Committee. I am here to urge reconsideration of the proposal to tax royalties as passive income for purposes of the foreign tax credit limitation. This proposal will have a significant adverse impact on America's computer software companies who currently are among this country's star exporters and top economic performers.

Many of the Clinton Administration's initiatives, such as extension of the research and experimentation credit, recognize the importance of making U.S. business more competitive in the global economy. The proposal to tax all royalty payments as passive income, however, is inconsistent with this policy objective. Microsoft believes this proposal may cause many U.S. companies engaged in manufacturing and selling products in foreign markets to develop their technology outside the United States, rather than subject themselves to the substantial additional tax cost associated with licensing technology developed in the United States. The passive royalty provision also will reduce the level of foreign earnings repatriated to the United States, because United States taxpayers will find it increasingly difficult to remit earnings to the United States without a substantial incremental tax cost. U.S. based companies may find it more efficient to reinvest in active operations conducted in foreign countries rather than remit the earnings for investment in United States operations.

BACKGROUND: MICROSOFT CORPORATION AND THE SOFTWARE INDUSTRY

Microsoft develops, markets and supports a wide range of systems and applications software for personal computers or "PCs." By making it easier to use personal computers for an increasing number of purposes, Microsoft products have contributed to the "PC revolution" during the last 15 years. The growth of our company has paralleled the increase in the number of people who use personal computers in this country, from one million in 1980 to more than 90 million today.

Microsoft's products include system software, such as MS–DOS and Microsoft Windows, that act as a computer's "nerve center" allocating computer memory, scheduling the execution of basic functions, and controlling the flow of information among the various components of the microcomputer. We also develop and market application software such as Microsoft Word and Microsoft Excel, our word processing and spreadsheet programs.

Microsoft is a leader in the global personal computer software market. Last year, more than *55 percent* of Microsoft's almost $3 billion in revenue came from foreign sales. Microsoft markets more than 100 products developed in 25 languages and sold in over 200 countries. Our R&D expenditures are significantly more than the average for all American businesses. We employ about 10,000 people in the United States (including over 3,000 programmers and other technical employees) and another 3,000 overseas.

According to a report prepared for the Business Software Alliance by Economist Incorporated, the computer software industry is the fastest growing industry in the United States. Now larger than all but five manufacturing industries, the software industry accounts for $36.7 billion of value added to the U.S. economy in 1992, up from $3.3 billion in 1977. Moreover, the U.S. software industry, and the prepackaged software sector in particular, have been extremely successful in world markets where U.S. prepackaged software products hold an estimated 75 percent market share.

THE PASSIVE ROYALTY PROVISION IS AT ODDS WITH THE WAY AMERICAN SOFTWARE COMPANIES DO BUSINESS AND MAY CAUSE THEM TO MOVE JOBS OFFSHORE

It is essential to understand that the fundamental aspect of any software program is the intellectual property that it embodies. The work of researching, writing, testing and perfecting a software program is very labor intensive. Moreover, practically all this software development work is done in the U.S. and involves precisely the type of highly-skilled, highly paid jobs that this country needs.

When we sell our programs we are essentially selling the right to use this intellectual property. We do not, however, sell the program itself because with every personal computer able to make copies we soon would be out of business. As it is, software piracy is extremely serious—if we could eliminate it our revenues would more than double!

At the "wholesale" level, American software companies sell their programs overseas by licensing them to computer hardware manufacturers who pay a royalty for

the right to "load" the programs into their machines before they are sold. Not only is this an efficient way of distributing programs, but it also significantly reduces the rampant problem of software piracy. A computer manufacturer selling a "naked" machine with no software programs is essentially inviting the purchaser to use copied programs.

At the "retail" level, we sell our programs over-the-counter in shrink-wrapped boxes. Once again, however, these products contain a license for the purchaser to use the software.

Thus some might characterize income from even these sales as royalties for purposes of the tax code (the IRS has yet to definitively rule on this despite various requests from industry members during the last several years).

In short, all of Microsoft's income, whether royalties or sales, is earned from selling software and it should not be treated differently for tax purposes. A significant share of the earnings of America's software companies from foreign sales will be hit by the Administration's proposal to limit their ability to apply foreign tax credits toward foreign source royalty income.

Unfortunately, we think, the result may cause U.S. software companies to move their software development offshore in order to ensure that income from these activities will be considered to have resulted from an active business. This is the *opposite* result of that intended by the Administration's proposal.

The *Wall Street Journal* [1] has recently reported on U.S. multinationals moving research facilities outside the United States. Significant cost reductions may be obtained by employing professionals in other countries such as India, Malaysia, or Russia. A number of countries have urged Microsoft to establish a research center in their countries. To date, Microsoft has avoided moving its research facilities outside the United States. However, the infrastructure needed to establish offshore facilities is available.

If it is not possible to efficiently sell products embodying intellectual property from the United States, then U.S. taxpayers, including Microsoft, must evaluate whether or not to continue to conduct research and development in the United States. In short, the royalty provision calls into question the fundamental issue of whether Microsoft will be forced to create jobs offshore. Relocating research and development is not a desirable alternative, but Microsoft must be able to compete in a global economy.

THE PROPOSAL ACTUALLY WILL ENCOURAGE U.S. BASED COMPANIES TO INVEST IN OPERATIONS IN FOREIGN COUNTRIES DUE TO THE ADDITIONAL TAX COST OF REMITTING THOSE FUNDS TO THE UNITED STATES

The Treasury Department has stated that this provision is necessary because U.S. taxpayers should be prevented from averaging or cross crediting high taxed income and low taxed income for foreign tax credit purposes. However, averaging foreign tax credits with respect to active business income is necessary because it fosters U.S. competitiveness in global markets and compensates, in part, for discrepancies between U.S. and foreign tax laws. It also promotes the repatriation of funds earned abroad to the U.S. for reinvestment in U.S. operations and creation of American jobs. In short, the foreign tax credit provisions have a significant impact on international trade. They should not be radically changed without carefully evaluating the impact on the American economy. Moreover, if the averaging or cross crediting provisions are going to be changed, then they should be changed explicitly and not by attempting to recharacterize particular types of income.

GENERALLY, THE GROWTH IN ROYALTY PAYMENTS SINCE 1986 IS DIRECTLY ATTRIBUTABLE TO TAX LAW AMENDMENTS, NOT TO TAX MOTIVATED TRANSACTIONS

The Treasury Department, in its "Summary of the Administration's Revenue Proposals" cites the increase in royalties since 1986 as evidence that taxpayers have engaged in tax motivated transactions designed to utilize excess foreign tax credits. In reality, tax law changes in 1984 and 1986 effectively required U.S. companies to license intellectual property, and to pay significant royalties. Congress was concerned with the tax free transfer of intellectual property outside the United States and changed the U.S. tax law to require substantial royalty payments.

The passive royalty provision is wholly inconsistent with prior law and appears to penalize multinationals that appropriately increased their royalties in accordance with the "super royalty" provision. Companies that licensed intangibles to their foreign subsidiaries and increased royalties as the subsidiaries' income increased, are

[1] See, *The Wall Street Journal*, March 10, 1993 and March 17, 1993.

now accused of engaging in tax motivated transactions when in fact the U.S. tax law required the growth in licensing transactions during this period.

THE PASSIVE ROYALTY PROPOSAL CAUSES SIMILAR CONSEQUENCES IN OTHER INDUSTRIES THAT SELL PRODUCTS OUTSIDE THE UNITED STATES

We would like to emphasize that while this issue is important to the software industry, the negative impact of this provision is not limited to software or other technology based products. We have consulted on this issue with 17 other American corporations with extensive overseas activity engaged in such diverse industries as consumer products, industrial manufacturing, apparel manufacturing, telecommunications, lumber and paper products. These companies represent the leading companies in their industries. Each of these companies must be able to move intellectual property efficiently in order to compete in the global marketplace. The enactment of the passive royalty provision will have a similar impact on these companies which may result in moving research activities offshore and returning fewer profits to the United States.

SUMMARY

Microsoft recognizes that additional tax revenues must be raised. However, we believe that this provision is unlikely to raise substantial revenues. Instead, this provision is likely to lead American companies to move development of intellectual property offshore rather than subject the royalty income to additional U.S. taxes. Rather than promoting growth in the U.S. economy, the passive royalty provision imposes a prohibitive tax increase on the development of U.S. based technology and deters capital investment in the United States. Thus, the passive royalty proposal does not provide any significant benefit from a tax or economic policy perspective. For these reasons, Microsoft respectfully requests that the tax package to be considered by this Committee not include the passive royalty proposal.

STATEMENT OF THE MULTISTATE TAX COMMISSION

The Multistate Tax Commission appreciates the opportunity to submit this written statement concerning the Administration's foreign tax proposals for the Committee's consideration. The Commission is an interstate organization representing 33 states.[1] One of the Commission's major activities is developing fair and administrable methods of dividing, for state tax purposes, the income of businesses operating across state and national boundaries. This statement concerns the proposal contained in President Clinton's deficit reduction plan to strengthen the federal government's authority to achieve a fair and administrable allocation of the income of multinational corporations to the United States. That authority is of course vested in Section 482 of the Internal Revenue Code.

During his campaign, President Clinton focused attention on the failure of federal policies to stop tax avoidance by multinational corporations due to their transfer pricing practices. He observed correctly that whenever a group of taxpayers avoids paying their properly owed share of taxes, all other taxpayers, unfairly, have to pick up the slack. He also clearly recognized that tax avoidance by multinational businesses hurts our economy, by placing dynamic, small and medium sized businesses who are often competing with them in the same markets—but without multinational operations—at a competitive disadvantage.

Why are state government representatives concerned about the transfer pricing issue? Very simply, because for every dollar that the federal government loses because of improper transfer prices, states—whose tax systems are now largely tied to the federal determination of U.S.-source income—lose 22 cents.[2] If the federal government is losing $10–12 billion annually, as President Clinton suggested during the campaign,[3] that means that the states are losing an **additional** $2—2.5 billion. This brings the combined government revenue losses from transfer pricing to $15 billion annually.

The Commission shares President Clinton's concerns that improper transfer prices are causing a serious drain on the federal treasury. MTC staff research suggests that $10–12, billion in annual losses is a realistic, if not conservative, estimate. Looking at just one category of transactions by one group of multinational businesses illustrates this. IRS data have consistently shown that foreign owned wholesalers and retailers—many of which act as distributors for affiliated foreign manufacturers—pay considerably more for the goods they resell than do U.S.-owned wholesalers and retailers. If they had had the 76 percent cost-of-goods sold to sales ratio of their U.S.-owned competitors rather than the 85 percent rate they reported,[4]

their 1989 taxable incomes would have been $35 billion higher. All other things equal, they would have paid $12 billion more in tax at the statutory 34 percent tax rate. Just this simple "back-of-the-envelope" calculation addressing just one *category* of multinational corporations can, in other words, suggest an annual revenue loss attributable to transfer pricing that is very close to President Clinton's campaign estimates.

Another way that a $10–12 billion annual revenue loss can be substantiated is by comparing it to the total volume of transactions between related corporations that cross the U.S. border each year. A conservative estimate involving some extrapolation of IRS data is $350 billion.[5] At this volume, transfer prices that are "off" on average by just 10 percent would again lead to an understatement of U.S. taxable income of $35 billion and underpayment of tax of $12 billion. This is not to assert that this is the average variance of actual transfer prices from "arm's-length" prices. It is not an implausible variation, however, given that penalties do not even potentially apply until inbound transfer prices are 100 percent too high and outbound transfer prices are 50 percent too low. It is also plausible that taxpayers would take an "aggressive" transfer pricing position to the extent of a 10 percent variance when there is no certainty concerning the true "arm's-length" price in any case and when the IRS has had such little success at sustaining its transfer price adjustments when they are appealed and litigated.

As part of his deficit reduction package, President Clinton proposes to clarify the statutory authority to implement proposed regulations issued by the IRS in January relating to the imposition of penalties when the IRS makes substantial adjustments to transfer prices. Under current law, two different levels of penalties may apply if an IRS auditor's transfer pricing adjustment is sustained through the appeals process and, if need be, the courts. The level of penalty depends upon how large the adjustments are in percentage terms and/or in total dollars. Some penalties may be avoided, however, if the taxpayer made a reasonable effort to determine the proper transfer prices and if the taxpayer reasonably believed that its transfer pricing methodology achieved an "arm's-length" result.

The purpose of the new regulations is to encourage taxpayers to set transfer prices through a deliberate and documented process established by legal and economic experts **before** tax returns incorporating them are filed. The **mechanism** to achieve this is foreclosing the "reasonable cause and good faith" exception to the penalties for taxpayers who do **not** establish and document transfer pricing practices in advance. No more will taxpayers be able to play "audit roulette" secure in the knowledge that should they be one of the unlucky few receiving a Section 482 assessment at the end of an audit, they can **then** expend the resources to hire the accountants, economists and attorneys to defend either their original transfer prices or other transfer prices leading to a smaller assessment. This strategy, should they lose, will now have a significant penalty cost.

The President's penalty-related proposal is a useful and necessary interim measure to minimize the losses to the federal and state treasuries that flow from the fact that nothing in Section 482 compels taxpayers to establish arm's-length transfer prices. However, we believe that the arm's-length pricing system has failed and needs to be replaced. The Administration's full strategy in approaching international tax problems is still, as we understand it, evolving. As that strategy develops, we would recommend that the federal government move actively to replace the failed arm's-length pricing system with a formula apportionment system.

Why has the arm's-length pricing system failed? Because it attempts to do the impossible. It tries to regulate the prices for every category of product, service or intangible asset exchanged between related, jointly owned and controlled corporations. There are more than 46,000 global corporations doing business in the U.S. that operate with and through affiliated corporations in foreign countries.[6] These corporations engage in $350 billion of transactions within their own family of related corporations in foreign nations every year.[7] This amount of controlled trade represents an enormous volume of transactions, and the amount of resources required to audit and adjust the prices for this volume of trade is overwhelming and well beyond even the recently expanded resources of the IRS.

Beyond the sheer volume of controlled transactions, there is the more fundamental problem that the arm's-length pricing method assumes an economic world that does not exist. Trade among jointly owned corporations is not, by definition, arm's-length, free market trade. So the IRS must attempt to discover free market prices for comparable transactions as a standard to adjust the prices in the controlled trade situation. The problem is that for major global industries—such as pharmaceuticals—automobiles, financial services, and electronics—there are frequently no international free market transactions to compare with the controlled trade among affiliated companies. As Louis Kauder, an international tax expert, testified before

the Senate Governmental Affairs Committee on March 25th, attempting to enforce the arm's-length pricing system under these circumstances is something like organizing an Easter egg hunt without first hiding any eggs. No batter how many children are invited to join in the search, and no matter how detailed the instructions are for finding the eggs, none will be found because none are out there."[8]

The fundamental problem of the absence of comparable uncontrolled transactions is illustrated by one of the famous cases the IRS lost: the Bausch & Lomb case. Bausch & Lomb licensed the use of a patent on a unique manufacturing process for soft contact lenses to its Irish subsidiary. The principal tax dispute was over whether or not the amount of royalty paid by the Irish subsidiary to its parent was sufficient. The IRS tried to raise the royalty price being paid, but the problem is that there is no free market price for patents in soft contact lens manufacturing processes. Absent a free market for this asset, the IRS could not prove that its assessment was correct. The case deteriorated, as most such cases do, into a debate over a range of prices, any one of which could be used because there is no single right answer.

Worse yet, unlike the typical case in which a taxpayer has the burden of proof to justify his or her method of reporting income, in the arm's-length world, the IRS, for all practical purposes, must shoulder the burden of proof. The IRS must prove, not only that the taxpayer's reported prices are incorrect, but what the correct prices are. Again, in the big-dollar cases involving valuable intangible assets, this is an impossible task because free market prices necessary for the IRS to prove the taxpayer wrong often do not exist.

Even in more routine cases involving widely sold consumer products, like VCRs or motorcycles, very complicated and subjective adjustments for "volume discounts," "location savings," "market risks," "market penetration strategies," and other economically relevant factors may have to be made. But every such adjustment adds a potentially disputable issue, and any number of prices within a broad range may end up being correct. Because the burden of proof has effectively been turned on its head, the global taxpayer has wide discretion to report what it wishes to various national tax authorities. The arm's-length system thus fails the first test of a tax system, namely that it be mandatory. Because it is based on a false economic premise and is flawed by a misplaced burden of proof, the arm's-length method is more like a voluntary contribution system than a real system of taxation.

The American states confronted the fundamental issues involved in dividing the income of multijurisdictional corporations much earlier than the federal government, because there was significant interstate commerce between related corporations long before there was significant international commerce. The states recognized very early on the practical impossibility of preventing improper income shifting on a transaction-by-transaction basis.

More importantly the states recognized the full range of economic synergies involved in being an integrated economic enterprise that make it theoretically impossible to identify where profit is earned. Jointly owned and controlled corporations that operate together on a global basis benefit from economies of scale, the ability to minimize risk, and the fact that technical expertise and information can often be obtained more cost effectively when it is fixed in the minds of employees than when it has to be purchased on the open market. These kinds of efficiencies generate value for the whole enterprise that is greater than the sum of the parts, and it is this value that cannot meaningfully be divided among separate legal entities as the arm's-length system attempts to do. In choosing formula apportionment of the combined income of all the members constituting an integrated economic enterprise over the current separate entity, arm's-length, transactional approach, the states were thus choosing a system that the "economic theory of the multinational firm" is only now catching up to. Formula apportionment is the method of tax accounting that best fits the economic reality of world trade conducted within global enterprises. It should also be emphasized that formula apportionment is a mandatory taxpayer reporting system, not an after-the-fact income reallocation system like Section 482.

A growing number of international tax experts have either flatly endorsed substituting a combined reporting formula apportionment system for the current arm's-length system, or suggested that the option be seriously considered. Among these experts are Ronald Pearlman, former staff director of the Joint Committee on Taxation, economist Lawrence Summers, President Clinton's nominee to be Undersecretary of the Treasury for International Affairs, and attorneys Stanley Langbein, Michael McIntyre, Louis Kauder, Dale Wickham, and Charles Kerester.[9]

Under a combined reporting, formula apportionment system, the legal entities comprising a distinct and integrated economic enterprise are first identified. For example, if a group of commonly owned corporations is really engaged in two separate businesses, say, steel manufacturing and a department store chain, and there are

no significant economic ties between the two businesses, then the income of the two separate businesses is apportioned separately.

Next, the combined income of the business is determined in a manner similar to the calculation of federal consolidated income, with the key factor being the elimination of intercompany transactions. Returning to the example, assume that the parent company of the department stores is a wholesaler. Further assume that it purchases all inventory from unrelated suppliers. It then resells most of the inventory to the related department stores incorporated separately in each state, and some of it to unrelated department stores. In this case, the charges from the wholesaler to the related retail stores would be eliminated. The business' combined income would be calculated by taking the total of the department stores' retail sales and the wholesaler's sales to independent department stores, and subtracting from it the wholesaler's inventory purchases and all other expenses paid by both the wholesaler and its related department stores to unrelated suppliers (e.g., rent, interest, wages).

Finally, the combined income is apportioned to each state with legal jurisdiction to tax a share of it in proportion to objective measures of the activities engaged ,in by the business in each state. The most commonly-used measures are property, payroll, and sales, and the apportionment is usually done on an equally weighted basis. Thus, if 10 percent of the business' sales to outsiders occurred in State A and 10 percent of its payroll and property were located there, State A would be able to tax 10 percent of the business' combined income.

California, Montana, North Dakota, and Alaska continue to require multinational businesses to do this combination and apportionment on a global basis (although they generally permit an election to include only corporations incorporated in or with most of their business in the United States). The federal government could adopt the same global apportionment system and thereby eliminate any need to examine or indeed worry about intercompany transfer prices.

As in all tax systems, there are complexities to work out and policy choices to be ,made. For example, an overall functional examination of a multinational corporate group needs to be made to determine whether it is engaged in one or multiple lines of business, and, if the latter, to determine which subsidiaries are involved in which business. But this is a far simpler matter than engaging in a functional analysis for transfer pricing purposes, which may require not only the determination, but also precise measurement, of which of two parties to a particular transaction contributed which assets, incurred which expenses, and bore which risks. The inevitable conclusion, however, is that the range of potential controversies between taxpayers and tax authorities is exponentially larger under a transaction-based transfer pricing enforcement system than it is under formula apportionment.

Many "red herrings" are pulled out of the barrel when a federal apportionment option is discussed. Addressing the objections raised to formula apportionment is beyond the scope of this statement. To give one example, however, it should be clear that is far simpler to translate into dollars the annual net income of an entire subsidiary than it is to determine which of two parties in a cross-border transaction is actually bearing foreign exchange risk and then to value this for pricing purposes.

From the standpoint of the resources required to enforce it effectively, formula apportionment beats a system based on adjusting transfer prices hands down. A comparison of the amount of staff time required by the federal arm's-length method and formula apportionment is shown on the chart accompanying this statement. The federal government spends at least three to seven times as many staff hours completing an international arm's-length audit that may cover only a small portion of a company's related-party transactions as compared to the hours the states spend on an international formula apportionment audit that covers all international issues. This comparison actually understates the greater efficiency of the states' approach, because a "best case" scenario for arm's-length reported in a joint 1992 Treasury/IRS report[10] is being compared to the "worst case" scenario of the states.

Does using three to seven times as much staff time as the states yield better results? Sadly, the answer is "no." The Internal Revenue Service has failed to sustain its transfer pricing adjustment in every major case it has taken to court in the last ten years. Losing badly in court, the IRS has turned to settling a large portion of transfer pricing cases, and in 1991 it settled those cases for an average 23 cents to 28 cents on the dollar.[11] These are not intended as criticisms of the IRS, for it has dedicated and talented staff working on these issues. The problem is that the arm's-length pricing system largely impedes success. The fault lies with the policy, not with the Service. But in comparison, the states have won the bulk of their international cases, and the U.S. Supreme Court has upheld the validity and fairness of their formula apportionment method.[12]

It should not be overlooked that states that are among the smallest in the nation, such as North Dakota and Montana, have succeeded in administering the international apportionment system when the federal government has failed to make arm's-length pricing work. Sadly, the Reagan Administration in the mid-1980's pressured these and other states to limit their use of international apportionment.

So what is our current situation? We have an approach to international taxation that loses the federal and state governments a conservatively estimated $15 billion a year, that shifts that cost unfairly to ordinary taxpayers and small businesses and costs the federal government three to seven times the staff resources as compared to the more efficient and more effective state system of formula apportionment. It is an approach under which the IRS has not been able to win a major court case in recent times, and it must settle other cases for a minor fraction of the original assessments. It is an approach that is doomed to fail because of the volume of transactions that must be reviewed and corrected and, more fundamentally, because the approach does not fit with the economic realities that lead to the formation of multinational corporations in the First place.

Why do we stick with a method that has failed so badly for nearly 30 years? The reason given time and again by Treasury officials is that the "Devil makes us do it." Who is the Devil in this case? International tax treaties. But is this a reasonable answer? No treaty and no law should require anyone to do that which is impossible. If they do, they should be changed. Further, the major treaties do not speak of adjusting prices to an arm's-length level. In fact, the treaties speak of adjusting profits in a manner that achieves arm's-length results[13] Treasury could, if it so decided and without revising the treaties, explore with other treaty partners developing formula apportionment processes that adjust profits rather than prices. Thirty years ago, the U.S. government led its trading partners down the arm's-length pricing path. We now know that path has reached a dead end, and it is time for the U.S. government, through Treasury, to lead its trading partners down a new path of dividing profits through formula apportionment.

Mr. Chairman and Members of the committee, we believe that in continuing to seek cover from transfer pricing problems in Section 482, the federal government is in fact parading naked in the international tax arena. It is time for this emperor to get a suit of clothes. He will not find a good suit of clothes in London, Brussels, Berlin or Tokyo, and he will certainly not find them in the Cayman Islands or Netherlands Antilles. The emperor will find a good suit of clothes in Sacramento, Salem, Helena, Boise and Bismarck. And when he finds this suit of clothes, he will discover that they fit well, are a good value for the money, and will last a long, long time. The Multistate Tax Commission urges the Committee to give serious consideration to the formula apportionment alternative to Section 482. As you move to implement President Clinton's transfer pricing penalty-related provision-and we support this as a necessary emergency measure-we also urge you to hasten the transition from a failed arm's-length pricing system to international formula apportionment.

ENDNOTES

1. The Member States of the Multistate Tax Commission are Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.

The Associate Member States are Alabama, Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia.

2. Multistate Tax Commission staff estimate based on a calculation of the weighted average state statutory corporate income tax rate as a percentage of the federal statutory rate.

3. Governor Bill Clinton, Putting People First. A National Economic Strategy for America, p. 22. The revenue to be gained by stepped-up enforcement of Section 482 is estimated there as growing from $9.0 billion in 1993 to $13.5 billion in 1997. The four-year average is $11.3 billion.

4. James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," Statistics of Income Bulletin, Winter 1992–93, p. 12, Figure F.

5. With regard to U.S. subsidiaries of foreign parent multinationals, the IRS Statistics of Income Division has only compiled the data on transactions with related parties for the 121 foreign-controlled U.S. corporations with over $1 billion in sales. The IRS reports a total of $89 billion inbound and outbound transactions for this group of companies, exclusive of the principal amount of loans. See: James Hobbs and John Latzy, "Transactions Between Foreign Controlled Corporations and Related Foreign Persons, 1988, Data Release," *Statistics of Income Bulletin,* Summer

1992, p. 122. (We exclude the principal balance of loans from our measure of related party transactions, since only the interest charges on the loans would ordinarily be subject to a Section 482 adjustment). These 121 corporations, according to IRS, account for approximately half of the total sales of all foreign-controlled corporations. We assume that the untabulated corporations engage in related-party transactions to the same degree as the tabulated ones, and thus double the figures reported for the 121 corporations.

With regard to U.S. based multinationals, the IRS has compiled data only for the 744 with more than $500 million in assets. See, John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988," *Statistics of Income Bulletin,* Fall 1992, p. 71. This article (at p. 66) reports $143 billion in related party sales of "stock in trade" with 7500 foreign subsidiaries. Unpublished data compiled for the Multistate Tax Commission by the Statistics of Income Division counts an additional $33 billion in related party sales of services, royalties, interest, etc. Since the IRS reports that the 7500 foreign subsidiaries of these 744 U.S. parents account for fully 92 percent of the sales of all U.S. controlled foreign subsidiaries, we have not extrapolated the related party transactions upward.

6. There were 44,840 U.S. corporations controlled by foreign persons that filed 1989 tax returns. See: James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," *Statistics of Income Bulletin,* Winter 1992–93., p. 7. The IRS also reports that 750 U.S. corporations with assets over $500 million control 7500 foreign subsidiaries. See: John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988," *Statistics of Income Bulletin,* Fall 1992, p. 71. However, this is by no means a complete count of U.S. based multinationals. A much more comprehensive compilation by the U.S. Commerce Department indicates that there are actually more than 2000 U.S. based multinational corporations that own a majority interest in over 15,000 foreign subsidiaries. U.S. Dept. of Commerce, *U.S. Direct Investment Abroad, 1989 Benchmark Survey, Final Results,* October 1992, p. M–25. It is worthy of note that a listing by Treasury and IRS of Commerce Department data sources that could be of use in Section 482 enforcement completely omitted this extremely comprehensive survey of foreign direct investment and a comparable one covering investment in the U.S. by foreign multinational corporations. See, U.S. Department of Treasury and Internal Revenue Service, *Report on the Application and Administration of Section 482,* April 9, 1992, p. 5–15.

7. See endnote 5.

8. Statement of Louis M. Kauder before the Governmental Affairs Committee of the United States Senate, March 25, 1993, photocopy, p. 9.

9. See: Kathleen Matthews, "Dolan, Pearlman Square Off Over Arm's-Length v. Formula Approach," *Tax Notes,* March 25, 1991, p. 1335; Lawrence H. Summers, "Taxation in a Small World," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century,* (New York: John Wiley & Sons) 1988, p. 71; Stanley I. Langbein, "A Modified Fractional Apportionment Proposal for Tax Transfer Pricing," *Tax Notes,* February 10, 1992, pp. 719–730; Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," in *Proceedings of the Eighty-Fourth Annual Conference of the National Tax Association-Tax Institute of America,* 1991, pp. 118–124; Louis M. Kauder, "Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now," *Tax Notes,* January 25, 1993, pp 485–493; and Dale W. Wickham and Charles J. Kerester, "New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?" *Tax Notes,* July 20, 1992, 339–361.

10. See: U.S. Department of Treasury and Internal Revenue Service, *Report on the Application and Administration of Section 482,* April 9, 1992, pp. 3–3, 3–4.

11. *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States,* Hearing before the Subcommittee on Oversight, of the Committee on Ways and Means, House Of Representatives, April 9, 1992, pp. 145–6.

12. This statement could be affected, however, by the outcome of a pending case, *Barclays Bank PLC* v. *Pranchise Tax Board, 2* Cal.4th 708(1992). California has prevailed through the California Supreme Court in this case, which involves a challenge to the constitutionality of the application of worldwide unitary combined reporting to a foreign parent corporation. Barclays Bank is seeking U.S. Supreme Court review of the case. In 1983, in the landmark case of *Container Corp.* v. *Calihrnia Franchise Tax Board,* the U.S. Supreme Court upheld the constitutionality of worldwide unitary combined reporting as applied to U.S. based multinationals.

13. Article 9–1 of the U.S. Model Tax Treaty provides:

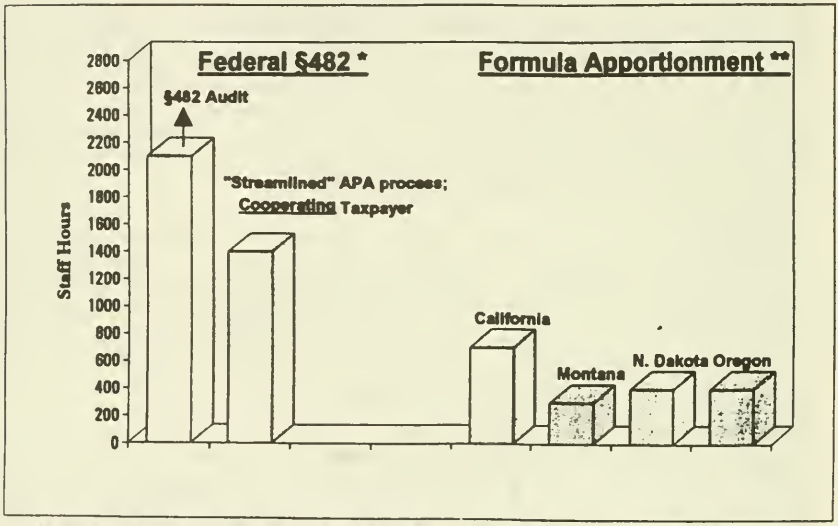
1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any **profits** which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the **profits** of that enterprise and taxed accordingly. **[Emphasis added]**

Administrative Staffing Requirements:

Federal §482 vs. Global Formula Apportionment



* Audit or advanced approval of limited set of related-party transactions. Source: U.S. Treasury Dept. and Internal Revenue Service, "Report on the Application and Administration of Section 482", April 1992, pp. 3-3, 3-4.

** First audit, covering three tax years, total tax liability. Subsequent audits generally require considerably fewer audit hours because facts to support determination of combined group have already been established. Source: Multistate Tax Commission Survey of State corporate audit directors.

DISCUSSION

Oxygenated components utilized as blend stock material in the manufacture of unleaded gasoline are specifically waivered by the EPA under § 211(f) of the Clean Air Act. In order to be granted a waiver, the oxygenated compound must show that it does not cause the failure of certified vehicles to meet regulated emission standards. Oxygenated compounds reduce CO and certain harmful emissions. Some are better than others. For example, some methanol blends can reduce NOx, toxic and other harmful emissions.

Existing § 211(f) waivered materials include ethanol, TBA, MTBE, ETBE, and several methanol/co-solvent blends ("methanol blends"), etc. Future oxygenated materials likely to receive EPA waivers include esters and other higher molecular weight alcohols and/or ethers, etc.

Methanol may be used in neat/stand alone type fuels (M 85). However, neat methanol is not an allowable component in gasolines for normal automobile usage, except as an intermediate in the manufacture of MTBE. In other words, methanol alone can not be included in gasoline without the concurrent use of a co-solvent. NAFA is not concerned about the treatment of neat methanol for use in stand alone fuels, which appear to be adequately exempted in the Energy Tax proposal.

Rather, NAFA is concerned that the current language of the Energy Tax proposal is discriminatory because it excludes very attractive waivered oxygenates, namely methanol/co-solvent blends.

If the purpose of exempting oxygenates for use in gasoline, is to encourage the reduction of air pollution, then all oxygenates that can accomplish this end should be exempted from the BTU tax.

Methanol blends are normally added to gasoline in concentrations ranging from 3% to 15% by volume, with the most typical concentrations being from 7% to 12% of the finished gasoline. This finished gasoline is used in convention vehicles without modification, just like ethanol and MTBE are used.

Co-solvents, which are also oxygenated, represent from approximately 30% to 75% of the methanol blend composition, with the most typical methanol blend composition being 50% methanol and 50% co-solvent. Co-solvent concentrations will vary depending upon seasonal temperatures and likely water exposure of the finished fuel. The highest percentage concentrations of co-solvents will occur in the winter months.

Co-solvents for methanol blends include C2 to C12 alcohols, C3 to C12 ethers, esters and ketones, including mixtures thereof. The preferred and most typical co-solvents are alcohols.

The alcohol co-solvents will have from two to twelve carbon atoms. The preferred cosolvent alcohols are saturates having high water tolerances and high boiling points. Representative alcohol cosolvents include ethanol, isopropanol, n-propanol, tertiary butanol, 2-butanol, isobutanol, n-butanol, pentanols, amyl alcohol, cyclohexanol, 2-ethylhexanol, furfuryl alcohol, iso amyl alcohol, methyl amyl alcohol, tetrahydrofurfuryl alcohol, hexanols, cyclohexanols, furons, septanols, octanols, and the like.

Representative ketone co-solvents (not yet waivered by the EPA) include lower alkenyl ketones such as, diethyl ketone, methyl ethyl ketone, cyclohexanone, cyclopentanone, methyl isobutyl ketone, ethyl butyl ketone, butyl isobutyl ketone, ethyl propyl ketone, and

the like. Other ketones include acetone, diacetone alcohol, diisobutyl ketone, isophorone, methyl amyl ketone, methyl isamyl ketone, methyl propyl ketone, and the like. A representative cyclic ketone would be ethyl phenyl ketone.

Representative ethers, which can be used as cosolvents in fuel compositions methyl alkyl t-butyl ethers such as methyl tert-butyl ether, ethyl tertiary butyl ether, also preferred tertiary amyl methyl ether, dialkyl ether, dimethyl ethers, diisopropyl ethers, diethyl ethers, ethyl n-butyl ether, ethylidenedimethyl ether, butyl ether, and ethylene glycol dibutyl ether, and the like. The representative straight ethers that can be used include dimethyl ether, methyl ethyl ether, di ethyl ether, ethyl propyl ether, methyl normal propyl ether, ethyl isopropyl ether, methyl isopropyl ether, ethyl normal propal ether, propyl ether, propyl isopropyl ether, isopropyl ether, ethyl butyl ether, ethyl isobutyl ether, ethyl secondary butyl ether, methyl normal butyl ether, methyl isobutyl ether, methyl secondary butyl ether, methyl normal amyl ether, methyl secondary amyl ether, and methyl iso amyl ether. Additional nonlimiting examples of di ethers suitable for the composition include methylene di methyl ether, methylene di ethyl ether, methylene di propyl ether, methylene di butyl ether, methylene di isopropyl ether, etc. Cyclic ethers may also be used including, 4,4-dimethyl-1, 3-dioxane, and tetrahydrofurans, such as, for example, 2-methyletrahydrofuran, 2-ethyltetrahydrofuran, and 3-methyletrahydrofuran.

Co-solvents can be co-produced in the same process stream as methanol and/or produced separately from natural gas, coal and/or petroleum based feed stocks. Bio-mass and peat production is possible. Methanol may be an intermediate chemical in the production of the co-solvent.

Ideal feedstocks include coal (which can be cleanly converted), natural gas, and petroleum.

Due to existing environmental burdens placed upon coal's usage and a need for an environmentally sound alternate market, i.e. automotive fuels, NAFA believes coal should be accorded a special exemption beyond just the production of synthetic natural gasoline.

NAFA believes coals' specific exemption should extend to all products, including oxygenates, intended for alternative fuel usage. NAFA believes that a subsidy, like that accorded ethanol, is warranted to encouraging coal's usage in the manufacture of alternate fuels, particularly environmentally friendly oxygenates, such as methanol, methanol blends, MTBE, TAME, etc.

The estimated 1996 market for methanol blends will approach 50 thousands barrels per day (barrels of oxygenates not finished gasoline). This would represent a part of the entire oxygenated component market, estimated at 600 thousand barrels. If methanol blends do not satisfy part of total demand, such demand will be satisfied by other exempted material, namely ethanol, MTBE, etc.

It should be noted that methanol blends do not enjoy tax subsidies currently enjoyed by ethanol and those proposed for ETBE.

NAFA's proposes the above problem be remedied by modifying the BTU tax exemption language so that all oxygenates used in gasoline, which are granted a § 211(f) Waiver under the Clean Air Act, be exempted from the BTU energy tax. This would be all inclusive and flexible enough to consider future developments.

STATEMENT OF THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

INTRODUCTION

My name is George Sydnor. I am President and Chief Operating Officer of James McGraw, Inc., of Richmond, Virginia, a distributor of industrial equipment and supplies to manufacturers. Our company was established in 1866—over 125 years ago. Our sales volume of $40 million places us in the top 50 industrial distributors nationally, underscoring that ours is an industry preponderantly comprised of small to medium-sized companies. Our approximately 2,800 customers range from independently-owned machine shops to multinational and Fortune 500 corporations.

I am also Chairman of the Board of the National Association of Wholesaler-Distributors (NAW), and it is in that capacity that I submit this testimony.

I want to point out that NAW was a founding member of the Tax Reform Action Coalition (TRAC), whose public testimony you have heard.

At the outset, I want to commend this Committee for the extraordinary effort it undertook in 1986 to produce a truly historic piece of legislation, despite tremendous political pressure from special interests. NAW salutes you again as we did in 1 for creating a tax code which greatly reduced preferences, enabling rates to be lowered. By so doing, you eliminated substantial bias in the code which favored one industry over another and which distorted investment decisions.

THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS AND THE WHOLESALE DISTRIBUTION INDUSTRY

NAW is a federation of 110 national wholesale distribution trade associations (a list is attached as APPENDIX A). NAW represents approximately 40,000 companies with 150,000 places of business. These firms range in size from those with less than $1 million in annual sales to those with over $13 billion. The typical firm has approximately $5–$10 million in sales and employs 30–50 individuals.

Wholesale trade is an enormous and economically potent industry with annual sales in excess of 3.1 trillion dollars. NAW represents the merchant wholesale distribution industry, the largest segment of wholesale trade.

THE PREVIOUS TAX CODE'S DISCRIMINATORY EFFECTS ON THE WHOLESALE DISTRIBUTION INDUSTRY

Prior to enactment of the Tax Reform Act of 1986, the tax system was grossly unfair. The numerous deductions, exclusions and credits which complicated the tax code created very wide disparities in the effective tax rates paid by various industries, and even by companies within those sectors.

Some taxpayers were able to sharply reduce their tax obligations through tax credits and deductions while a similar capability was denied to other taxpayers with comparable taxable income simply because they were in a business where the activities needed to trigger the use of preferences were of secondary importance, at best, to their direct business operations.

For instance, labor and inventory-intensive industries, like wholesale distribution, made relatively nominal use of most of the previous code's capital cost recovery provisions which enabled other industries with similar net taxable income to pay much lower rates of tax on similar levels of operating income. The reason for this, in the case of our industry, is that 80 percent of the typical wholesaler-distributor's assets are in inventory and accounts receivable, not in capital assets.

The result was a tax subsidy for certain types of business activity and investment at the expense of high effective rates paid by others. Indeed, studies conducted by the Joint Committee on Taxation found that the wholesale distribution industry paid either the highest or the second highest effective tax rate of the industries studied—approximately 35 percent in 1983, for example.

NAW'S SUPPORT FOR TAX REFORM

NAW's decision to support the principles of tax reform in 1986 was not made in a vacuum. In 1985, NAW commissioned a study by Arthur Andersen & Company, which analyzed the actual tax returns of wholesaler-distributors against the Treasury Department's November, 1984 and May, 1985 tax reform proposals. The study came to two important conclusions: first, the proposed reduction in tax rates would offset the loss of preferences in prior law; and that the proposal would reduce the disparity in effective rates between wholesaler-distributors and other industries, thus creating a more level playing field.

This is not to imply that the exchange of tax preference for lower rates was an easy one for many wholesaler-distributors to make. Indeed, the changes made by the '86 Act in inventory cost capitalization were of significant specific cost to wholesaler-distributors. However, it was NAW's and the wholesale distribution industry's strongly held belief that a significant reduction in corporate and individual tax rates outweighed these factors. Central to this conclusion was our belief that market forces, rather than public policy, no matter how skillfully crafted, can best determine investment decisions.

Of identical import is that retained earnings are the principal and often sole source of growth capital for small, entrepreneurial businesses. The increase in retained earnings generated by the Tax Reform Act of 1986 for many wholesaler-distributors translated into more investment in jobs, inventory, warehouses, computers, delivery trucks and services.

NAW considers the Tax Reform Act of 1986 to be the most important piece of tax legislation passed in the 47-year history of our organization. We strongly urge you to preserve its principles as you move to meet the requirements of the budget resolution.

THE PRESIDENT'S PROPOSALS

As this Committee begins its work on the proposals which President Clinton has made, we all recognize that today's environment is far different from that of 1986. The President has successfully focused the public's attention at long last on the vital need for deficit reduction and is waging a superb campaign to keep that goal readily in sight. We applaud him for his efforts, and our members are eager to work with him to achieve meaningful reductions in our annual Federal deficits and our massive national debt.

As ever, however, the "devil is in the details." NAW has always believed that cuts in Federal spending must be the core element of deficit reduction. We hold that same belief today. Unfortunately, in our view, the package which is before the Congress today relies far too heavily on tax increases and far too lightly on spending reductions. For business, taxes will rise by some $170.1 billion under the President's plan. Proposed business

CONCLUSION

The President has characterized his tax proposal as one of "shared sacrifice." To abandon the principles contained in the Tax Reform Act would result in a sacrifice by some to the benefit of others. NAW strongly urges this Committee to retain the level playing field which was the linchpin of the Tax Reform Act and reject the President's proposal to raise the top tax rates and reinstate preferences into the code.

Attachments.

APPENDIX A

National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Safety Services Association, Inc.
American Veterinary Distributors Association
American Wholesale Marketers Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association for Suppliers of Printing & Publishing Technologies
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association

Electrical-Electronics Material Distributors Association
Engine Service Association, Inc.

Farm Equipment Wholesalers Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Food Marketing Institute
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Health Industry Distributors Association
Hobby Industries of America

Independent Medical Distributors Association
Independent Sealing Distributors
Independent X-Ray Dealers Association
Industrial Distribution Association
International Association of Plastics Distributors
International Hardware Distributors Association
International Sanitary Supply Association
International Truck Parts Association
International Wholesale Furniture Association
Irrigation Association

Jewelry Industry Distributors Association

Machinery Dealers National Association
Material Handling Equipment Distributors Association
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors, Inc.
National Association of Floor Covering Distributors
National Association of Flour Distributors, Inc
National Association of Hose and Accessories Distributors
National Association of Meat Purveyors
National Association of Recording Merchandisers
National Association of Service Merchandising
National Association of Sign Supply Distributors
National Association of Sporting Goods Wholesalers
National Association of Wholesale Independent Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Insulation and Abatement Contractors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists Association
Northamerican Heating & Airconditioning Wholesalers Association
North American Horticultural Supply Association
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute
Suspension Specialists Association

Textile Care Allied Trades Association

United Products Formulators & Distributors Association

Wallcoverings Association
Warehouse Distributors Association
for Leisure and Mobile Products, Inc.
Water and Sewer Distributors of America
Water Systems Council
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers Association, Inc.
Wine & Spirits Wholesalers of America Inc.
Woodworking Machinery Distributors Association
Woodworking Machinery Importers Association

National Association of Wholesaler-Distributors
1725 K Street, NW, Washington, D.C. 20006 • 202/872-0885

4/27/93
110 Member National Associations

CLENDENIN BROTHERS, INCORPORATED
Manufacturers Established in 1885

APPENDIX B

John C. Corckran, Jr.
Chief Executive Officer

February 26, 1993

The Honorable Benjamin L. Cardin
U. S. House of Representatives
227 Cannon Office Building
Washington, DC 20515

Dear Congressman Cardin:

Thank you for the positive response you gave when I called your attention to the inequitable tax load being placed on small businesses in the current tax proposal. As I told you, I was not calling on you attempting to say, "Please do not raise my taxes.", because that issue was clearly settled in the Presidential election. What I did point out was that, including the Bush tax increases, small business taxes (more specifically, S-Corporations) will have been increased from 28% to 40.7% if the President's proposals are enacted as they have been proposed. This is a 45.4% increase.

First, let me reiterate how I reach 40.7%, since that differs somewhat from published reports. The Bush increases raised the top rate to 31%, plus it reduced standard deductions by 3%, which is essentially a 1% additional tax (32%). The Clinton Proposal would increase the top rate to 36%, plus the 1% tax added by standard deduction limitations (37%). Add a 10% surtax and you get 40.7%.

The effects of a 45.4% increase in our taxes will have serious effects on the S-Corporations my brother and I control and on the economy as a whole. Since I told you I was not merely asking you to not increase my taxes, I will focus on my analysis of its' negative effects on the economy as a whole first.

Virtually all of the job growth in the economy in the past ten years has come from small businesses. When the Bradley-Gephardt Tax Reform bill was passed by Congress and signed by President Reagan, it provided two resources to small businesses. The first was time. With all of the loopholes, special interest breaks and tax traps eliminated, we could take the 30-50% of our time that had previously been spent on tax reduction and devote that to growing our businesses. The second is obvious and that was cash. By reducing the marginal tax rates and allowing us to use S-Corporation taxes, we responded by investing in and growing our businesses and, correspondingly, increasing our employment. If you pass the 45.4% increase in taxes on S-Corporation owners, you take back a lot of the cash. As our cash is reduced, our ability to invest and grow is reduced, and the rate of job creation will also be reduced. If the tax law passes as is, and many of us are forced back into C-Corporation status, you take back the time as well, since the biggest tax trap is doing something that the Internal Revenue Service could call a dividend. I sincerely believe that this tax proposal will have a large negative effect on the small business sector and its' investment and employment growth.

Clendenin Brothers, Incorporated is in your district. My brother Jim and I both live in your district and I would guess that most of our employees live in the district as well. Our great-grand uncles started in business in 1865 as copper merchants when Baltimore had many copper refineries. The refineries have disappeared and we have switched our emphasis to aluminum. Three generations before us have deferred consumption, saving and investing in the future, and we are doing the same thing. To us, long-term does not mean six months, it means two more generations. Clendenin invested more in new plant and equipment in the 1980's than in its' entire previous history. We are doing our job. The number of employees in companies controlled by my brother and myself has increased from less than 150 to more than 450. Out of curiosity, I looked up our 1982 tax returns. For 1992, we will pay substantially more to the United State Government than we paid in 1982, in spite of the reduction in marginal rates. We will also pay more to the City of Baltimore and to the State of Maryland.

Clendenin Brothers has just completed the purchase of a new building in the City. This building will give us access to more than twice the space we now occupy. The new tax proposal has already had an impact on our expansion plans and will continue to do so if it is passed as is. We had initially planned to replace the entire roof and install a new heating system. These expenditures would have cost about $500,000 and would have been placed with contractors in the area. We are now debating whether we can just maintain the roof for a while and live with the minimal new heat plant, lowering the cost to about $50,000. We are rapidly losing our enthusiasm for vigorous expansion and investment and turning to caution, conservative investment and cost control. I do not think we are the only ones.

I think you agree that the proposed increase in taxes on S-Corporation owners is inequitable. I am grateful for your commitment to take the lead in trying to find a way to correct this inequity without damaging the Plan that the President has proposed and the majority of Americans appear to support. I also do not believe that the President or his advisors were aware of the extreme penalty placed on small businesses by his plan and that, if they were made aware, they would also support some form of relief. I sincerely believe that the macro-economic effects of that aspect of the tax plan will be damaging to the economy and employment growth. I will be available to give you all of the support that you or David may request. Again, thank you very much for taking the time to meet with me and for your positive response.

Sincerely yours,

John C. Corckran, Jr.

JCC:mja

cc: David Koshgarian
Dirk Van Dongen,
President, National Association of Wholesaler-Distributors

STATEMENT OF THE NATIONAL BASKETBALL ASSOCIATION

This Statement contains the comments of the National Basketball Association ("NBA" or "League") on President Clinton's Tax Program for 1993, with respect to the proposal to reduce the deductible portion of the cost of sporting events tickets from 80% to 50%.

The enactment of this provision of the Program would unjustifiably discriminate against sports ticket purchases relative to other legitimate business expenditures. Based on existing tax law, as long as the expense of a sports ticket is incurred for a legitimate business purpose, the expense should be deductible; the government should not mandate preferential treatment for some expenses over others.

The enactment of such legislation would also substantially impair the operation of existing sports teams, would have adverse effects upon the general economy (specifically the economies of major cities) and would deprive many people of the ability to attend professional sporting events.

In addition, this provision of the Program is unnecessary to protect tax revenues because any alleged abuse in this area is controllable under the existing law and auditing procedures carried out by the Internal Revenue Service. Further, based on a survey of the NBA teams, if the proposal is adopted, businesses are likely to reduce their entertainment expenditures; therefore, any federal tax revenue gained by reducing the deduction would be offset by a corresponding tax revenue loss at both the federal and local level resulting from a decrease in the income of the teams, concessionaires, restaurants and others. In fact, because of the multiplier principle, discussed below, the revenue loss attributable to the proposed reduced deduction could far surpass any direct revenue gain, thereby resulting in a significant negative impact upon the economies of our cities.

Specifically, the following comments are material with respect to this proposal:

TICKETS TO SPORTS EVENTS SERVE A REAL BUSINESS NEED AND SHOULD BE TREATED SIMILARLY TO ANY OTHER LEGITIMATE BUSINESS EXPENDITURE

The proposed legislation is patently unfair in its discriminatory treatment of business sports entertainment expenses as compared to other legitimate business expenditures. Existing tax law allows a business deduction for an expense that is ordinary and necessary and is directly connected with or pertains to the taxpayer's trade or business. As long as a sports ticket expense is incurred for a legitimate business purpose, the factual determination of which is similar to dozens of other determinations encountered by the IRS, the taxpayer should be permitted to deduct that expense to the extent allowed under current law.

Businesses purchase tickets to sports events for a variety of legitimate business purposes that are comparable to the purposes served by other fully deductible expenditures relating to sales, business promotion, marketing and advertising. By providing an informal setting in which a business person is able to maintain close contact for a number of hours with a customer, client or supplier, a sports event affords a unique situation in which a business person can cultivate a prospective or ongoing business relationship. Similarly, a sports event provides an excellent place to meet after a substantial business discussion or to prepare for the negotiation of a business transaction.

In addition, tickets to professional basketball games are often used as a promotional device by companies that offer free tickets with the purchase of items by their customers. For many small businesses, the use of sports event tickets provides a cost-effective means of marketing and competing with those businesses able to devote greater resources to marketing and advertising purposes. Companies also frequently give away tickets to sporting events as incentives for more efficient work and for the promotion of better employer-employee relations.

The conduct of the business community reflects its belief that the use of tickets to sports events serves important business purposes. In fact, as discussed below, more than 60% of tickets sold for NBA games are purchased by businesses. The proposed legislation offers no principled basis -- and none exists -- for distinguishing between a business's deductions for such expenditures and its deductions for any other legitimate business expenses, including, for example, advertising, marketing or promotional expenditures. The use of sports entertainment tickets should therefore be afforded tax treatment equivalent to that of any other legitimate business expenditure.

THE PROPOSED LEGISLATION WILL ADVERSELY AFFECT THE ECONOMIC VIABILITY OF THE NBA TEAMS AND RELATED BUSINESSES

NBA teams rely heavily on game attendance for their revenues. In the NBA's 1991-1992 season, revenues from receipts at the gate totalled approximately $403 million and constituted 46% of the NBA's total revenues. About 62% of this total ($250 million) comes from tickets purchased by businesses, both large and small. The percentage of season tickets sold to businesses is even higher. Season ticket sales are essential to the operation of a sports team because they represent known amounts of income that enable the team to budget its expenses (including salaries) for the next season. It is unlikely that businesses' season ticket purchases could ever be replaced by individuals' season ticket purchases because of the substantial outlay required for each season ticket.

Based on information supplied by the NBA teams, if the deductible portion of the cost of sporting events tickets is reduced, the loss to the teams on ticket sales to businesses (after taking into account those lost sales that would be recovered by sales to others) could reach $40 million.[1] Such a reduction in the teams' revenues would jeopardize the teams' ability to sign contracts with qualified players and pay their high, competitive salaries, and may threaten the financial viability of some teams.

Moreover, each team provides an operational base for a host of related enterprises, such as refreshment and souvenir concessions. A decrease in game attendance resulting from the proposal will have the direct effect of decreasing sales in these ancillary businesses, which, like the teams themselves, can little afford such a drain on their income.

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[1] Any attempt by the teams to recoup lost ticket sales by raising their ticket prices may well have the unwanted effect of foreclosing attendance to a substantial number of basketball fans who would be financially unable to bear the increased prices. In any event, the law of diminishing returns would limit the amount by which teams could raise ticket prices, thereby limiting the revenues that teams could recover by increasing their ticket prices.

THE PROPOSED LEGISLATION WILL ADVERSELY AFFECT THE COMMUNITY AT LARGE, ESPECIALLY THE MUNICIPALITIES AND SPORTS FANS

To fully appreciate the consequences of the proposed legislation, it is necessary to view its impact beyond the narrow scope of the sports industry and to examine its potential effect on the community at large. In addition to promoting ancillary enterprises within the industry, the member teams of the NBA are an integral part of the economy of the municipalities in which they play and enjoy significant business relationships with, or otherwise affect, a variety of industries, including municipal and private parking, public transportation, taxi services, food establishments, hotels, etc. The effect of the proposed legislation on these other industries and on the industries which they in turn service would be substantial. In economic terms this is known as the "multiplier principle" and stands for the proposition that if the subject enterprise and the people involved therein are injured, other enterprises who derive income from the subject enterprise will also be hurt, and all enterprises that service these secondary enterprises will be hurt, and so forth.

As applied to the NBA, the President's proposal would trigger the multiplier principle, resulting in overall losses to the sports industry and to the national economy of many millions of dollars. Concern over the adverse impact of the proposed provision has been echoed by government officials of every major metropolitan area throughout the country. If the proposal became law, municipalities are likely to suffer as a result of a general reduction in the economy caused by a decreased demand for services and subsequent job loss. In addition, these local governments would be injured directly by a loss of revenues generated through sales and excise taxes now collected on the items of expenditures, such as ticket sales, concessions and parking, which would be reduced.

Moreover, about half of the NBA teams are tenants in municipally owned or financed arenas. Because many arena rentals are based on a percentage of revenues, a reduction in ticket sales would mean a direct loss of revenue to local governments from the operation of such arenas. Concession and parking revenues retained by municipal authorities, also a direct function of game attendance, would similarly be diminished.

The alleged benefactors of the proposed legislation, the non-business spectators whose tickets are not tax-deductible, will suffer along with the teams, the providers of services and the municipalities. As noted earlier, in order to compensate for the reduction in ticket sales to businesses, NBA teams may be forced to raise ticket prices, thereby limiting the number of spectators able to attend a sporting event. If the number of spectators declines, then the amount they spend on related activities will also be reduced. Under the multiplier principle analysis, all the dependent industries and their employees in turn will be injured as a consequence. In addition, the ultimate burden of the proposed legislation may have to be shifted to taxpayers through an increase in local taxes to compensate for the loss of rent and taxes payable by the city's professional sports teams. The business purchaser of sports tickets would thus be denied a deduction for a substantial portion of a legitimate business expense, but ironically the cost would be borne by the ordinary taxpayer who may no longer be able to attend the sporting event at all.

CONCLUSION

In summary, the proposed provision is an unwarranted and ineffective means of attempting to generate additional tax revenue. The proposed reduction in the business deduction for the purchase of sports tickets unjustifiably distinguishes the purchase of sports event tickets from other legitimate business expenses. The enactment of such legislation would impose undue burdens on sports teams and on the general economy by reducing the economic viability of professional sports teams, injuring local governments and a myriad of ancillary enterprises, and greatly reducing the number of professional sports patrons. The NBA urges rejection of the proposed provision in order to avoid these adverse consequences.

If any material is submitted to the Committee in connection with the proposed Program which may require further comment from the NBA, the NBA would appreciate the opportunity to make such comment.

STATEMENT OF THE NATIONAL CLUB ASSOCIATION

INTRODUCTION

The National Club Association submits these comments on the Administration's proposed changes to the tax deductibility of club dues, business meals, and entertaining.

The National Club Association (NCA) is the trade association representing the legal, legislative and business interests of private social, recreational and athletic clubs. Over 1,000 such clubs throughout the country, with an estimated one million members, belong to NCA. Member organizations include country, golf, city, yacht, tennis and athletic clubs. The scope of these club operations range from small clubs with limited membership and facilities to larger, full-scale operations with dining and extensive recreational facilities. Some of these facilities are operated on a seasonal basis while many are open year round.

The private club community has nearly 7,000 clubs which employ over 450,000 full-time and 220,000 part-time personnel. Nearly all clubs have food and beverage service. Our most recent survey shows food and beverage revenues to be over $13.6 billion annually. For example, nearly 50 percent of city club revenue comes from food and beverage purchases.

THE PROPOSALS WILL HAMPER THE ECONOMIC STIMULUS PACKAGE

The economic plan of the Administration, touted as a stimulus package, is relying on both spending and tax incentives to build the economy and create jobs. If, however, the deduction for club dues is repealed and business-meals and entertaining deductibility is reduced to 50 percent, the financial impact on club employees, mid-level executives, club members, and the economy will be just the opposite.

Many small businesses invest in business-development entertaining as a more effective means of generating business than other options, such as high-cost advertising which few employers can afford. Expense and dues deductions merely reflect the investment businesses make to conduct business and thereby generate taxable net income.

Changes to the tax deductibility of club dues, business meals, and entertaining will be a blow to the club community, still feeling the effects of a slow economy. For example, in a letter to Congress last year, a manager from a Midwest country club, wrote, "Due to the economy, or maybe I should say recession, our membership is off about three percent over the previous year. A high percentage of our existing members are small business, middle-income, working executives. Increasing the net cost of club membership [by denying deductibility of dues] will prompt many employers to discontinue such support of their employees. Now comes the serious part, jobs, for women and minorities. As you know, our industry employs a high percentage of these groups. I would project [that denying the deductibility of dues] would result in a 20-percent layoff of employees and a 15-percent loss of club revenue."

In addition, these changes would deny important business opportunities to many small businesses and small business executives who rely on them for critical marketing activities. Business development is good for America and should be encouraged. The government should not engage in determining how and to what extent a taxpayer generates business. To repeal, in particular, club dues and business-entertaining expenses, and treat them differently from other business expenses is inherently inequitable.

The club and hospitality industries and their many employees have been unfairly targeted. We believe in a strong economy and in investing for the future. The club community is a part of that future. The sales and services stimulated from the business use of clubs should remain legitimately deductible activities and are a critical element in a free enterprise economy.

IMPACT ON EMPLOYMENT AND REVENUE

Dues provide the dollars needed to cover fixed overhead in a club. Since variable costs in a club are relatively small, the only practical way to reduce costs and match reduced revenues is through payroll reductions. Very few clubs have the economic capacity to withstand revenue reductions. A recent sampling of clubs showed that over 64 percent of the club industry would foresee a potential decrease in their membership base if the deductibility of club dues were repealed. In addition, clubs would suffer a combined revenue loss of over $1 billion if club dues were repealed. The resulting effect is job loss, reduced business for suppliers and other lost opportunities.

City clubs, which are typically located in downtown business centers, will be particularly hard hit. Nine out of ten clubs indicate that changes to deductibility will result in loss of revenues. Many may not survive the blow. In addition to putting club employees out of work, the closing of these institutions would further reduce the economic strength so important to business centers in major urban areas.

The club community employs well over 600,000 full-time, part-time and seasonal employees. The projected loss of jobs is estimated to be between 68,000 to 78,000 for full-time positions. The loss in payroll taxes would be approximately $140 million a year. This does not consider the tens of thousands of part-time positions and related payroll taxes lost.

Many of these jobs are entry-level and held by minorities and women. Since the vast majority of these jobs have few transferable skills, those individuals losing jobs are likely to face some period of unemployment, probably prolonged. Many of these fine employees have been with their club employer for many years. Last spring, we received a number of handwritten letters (some in Spanish) from club employees concerned about losing their jobs. One such letter said, "I am an employee of a club. My title is a maid in the housekeeping department. This job is my only income. If the staff members are reduced, it may cause me my job. So please my Rep. Dan Rostenkowski I am opposed to the proposals that would end the deductibility of club dues." Another letter said, ". . . I earn $6.63 per hour, self supported [sic]. No other income. I am opposed to the proposals that would end the deductibility of club duse [sic]. I am sadden [sic] to hear at this possibility this could end my job."

These job-loss projections do not include the tertiary impact on suppliers, specialized equipment manufacturers and vendors that serve the club industry. The data also does not include the revenue and job losses that would result from a decline in corporate sponsorship of golf tournaments, which proceeds go to charity.

IMPACT ON SMALL-BUSINESS MARKETING EFFORTS

Changes to tax deductibility of dues and business meals would unfairly discriminate against the business women and men who are often the key source of membership in a club, especially city clubs. If legitimate dues deductions are disallowed, not only will many existing members resign, but many potential members may be discouraged from joining. These proposals would also hurt small businesses which depend on business entertaining for their marketing and advertising activities. The young entrepreneur or salesperson who cannot afford expensive media advertising, the young lawyer trying to build a practice, the new stockbroker working to develop customers, the accountant who needs to meet clients in a relaxed setting to develop the essential relationship of trust—these are examples of the business people who need and use clubs and utilize these marketing approaches the most. They represent the middle-income taxpayers who, if denied such deductions, would be compelled to continue using these marketing tools and bear the cost themselves. More affluent taxpayers and large corporations will be able to turn to alternative marketing means like the print media and television advertising, which are still deductible.

Clearly, the rational business person is going to convert nondeductible dollars to some deductible use in order to draw business to the company or firm. As a result, the direct revenue benefit to the Treasury will be little. Many clubs will cut back and some will shut their doors resulting in thousands of club-industry employees working reduced hours or losing their jobs.

THE ADMINISTRATION'S PROPOSALS DO NOT PROMOTE TAX FAIRNESS

The Administration's proposals speak of tax fairness. In short, what has happened is that the club and hospitality industries are being used to illustrate that business cannot get away with special privileges that may have some type of perceived personal value and pleasure.

If, indeed, fairness is a central criterion in these tax proposals, then it is unfair to preserve the deductibility of other ways of conducting business. Expenditures for television and radio commercials, newspaper and magazines, or direct-mail advertising remain deductible. Likewise, so are offices in the newest and highest-rent buildings along with top-of-the line furniture and decor. In addition, a business can deduct expensive television "image" advertising, which makes no attempt to sell a product or service, while face-to-face business entertaining expenditures are not fully deductible. We have no quarrels with how other companies invest their money. We are simply hoping for an equitable balance.

The club industry is willing to pay its fair share, but there is no basis for treating these expenditures differently. The fairness standard of the proposals will not be followed if the government selects only one perceived area of "abuse" over others for disallowance. The government already has established "reasonable" expenditure levels in all areas of business. There is no rationale that can explain why club dues/business-meals expenditures are less valued than desks, carpets, or office rent.

One can argue that, at least in the case of dues/business meals, there is some possibility that a sale will be made or a business relationship enhanced that may help stimulate the economy. Conversely, does investing in a $5,000 inlaid mahogany desk rather than a $500 one truly enhance the businessperson's unique opportunities to increase his sales or business? Likewise, many companies offer employees exercise or workout rooms the value of which some may question in terms of generating business.

The thrust of the President's proposals appears to suggest that all income belongs to the government unless it is specifically remanded to the company or individual that earned it. Unfortunately this prompts critics of clubs and business lunches to argue that government is "paying for" part of the lunch, i.e., a government subsidy.

This argument is flawed. If the money spent on club dues and business meals is intended to maximize net income, then no subsidy is involved. From an economic standpoint, it makes no more sense to disallow these investments than it does for capital equipment, salaries, or advertising—all of which are used to generate profits. It is not the business of government to determine or influence how a company should invest or market goods or services. In effect, this says that the government knows better than an owner how his or her business should meet its objectives. Surely our society does not want to have government set arbitrary deductibility standards for business decisions.

One wonders whether we are observing economic policy crafted at the conceptual level (such as the mission to create jobs) versus actual concerns about business development practices and maintenance of private sector jobs for low and middle income workers and suppliers who earn their living in the hospitality industry.

Taxpayers are required to substantiate the business purpose of such expenses. As a result, we believe the detailed business deduction substantiation requirements provide ample authority for the IRS to identify and prevent any misrepresentation by taxpayers. Deductions are not allowed for that portion which is personal. Current documentation and substantiation requirements are very clear. Taxpayers claiming deductions for club dues and business meals must show a business purpose, and must keep clear and verifiable records. For deduction of club dues a taxpayer must show that the club was used primarily (more than 50 percent) for the furtherance of the taxpayer's trade or business and that the expenditure was directly related to the active conduct of such trade or business.

The taxpayer must also provide detailed records as to the number and duration of occasions on which the club was used during the taxable year for business, and the number of occasions on which the club was used during the year for nonbusiness activities.

For many taxpayers, the club is an extension of the office, and the business meal is simply another opportunity to meet and conduct business. For these individuals this is pursuing business. Business persons take clients and customers to clubs as

well as to restaurants and to hotel meeting rooms. They meet over breakfast, lunch, or dinner because they believe such a meeting is a wise investment of their time and money. Whatever personal pleasure is derived from these activities is purely incidental. People engage in business entertaining to achieve an objective, not to dine for pleasure.

Arguably, there are many deductible business expenses that do contain a degree of personal pleasure, such as the quality of one's office furniture, the view from the penthouse office, the design of the employee's lounge or cafeteria, and the company exercise facility. And, what about the personal pleasure of a first-class plane ticket on business trips? The list is endless.

CONCLUSION

In conclusion, NCA supports the objective to have a strong economy. We are opposed, however, to any changes in the treatment of club dues, business meals, and entertaining expenses. If enacted, these changes will not stimulate a revitalization of our economy. The impact in human terms will be substantial and personal, particularly for entry-level service and club employees who have little expectation of being re-employed quickly.

Several years ago the Congress passed a luxury tax on airplanes, boats, jewels, furs and cars. Unfortunately, this tax change nearly ruined several industries, put many employees out of work, and added to our unemployment rolls. The lesson to be learned is that taxpayers will often change their habits when confronted with a change in tax treatment. I sincerely hope the Congress does not repeat this past mistake.

STATEMENT OF THE NATIONAL GRAIN AND FEED ASSOCIATION

Chairman Moynihan and members of the committee: First, the National Grain and Feed Association thanks the committee for this opportunity to submit testimony on an issue of vital importance to the agricultural sector of the economy.

The National Grain and Feed Association (NGFA) is the national nonprofit trade association of 1,200 grain, feed and processing firms comprising 5,000 facilities that store, handle, merchandise, mill, process and export more than two-thirds of all U.S. grains and oilseeds utilized in domestic and export markets. The NGFA also consists of forty affiliated state and regional grain and feed associations whose members include more than 10,000 grain and feed companies nationwide.

The NGFA urges the committee to carefully consider the damaging effects of federal trade taxes on both the domestic economy and the competitiveness of U.S. exports. The NGFA is particularly concerned about several provisions contained in the budget proposal—A Vision of Change for America—now being considered by Congress. One proposal would increase, by over one ($1) dollar per gallon [1], the tax on diesel fuel used by commercial towing companies on the inland waterways. Another proposal would significantly increase the fees charged on inspections of export grain by the Federal Grain Inspection Service.

The recently released General Accounting Study—*MARITIME INDUSTRY: Federal Assessments Levied on Commercial Vessels*—shows that waterborne commerce already bears a heavy burden of taxes and so-called user fees. Assessments levied by 12 federal agencies on waterborne trade totaled $1.9 billion in fiscal year 1991 alone. Exports of U.S. grains are directly impacted by a host of taxes, user fees and assessments including the harbor maintenance tax, the vessel tonnage tax, commodity inspection fees and the inland waterways fuel tax.

The impact of maritime taxes and user fees are significant. A typical 50,000 metric ton shipment of corn from New Orleans to Japan via the Panama Canal incurs

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[1] The administration's FY94 Budget released on April 8, 1993 appears to have actually raised the stakes by proposing a "blank check" for the Corps of Engineers. The budget document provides that: "Proposed legislation would also authorize the use of the Inland Waterways Trust Fund to cover up to 100 percent of the Corps of Engineers Operation and Maintenance (O&M) costs on taxed segments of the Inland Waterways (IWW) System within four years. Under this legislation, fuel taxes would be increased each year, starting in Fiscal Year 1994 to reach the amount necessary in the fourth year to fund 100 percent of O&M costs on the taxed segments of the IWW. Receipts would be available for O&M subject to appropriations." *Budget of the United States Government for Fiscal Year 1994*, Appendix 517 (April 8, 1993). Thus, the fuel tax could increase by much more than $1 per gallon if Corps of Engineers' expenses increase or if initial revenue projections are inaccurate. The Corps of Engineers, at the March 30, 1993 meeting of the Inland Waterways Users Board, said that up to 38.3% of grain now being moved by barge could be diverted to other modes because of increased barge rates. That means the barge fuel tax would need to increase more in later years to make up for diverted freight.

$120,423 in taxes and fees using the data from the GAO study. The proposed one ($1) increase in the inland waterways fuel tax would add another $273,600 in costs to such a shipment, bringing the total maritime taxes and users fees associated with a typical export shipment of corn to a staggering $394,023 or $7.88 per metric ton. Set forth below are the taxes, user fees and assessments incurred on a typical[2] 50,000 metric ton export shipment of number 3 yellow corn shipped from Peoria, Illinois by barge[3] to the port of New Orleans, and then by ocean vessel to Japan via the Panama Canal:

1.	Certificate Fee for Vessel Tonnage Tax (p.56)	$4.50
2.	Clearance of Vessel (p.56)	18.00
3.	APHIS User Fee (p.67)	544.00
4.	APHIS Phytosanitary Fee (p.68)	30.00
5.	Customs Bulk Carrier Fee (p.68)	100.00
6.	Fed. Grain Insp. Serv. Stowage Examination (p.69)	210.00
7.	Panama Canal Commission (PCC) Gen. Tug (p.70)	2,700.00
8.	PCC Tug Lines (p.70)	50.00
9.	PCC Offshore Pilotage (p.71)	800.00
10.	PCC Port Pilotage (p.72)	800.00
11.	PCC Tolls (p.73)	48,620.00
12.	PCC Transit Booking Fee (p.66)	5,060.00
13.	Customs Vessel Tonnage Tax (p.76)	5,940.00
14.	IRS Inland Waterways Fuel Tax (p.76)	46,512.00
15.	Customs Harbor Maintenance Tax (p.79)	6,875.00
16.	Federal Grain Inspection Service Inspection Fees[4]	2,520.00
	Subtotal:	$120,423.50
	$1/gallon increase in Inland Waterways Fuel Tax:	$273,600.00
	Total Cost to Export Shipment:	$394,023.50

[4] This inspection fee is paid directly to the USDA's Federal Grain Inspection Service by the loading export elevator for federally mandated export grain inspection and is in addition to those fees identified in the GAO study.

INLAND WATERWAYS FUEL TAX

Congress has already expressed strong opposition to the administration's inland waterways fuel tax proposal. The House Budget Committee Report states that: "[T]he Committee (1) recommends that increases in the inland waterway fuel tax should be based on impact studies." No such studies have been done. As you are aware, the Senate passed, on a vote of 88 to 12, a "Sense of the Senate" resolution rejecting the proposed barge fuel tax. As part of the House-Senate Conference Agreement on the budget, both the House and Senate then adopted the "Sense of the Senate" resolution providing that: **"There shall not be an increase in inland fuel taxes beyond those increases already scheduled in current law [emphasis added]."** 139 Cong. Rec. H1747–61 (daily ed. March 31, 1993).

The NGFA's opposition to the proposed 525% increase in the inland waterways fuel tax is based on the following reasons:

First, the $1 per gallon tax increase would lead to significantly decreased farm income. In 1991, sixty-five percent of all U.S. grain exports, a total of sixty-three million tons with a total value of $10–15 billion, moved on the inland waterways. The price of these grains and oilseeds is determined by worldwide supply and demand in a global marketplace where U.S. farmers must compete with the production of farmers in Europe, South America, and the far East. It is very unlikely that this proposed increase in transportation costs[5] could be passed on to foreign buyers who have a large choice of alternative suppliers.

[2] The figures used are conservative and are based on the recently released United States General Accounting Office study—*MARITIME INDUSTRY: Federal Assessments Levied on Commercial Vessels* (March 1993; GAO/RCED–93–65FS). The page numbers referenced correspond to the pages in the GAO report. Additional assessments would be incurred under some circumstances.

[3] The barge movement assumes two twenty-six barge tows.

[5] "Transportation is a key element in the marketing system of bulk agricultural commodities. . . . Since most grain shipped by barge is destined for an export point, the **cost of barge trans-**

Continued

Additionally, merchandising margins in the grain and feed industry are extremely thin as are the operating margins of most barge carriers. A tax increase of this magnitude is larger than the combined margins of both the export grain and barge industries. Thus, it is inconceivable that this increase could be absorbed by these industries.

The only segment of the industry remaining to absorb this tax increase is the producer himself. A 1985 study by the Department of Agriculture[6] showed that fully seventy percent of a five cent per bushel fuel tax would be borne by the U.S. farmer. With another $1 per gallon in taxes, NGFA believes that this percentage will increase to the 85 to 95 percent level. The National Grain and Feed Association estimates that this tax will cause declines in annual market cash receipts to farmers of up to $431 million per year, just in those states which are directly adjacent to the waterways.

Second, the $1 per gallon tax increase is applied unfairly to only one segment of inland waterway users. Barge navigation is only one of many beneficiaries of inland river operations. Many programs are undertaken for a variety of public purposes, i.e. flood reduction, hydropower, water supply, and bank stabilization. In the absence of all commercial navigation, costs for these other purposes would continue, but the commercial navigation interests are now being asked to pay for all of these costs. By way of analogy, this would be akin to asking the commercial trucking industry to pay for all of the operations and maintenance of the interstate highway system.

Third, the projected revenues derived from the $1 per gallon tax are based on faulty economic theory. The present proposal estimates revenues in 1997 from this tax to be $460 million. However, this estimate is based on traffic volume remaining constant or even increasing slightly in the face of a five-fold increase in operating costs.

As farm income decreases due to this tax and the cost of production increases due to higher transportation costs of inputs such as fertilizer, overall farm production and U.S. exports will decline. In fact, the USDA study quoted earlier estimated that a five cent per bushel tax would cause a decrease in U.S. grain exports of 365,000 tons. With the $1 per gallon increase, exports could fall more than twice that amount. Thus, as the volume of export grain declines, the revenues from this tax would also decline to levels far below the projected $460 million.

In addition, there is good reason to believe the true net revenue increase that would be realized by government has been vastly overstated. Given the proximity of the corn belt region to the river system, we would expect midwestern corn prices to be depressed in a range of four to eight cents per bushel, depending on location. If we assume an average decline of five cents per bushel, revenue gains from this tax would be offset by increased federal deficiency payments under current government farm programs.

Based upon USDA's own *Final Regulatory Impact Analysis, November 16, 1992,* a five cent per bushel decline in average U.S. corn price would cause additional government costs in a range of $300 to $500 million.[7] This impact is for corn and feed grains alone. The added program cost to the federal government due to lower wheat and soybean prices would be in addition to this cost. Thus, even with conservative

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portation is a key issue in the total cost of marketing export grain. This cost is especially important with the increased competition from several grain exporting countries. Increased operating costs for barge operators may be reflected in higher transportation rates and reduced bids to producers by river elevators [emphasis added]." Patricia Miller & Lowell D. Hill, *ORGANIZATION AND STRUCTURE OF THE BARGE INDUSTRY TRANSPORTING GRAIN AND OILSEEDS,* Department of Agricultural Economics, Agricultural Experiment Station, College of Agriculture, University of Illinois at Urbana-Champaign (May 1986).

[6] Theresa Sun & Lester Myers, *A WATERWAY TAX ON GRAINS: A FUNCTIONAL MARKET ANALYSIS,* United States Department of Agriculture, Economic Research Service, Technical Bulletin Number 1705 (July 1985).

[7] A recent analysis of the impacts of the Clinton Economic Package on U.S. agriculture by the University of Missouri concluded that price support payments from the federal government to farmers would increase by $380 million during fiscal years 1994–97 if the barge fuel tax proposal is enacted. *See ANALYSIS OF THE IMPACTS OF THE CLINTON ECONOMIC PACKAGE ON U.S. AGRICULTURE,* Food and Agricultural Policy Research Institute, University of Missouri (Policy Working Paper #2–93, April 1, 1993). At the March 31, 1993 meeting of the Inland Waterways Users Board, the U.S. Army Corps of Engineers estimated that a barge fuel tax of $1.20 per gallon would result in up to 38.3% of grains presently moved by barge being diverted to other transportation modes such as rail. *See Grain Transportation,* AMS Transportation and Marketing Division, United States Department of Agriculture (April 5, 1993). A diversion of such magnitude would reduce the amount of fuel tax revenue from grain barge movements to $143 million during fiscal years 1994–97. **Thus, the net impact of the barge fuel tax would be to increase the budget deficit by $237 million!**

assumptions about the farm price impact of the tax, we believe a more careful assessment of the full impacts of this tax would demonstrate that the federal government could actually lose revenue rather than gain it with this proposal.

Fourth, the $1 per gallon tax increase will divert traffic from the inland waterways to other modes of transportation with significant environmental impacts. Barge transportation on the inland waterways is the most environmentally friendly mode, using less fuel per ton-mile, creating less air and noise pollution and having a superior safety record for the movement of petroleum and hazardous chemicals.

In a study conducted by the Minnesota Department of Transportation, it was found that if waterway traffic in Minnesota, one of the states most affected by this tax, was shifted to rail, fuel use would increase by 331 percent, emissions would increase by 470 percent and probable accidents would increase by 290 percent. For a shift from barge to truck, the increases would be 826 percent, 709 percent, and 5,967 percent, respectively. Thus, by driving cargo to other less environmentally friendly modes of transportation, this tax poses significant environmental risks for all Americans, not just those concerned with commercial navigation on the inland waterways.

Fifth, as a final point, we are extremely concerned about how such a heavy tax will affect U.S. cost competitiveness with our major competitors. Data from a recent Purdue University study[8] indicates the U.S. has four major competitors in corn production whose average cost of production is $3 per ton less than U.S. However, the high level of efficiency in the U.S. marketing system gives the U.S. farmer a $9 per ton advantage in delivering corn to world customers. Looking at total delivered cost, the U.S. farmer has a slight advantage of *$6 per ton* over major competitors. This heavy taxation of waterways, would effectively add about *$3 per ton* to the delivered price. Thus, with this one action, the *U.S. government would be eroding 50 percent* of our competitive advantage that we currently have in the production and delivery of corn to world markets. Most experts agree that the U.S. has its greatest comparative advantage in the production and marketing of corn, with even stiffer world competition in the production and delivery of soybeans and other grains, so the percentage loss in our competitive position for other sectors would be even greater. If agriculture is to be given a legitimate opportunity to grow and expand its share of world markets, we must protect our natural competitive advantages and efficiencies in the transportation infrastructure.

However, the grain and feed industry also recognizes the need for all Americans to share in the process of reducing the federal deficit. To that end we would like to make the following suggestions in order to reduce spending and/or increase revenues from the inland waterway sector:

First, the Congress should look to implement a meaningful reorganization of the Corps of Engineers structure. The Corps itself has already put forth a plan to reorganize which would lower its overhead by an estimated $115 million per year. Although this plan has been put on hold pending further review, we believe that even further savings could be found by efficient reorganization of the Corps of Engineers manpower and resources.

Second, along with any reduction in the overhead of the Corps of Engineers, the Congress must look to reduce Corps of Engineers spending on navigation operation and maintenance. Through careful review of projects and procedures, it would be possible to reduce the Corps operation and maintenance spending by $35–40 million per year.

Third, spreading the tax burden of operating and maintaining the inland waterways to other beneficiaries of the system would bring in additional revenue. It would seem more than equitable that users of the inland waterways other than the commercial towing industry should also contribute to the maintenance and operation of a system which provides many recreational, hydropower and water supply programs. Such revenue increases, while small individually, could easily total to $50 million per year.

Thus, by focusing on the three areas outlined above the Congress could easily meet the $200 million a year goal contained in *"A Vision of Change for America"* without completely crippling the agricultural sector of our economy which is so vital to our country's balance of payments and continued economic growth.

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[8] The average variable production cost for corn of the four major competitors (Argentina, Brazil, South Africa and Thailand) of the U.S. is $56 per ton as compared to $59 per ton for U.S. producers. The average marketing cost of the four major U.S. competitors is $34 per ton as compared to $25 per ton for the U.S. Thus, total delivered costs for the four major U.S. competitors is $90 per ton as compared to $84 per ton for U.S. corn. Data based upon 1986 estimates, presumed to be the most recent comparative data available on international competitiveness. *Indiana Agriculture 2000: A Strategic Perspective,* Purdue University (June 1992).

FEDERAL GRAIN INSPECTION SERVICE FEES

The NGFA is also extremely concerned about the President's proposal for new user fees to finance the operation of the Federal Grain Inspection Service. Specifically, the proposal—identical to the one proposed previously by Presidents Reagan and Bush, but rejected by Congress—would shift approximately $6.8 million per year in standardization costs to user fees, which could increase FGIS user fees by as much as 25 percent. Currently, industry user fees already pay the entire cost of official inspection and weighing, and account for approximately 76 percent of the FGIS budget. The use of the official system is mandatory for export shipments and is also offered by FGIS designated official agencies as an option at interior markets.

Standardization activities involve establishing and maintaining the official U.S. grain standards, developing and implementing standard methods and procedures for grading and weighing grain, maintaining a quality control program covering all aspects of inspection, and approving equipment used for official inspection and weighing. In addition to benefiting all participants in U.S. agriculture, these activities guarantee foreign customers that the U.S. system of grain grades and weights is reviewed and overseen by an independent entity administered and funded solely by the U.S. government.

Domestic utilization of official FGIS services is at an all time low. The use of FGIS services is declining and its financial resources low because fees are not priced competitively with other domestic grading services offering comparable quality. A further move by government to force additional costs on the relatively smaller number of remaining users of FGIS services will only exacerbate this problem and cause additional erosion in the FGIS customer base.

Furthermore, the proposal to have standardization paid for by user fees is fundamentally flawed. There are many "users" of the official standardization system, including farmers, country elevators, terminal elevators, and processors. Many of these "users" rely on the unofficial grades which are nevertheless based upon official grades set by FGIS in its standardization activities. All of these "users" benefit from standardization activities. However, we believe that shifting the cost of FGIS standardization activities to industry paid user fees will cause a further erosion of companies using the official system and cause even more of the financial burden to be borne by a small segment of those who benefit. This spiraling process of increased fees causes a reduction in the FGIS customer base and the need to further increase future fees. The end result will be a disproportionate share of the costs of FGIS standardization activities being borne by exporters who are required by law to use the official system.

Thank you again. Please contact the National Grain and Feed Association if the committee has any questions.

Statement of the National Hockey League

INTRODUCTION

The President's plan has the important twin objectives of reducing the deficit and stimulating growth of the economy. But the Treasury's proposal for a drastic reduction in the deductibility of meals and entertainment expenses runs contrary to those goals: It is anti-growth and anti-jobs. It severely discriminates, without justification, against the entertainment industry—which includes not only professional and college sports, but commercial and non-profit music, theater, and the other arts that contribute so much to the American quality of life. The proposal will reduce, not increase, tax revenues, and increase, not reduce, the deficit.

The National Hockey League ("NHL") strongly opposes the Administration's proposal to reduce the deductible portion of the cost of business meals and entertainment expenses from 80 percent to 50 percent. The enactment of such legislation would:

1. Drastically reduce the revenues realized by state and local governments generated by the sports industry, such as rental payments made by sports teams to municipally-owned facilities, admission taxes, concession income, parking income and other direct and indirect payments by teams and their fans, thus requiring such local and state governments to raise taxes or further reduce services to replace the lost revenues;
2. Result in severe job losses and potential business failures in sports related industries; a high percentage of that loss will likely be concentrated in urban areas;
3. Adversely affect thousands of construction and other jobs dependent upon capital projects, such as the building of new arenas or renovation of existing facilities;

4. Result in a substantial negative impact upon revenues for NHL teams as well as other sports franchises, threatening the viability of NHL and other sports franchises in medium and small cities.

I. UNDERSTANDING THE ECONOMIC CONTRIBUTIONS OF THE PROFESSIONAL SPORTS INDUSTRY

Professional sports makes a significant contribution to income and employment in cities throughout America. The most comprehensive study on this subject was prepared in 1984 by Dr. Edward Shils of the Wharton School of Finance analyzing the economic impact of the professional sports teams on the economy of the City of Philadelphia.[1] That report concluded that for the City of Philadelphia for the 1983 year alone, the professional sports complex:

—Resulted in direct income to the City in excess of $201,000,000;
—Generated a multiplier increment of over $141,300,000 (utilizing a conservative multiplier of 1.7 for each dollar spent by fans directly);
—Accounted, as a result of the above items, for a total direct and indirect economic contribution to the City of over $343,000,000;
—Created over $15,100,000 in direct annual income to the City in the form of rental payments for arenas, parking, concessions and taxes and, the $343,000,000 aggregate economic impact produced an estimated additional $20,500,000 in tax payments to that City in the form of taxes such as wage and net profits taxes, merchantable and general business taxes and otherwise;
—Resulted in jobs for more than 3,000 local vendors supplying "sports related" goods and services.

The eagerness that cities throughout the country have shown to host sports teams confirms the results of Dr. Shils' study. Professional sports is a vital part of a local economy and any substantial reduction in the revenues and spending associated with a local team will produce a severe adverse impact.

II. THE PROPOSAL TO FURTHER REDUCE THE DEDUCTIBLE PORTION OF BUSINESS MEALS AND ENTERTAINMENT EXPENSES WILL RESULT IN A SUBSTANTIAL DECREASE IN BUSINESS SPENDING ON ENTERTAINMENT RELATED ITEMS

The underlying premise of the proposal—that it will not result in a reduction by businesses of their meals and entertainment spending—is directly contrary to the NHL's experience following the reduction of the deductible amount from 100 percent to 80 percent in the 1986 Tax Reform Act. U.S. based NHL Member Teams[2] reported on the average a noticeable drop in season ticket purchases by businesses after enactment of the 1986 Tax Reform Act, in which the deductibility of business meals and entertainment expenses was reduced by *only* twenty percent (20%).[3]

If enacted, the 1993 proposal would have an even greater effect on season ticket purchaser for NHL U.S. Member Teams and their revenues. The current survey of the U.S. Member Teams projects an average sixteen percent (16%) decrease in *ticket revenues* if this additional reduction in deductibility is enacted. This would cost the U.S. member clubs nearly $50,000,000 per year.

The assumption that businesses will not reduce entertainment spending is wrong with respect to sporting events. With only one-half of the amount spent deductible, businesses would become more conservative in their approach to spending on meals and entertainment. A more realistic assumption is that businesses will, in fact, modify their spending behavior (as they have done in the past) and that attendance and ticket revenues will decline. And, the decrease in attendance would bring with it a

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[1] "Report to the Philadelphia Professional Sports Consortium on its Contributions to the Economy of Philadelphia," prepared by Dr. Edward B. Shils, the George W. Taylor professor of Entrepreneurial Studies and director of the Wharton Entrepreneurial Center at the Wharton School, University of Pennsylvania.

[2] Teams in exiatence in 1986 were: Boston, Buffalo, Chicago, Detroit, Hartford, Los Angeles, Minnesota, New Jersey, New York Islanders, New York Rangers, Philadelphia, Pittsburgh, St. Louis, and Washington. San Jose and Tampa Bay commenced play in 1991 and 1992 respectively. Anaheim, California and South Florida will commence play in 1993–94.

[3] We find incomprehensible the dissertation issued May 18, 1993 by the Congressional Research Service entitled "Effect of Current Tax Proposals on Employment in the restaurant and Entertainment Industries," which asserts that (i) higher tax rates offset the limit on deductions by, in effect, making the deductions more valuable; and (ii) there will thus be virtually no effect on the restaurant or entertainment industry from the proposed tax law from 100% to 80% whereas the current bill would reduce the allowance by an additional 30 percentage points. The monograph submitted by the NHL or the NBA and its conclusion is directly contrary to the substantial drop in season ticket purchases by businesses actually experienced by the professional sports teams after enactment of the 1986 Tax Reform Act described above.

decrease in spending for concessions and other "sports related businesses"—such as vendors, restaurants, hotels and transportation.

III. THIS PROPOSAL WILL CAUSE A SUBSTANTIAL LOSS OF REVENUES AND JOBS IN SPORTS RELATED INDUSTRIES

A fan attending an NHL or other professional sporting event does more than simply buy a ticket. The fan pays for transportation to the city and to and from the arena; buys food and drink before, during or after the game; parks in a municipal or other parking lot; buys game programs and novelties; and frequently stays in a local hotel overnight. Each of the industries that supplies these products or services to sports fans would be seriously damaged by the proposed legislation, as would the nearly 100 communities whose economy includes professional sports.

The magnitude of the loss to local economies can be estimated based on Dr. Shils' study and the recent survey of NHL clubs. Each of the approximately 8,400,000 fans who buys a ticket to an NHL game spends an average of $5.50 on concessions. A fall in attendance of sixteen percent (16%) would reduce gate receipts and in-arena spending on an overall basis by approximately $47,400,000. Using a conservative multiplier of 1.7,[4] this overall decrease would result in over $80,000,000 in lost spending simply attributed to hockey.

When similar reductions are applied to the other major sports leagues, the decrease in revenues and spending becomes staggering. A sixteen percent (16%) reduction in attendance and a corresponding loss in spending of $5.50 per person would mean lost gate receipts of approximately $250,000,000 from all sports and about $85,000,000 in concessions. This projects to an aggregate decrease in revenues and spending from the sports industry of $335,000,000 and becomes $569,500,000 using the 1.7 multiplier. The overall loss of spending at sporting events will adversely affect not only the sports team themselves, but also the industries dependent upon sports—the food, entertainment, hotel, transportation and other industries which are involved in supplying products and services to the professional sports industry. This translates into job losses—in addition to the ushers, ticket takers, vendors, security personnel, management and sales personnel, there are also those employed in these dependent industries as well as others who indirectly supply the products and services (hotel personnel, truckers) whose jobs may be lost as a result of curtailed sports revenues.

A majority of the employees who would lose their jobs under this proposal would be residents of urban areas who are entering their first level of employment: the worker in the meat processing plant; the man who makes the hot dogs; the parking lot attendant; the usher; the beer vendor, etc.—these are the people who will be hurt the most.

IV. THE PROPOSED REDUCTION WILL ADVERSELY AFFECT SIGNIFICANT REVENUES REALIZED BY STATE AND LOCAL GOVERNMENTS FROM THE SPORTS INDUSTRY

In addition to the loss of revenue and jobs in the private sector discussed above, the proposed reduction will have a serious negative effect on state and local municipal governments. The sports industry provides significant revenues to local governments in the form of "direct" payments such as admissions taxes, rentals for use of municipally owned arenas and other taxes, as well as "indirect" payments that result from activities associated with the sporting event—taxes on novelties, concessions, entertainment and the like. For example, the Shils report estimated that in 1983 the sports industry produced over $15,100,000 in direct payments to the City of Philadelphia and an additional $20,500,000 in taxes from sports related industries for an aggregate contribution to municipal revenues of $35,600,000. During the 1991–92 season NHL U.S. Member Clubs alone made more than $25,000,000 in payments, not including state and local income taxes, to state and local municipal governments for sales tax, ticket surcharges, property taxes and rental payments. The aggregate payments by all sports teams is doubtless at least four times that amount. These revenues are critical to the municipalities that receive them.

Thus, the inexorable impact of the proposal and its corresponding decrease in attendance and related spending will be to reduce payments from sports teams to state and local governments. A reduction in sports-related spending will also limit the ability of municipalities to meet previous capital commitments. For example, nine of the sixteen NHL U.S. teams currently rent municipally-owned arenas and pay rent to municipalities based in part upon revenue from ticket sales. Significant reductions in ticket sales revenue—and corresponding reduction in rental payments will severely diminish the ability of many municipalities to pay for those facilities.

[4] The 1.7 multiplier was used in the Shils report, supra.

The municipalities will suffer additional losses in sales and other taxes that will occur from the corresponding decrease in spending: at restaurants; on parking; novelties; and on concessions.

The ultimate result will be an increase in local property and sales taxes to compensate for the loss of rent and taxes payable by the sports teams. Such a scenario would be an ironic unanticipated consequence of the tax proposal: the cost of reducing the deductibility of business meal and entertainment expenses will be billed to the so-called "ordinary taxpayer" who may not be attending a sporting event or utilizing the sporting arena at all.

V. THE PROPOSAL WILL ADVERSELY AFFECT SIGNIFICANT PUBLIC WORKS PROJECTS

A further consequence of this proposal will be to discourage major sports-related public works projects and threaten the new jobs that are typically created by such projects.

In the NHL alone there are at least 10 new U.S. hockey arenas in the proposal or construction stage (others in the planning stage) that are ultimately dependent upon the economic health of sports franchises. When considering the other professional sports, the number of planned construction projects is likely significantly more. The feasibility of these projects is based upon a minimum level of rentals, admission taxes, sales taxes and other revenues produced by the teams. It is possible that many of these proposed arenas may not reach the construction phase if this legislation passes. Loss of these proposed arena projects, the cornerstones of urban revitalization, will severely hamper the Administration's goal of rebuilding our cities.

The economic importance of an arena project to a municipality is apparent from the example of one NHL Team, located in a smaller geographic market, that is contemplating a new arena. The economic impact study prepared by Ernst & Young Valuation Services in connection with that planned new arena concluded that:

—the total economic output associated with the project to the city would grow from approximately $36,400,000 preceding construction to $81,600,000 in the post construction phase, with a high of $124,100,000 during the construction phase;
—there would be an increase in employment (direct and indirect) from an average annual level of 350 jobs pre-construction to an average of 469 jobs post-construction, with a high of 1010 jobs during construction;
—the state and local municipalities would realize increased tax revenues from an estimated $5,300,000 annually pre-construction to an estimated $11,300,000 annually post-construction, with $12,100,000 annually during the peak construction phase.

It is clear from this analysis that these projects are a significant source of increased jobs and revenues to the private and public sector. It may be, however, that few, if any, new sports facilities will be constructed if the proposal is enacted. As you may be aware, financing for arena projects, both public and private, is dependent on projected revenue streams from the arena. The proposal's adverse impact on team and facility revenue will imperil and, indeed, in some cases eliminate the business financing of multi-million dollar investment projects which would otherwise contribute substantially to the economies and vitality of cities throughout the country.

Thus, whereas the Administration's economic objectives are to stimulate growth and job creation, the proposal, in fact, has the unintended effect of eliminating a great number of jobs, threatening major projects which are a primary focus of their communities and are keys to the future growth of the cities whose vitality is of major importance to the economy.

VI. UNINTENDED IMPACT ON SMALL BUSINESS

A. The stated underlying rationale for the proposal is that the reduction in the deductible percentage "will reduce the amount of personal expense inherent in these expenditures that are deducted for tax purposes." This rationale fails, however, when it is applied to the situation of the small business persons and entrepreneurs.

Several years ago a member club of the NHL in a small market conducted a demographic survey of its business season ticket holders. That survey found that 66% of those businesses surveyed were either individually owned or small businesses with less than 250 employees. In fact, it is the NHL's experience that the typical business season ticket holder or business purchaser of individual game tickets is the small business person. The tickets purchased by small businesses are generally used for customers, suppliers, employees, and as a marketing tool to enhance relation-

ships with present customers and clients and, more importantly, to develop new ones.

The entertainment of current and prospective customers, suppliers, and clients at sporting events is one of the few ways in which the small business can compete with its large corporate competitors. Small businesses cannot, for example, afford to underwrite extensive advertising campaigns involving multi-media exposure or to attend seminars and trade shows at resort locations. Such advertising and promotion opportunities, which remain totally deductible, are reserved for large entities with vast resources. A sporting event provides the small business person with a perfect setting to "compete" on an equal footing with big business by providing the business person with three to four hours of close contact with the customer, client, or supplier. Unlike the typical business lunch or seminar, attending a sporting event provides the small business with a unique format for conducting business and the data from our Member teams indicates that it is the small businesses that take advantage of this opportunity.

In this difficult and extremely competitive economy, small businesses must be highly sensitive to changes in their expenses, and would be most disadvantaged by the Treasury's proposal. Thus, the Administration's proposal would have the unintended effect of reducing the competitiveness and undermining the growth of small businesses.

VII. UNINTENDED EFFECT—INCREASED TICKET PRICES AND LOCAL TAXES

Another damaging consequence of the proposal will be on the "ordinary fan" attending games. Most significant expenses for a team are fixed—rent, operation, salaries—and, in the sports industry today, the only possible way to recoup lost revenues resulting from the proposed reduction would be through ticket price increases. In order to cover the projected per team loss of revenues in the NHL, the average U.S. ticket price would have to go from $24.75 to $29.25 ($58.50 for a pair) and $2,457.00 for a pair of season tickets—a price beyond the means of a majority of "ordinary fans" (who may be small businessmen) whom the proposal would purportedly benefit. For sports teams it is season ticket revenues, more than individual game day purchases, that are the lifeblood of the sports industry. Marginal franchises and those in small cities could not stand such a price increase and would have to move or die.

VIII. THE CONSEQUENCES OF THE PROPOSAL'S EFFECT OF REDUCED REVENUES TO SPORTS TEAMS AND NHL TEAMS IN PARTICULAR

We have seen the economic benefits to localities produced by sports teams and sporting events and the significant adverse effects that result if spending related to the sports industry is caused to be reduced. The adverse affects resulting from enactment of the proposal are distinct possibilities—not cries of wolf—especially when viewed from the perspective of the sports industry itself and hockey in particular.

The estimated decrease in gate receipts will likely have serious implications to many NHL teams. Member clubs of the NHL are extremely dependent upon gate receipts—more so than any other major professional sport—and a large percentage of each Member Team's gate receipt is directly tied to support from the local business community. On an average, at least sixty percent (60%) of a team's revenues are from gate receipts. Unlike the other major sports, the NHL cannot rely on revenues from television to support its Teams. In 1991-92 the average share of national television revenue for each of the NHL teams amounted to less than $1,500,000 or less than 7.3% of the average total revenues and the figures for 1992–93 will not be substantially different. The projected reduction in gate revenues may in some instances, bring into question the economic viability of certain NHL teams. Thus, the proposed reduction does have serious and real consequences to professional sports. It also will produce economic injury to the related industries and employees which depend on sports for their survival and will place an increased burden on the ordinary fan and ordinary taxpayer in the form of higher ticket costs and additional taxes to support municipally financed sports facilities.

This is at least the fourth time in recent years federal legislation has sought to punish the sports and entertainment industry under the guise of "fairness." Our ability to amortize the cost of player contracts has been sharply restricted; the deductibility of the premium price paid for luxury boxes has been substantially eliminated; the deductibility of tickets and related sports and entertainment expenditures has already been reduced by 20 percent. A further reduction by another 30 points—for an industry that contributes so much to the economy and the morale of the American people—is totally unwarranted. Abuses are adequately dealt with under the existing statute, regulations and rulings. The further onslaught on the

sports and entertainment industries as proposed would itself be unfair and would produce only lost revenues, lost tax revenue and lost jobs.[5] We urge that needed tax proceeds be generated—as they can be—by measures applied across the board in all industries, without discrimination and without needless harm to an important segment of the economy.

STATEMENT OF THE NAVAJO NATION

INDIAN EMPLOYMENT AND INVESTMENT TAX INCENTIVES TO ADDRESS INDIAN COUNTRY UNEMPLOYMENT AND INFRASTRUCTURE DEFICIENCIES

My name is Peterson Zah. I am the elected President of the Navajo Nation, the country's largest Indian tribe. Spanning the states of Arizona, New Mexico and Utah, the Navajo Nation has a total land area equivalent in size to the State of West Virginia, and encompasses almost one-third of all American Indian lands in the Lower-48 states.

I thank the Chairman and the Members of the Committee for the opportunity to submit this written statement for inclusion in the hearing record. My statement is in strong support of the "Indian Employment and Investment" tax incentives about which the Navajo Nation previously testified before this Committee in February, 1992, and which the 102d Congress subsequently enacted last October as Sections 1131 and 1132 of H.R. 11, the "Revenue Act of 1992." But for President Bush's veto of that legislation on the day following the general election, those Indian country incentives could, as we speak, be helping tribal leaders in 32 states address what I described last year as "the deplorable conditions existing in Indian country—conditions which truly are a national disgrace."

The Indian country tax incentives which Congress passed in H.R. 11 have now been re-introduced in the Senate and the House as S. 211 and H.R. 1325, respectively. With a proven legislative track record, these measures have continuing bipartisan support; to date, five Members of this Committee—from both sides of the aisle—are co-sponsors of S. 211.

The purposes of my statement are threefold. First, to make you aware of Indian country conditions that cry out for the type of innovative, private sector-oriented economic development tools that these tax incentives represent. Second, to explain why these Indian country tax incentives—because they can potentially benefit all of Indian country—are far superior to the Administration's pending proposals to establish just one Indian "empowerment zone" and five Indian "enterprise communities." Finally, I will attempt, with all the persuasive powers at my disposal, to convince you of the urgent need for, and the singular importance of, adoption of these Indian country tax incentives by the Committee in the 1993 tax legislation that you will report to the full Senate.

CONDITIONS IN INDIAN COUNTRY

Indian Unemployment and Poverty—56%. For American Indians, 56% is a tragic number, because it constitutes the average Indian unemployment rate on reservations throughout the United States. As Chairman Daniel K. Inouye reported during the Select Committee on Indian Affairs 1989 hearings on Indian economic development:

> **The unemployment rate on the majority of Indian reservations is simply incomprehensible** to the average American. During the height of the so-called Great Depression in the 1930's, unemployment averaged 25 to 30%. **In 1989 the average rate in Indian country is 52%!**

In 1993, that rate is 56%.

The conditions of poverty that persist throughout Indian country are unspeakable. Despite our reputation as one of the tribes which is "better off," 56%—coincidentally—of Navajo people live below the poverty level. It is not unusual for households at reservations across the country to lack telephone service, or electricity, or running water, or all of the above. The result is that here, within the borders of the United States of America, most reservations have living conditions which are far

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[5] The concept, that tax changes are counterproductive and revenue negative if they would adversely affect jobs or revenue in an industry, has been accepted by the Administration and House Ways and Means Committee as the basis for repeal of the excise tax on boats, aircraft, automobiles, jewelry, and furs. The repeal of the luxury tax was based on data submitted by those industries to show that the tax had a serious economic impact on revenues and jobs—precisely what the data set forth in the submission on behalf of professional sport also shows.

worse than exist in many of the Third World countries to which the federal government provides substantial foreign aid.

Stated simply, there is no single group of U.S. citizens that—uniformly—is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that—uniformly—is more deficient in infrastructure and job opportunities than Indian reservations.

Disincentives to Private Sector Investment in Indian Country—If one were to travel reservation-by-reservation—across 32 states—he or she would well understand the economic deprivation that tribal leaders and Indian people confront each and every day. We work very hard to attract new private sector jobs and investment to our reservations. The Navajo Nation, for example, offers the advantages of a large workforce, rich natural resources, an ideal location, and a well-trained, sophisticated three-branch government. However, tribal leaders' efforts are continuously undercut by a variety of obstacles—endemic to investing on reservations—that have prevented Indian country economies from securing their fair share of the business and jobs in this country.

First and foremost are massive infrastructure deficiencies. For example, the Navajo reservation has 2,000 miles of paved roads, while West Virginia is the same size and has 18,000 miles. Many of the dirt roads on which our people heavily depend are simply impassible when the weather is bad. As noted above, even something so basic as telephone service is lacking in Indian country; over half of all reservation Indian households lack basic telephone service. Roads, telephones, electricity, etc. are taken for granted by investors/employers even in the most distressed inner cities of the United States, but their absence from large portions of Indian country poses a daunting barrier to tribal leaders' attempts to attract new private sector investment and jobs.

Another significant disincentive to economic development—which I hope the Committee will address in the future—is **the growing problem of "double taxation,"** wherein states increasingly are assessing taxes on non-Indian business activities permitted by, and occurring wholly on, Indian lands. As I explained in July of 1991 to the House Ways and Means Subcommittee on Select Revenue Measures:

> This double taxation interferes with our ability to encourage economic activity and to develop effective revenue generating tax programs.
>
> * * * * *
>
> We find it especially hard to attract business to the reservation unless we make concessions that nearly defeat the purpose of wanting to attract business to the reservation in the first place.

These infrastructure deficiencies, double taxation and related problems lead to the same result nationwide—*Indians do not compete on a level playing field with even the most economically distressed non-Indian areas.* As a result, Indian country is typically left behind, or left out altogether, from economic development opportunities. To help level that playing field, and to provide tribal governments and Indian country business planners with additional tools to compete, the Navajo Nation believes that new approaches—tied to the tax code, and geared to the private sector—must be tried.

INDIAN EMPLOYMENT AND INVESTMENT TAX INCENTIVES

Indian Country Tax Incentives: The Preferred Approach—I will not review in detail the specifics of the "Indian Employment and Investment" tax incentives. They were added to H.R. 11 by the Senate, and thereafter adopted by the full Congress in October, 1992. The legislative language is set forth at pages 45–53 of the "Conference Report to Accompany H.R. 11" (H.R. Report No. 102–1034, issued October 5, 1992); the Conference Committee's detailed explanation of those Indian country tax incentives can be found at pages 715–718 and 721–725 of the Report.

In summary, the **Employment Credit** provides for a 10% credit to the employer based on the qualified wages and qualified health insurance costs paid to an Indian. As an added incentive, a significantly higher employment credit of 30% is offered to reservation employers having an Indian workforce of at least 85%. The credit, which is limited to "new hires" and to those employees who do not receive wages in excess of $30,000, focuses on job creation and would be allowed only for the first seven years of an Indian's employment.

The **Investment Tax Credit** is geared specifically to *reservations where Indian unemployment levels exceed the national average by at least 300%.* The legislation provides 10% for personal property, 15% for new construction property and 15% for *infrastructure investment* on or near reservations. (If a nationwide investment tax

credit and/or employment credit were to be adopted in 1993, the Indian reservation tax credit percentages would likely need to be adjusted upward to maintain the so-called "Indian differential," which is absolutely essential in order to help mitigate the unique problems—particularly the lack of infrastructure—that act as disincentives to Indian country investment.) One-half of the specified credit percentages would be available for qualifying investments on reservations where unemployment exceeds 150% but does not exceed 300% of the national average.

In response to concerns raised by several Members during Senate consideration of these measures in 1992, "anti-gaming" restrictions were incorporated in H.R. 11. These prevent both the investment and employment incentives from being used with respect to the development and/or operation of gaming establishments on Indian reservations.

Most importantly, these incentives would potentially benefit all of Indian country. This is the critical difference between these Indian country tax incentives and alternative approaches that would provide only for a limited number of Indian empowerment zones and/or enterprise communities.

Empowerment/Enterprise Zones and Other Pending Proposals Will Not Help Indian Country—Now, I am not opposed to the enterprise zone concept; in fact, I testified generally in favor of such proposals several years ago. However, that approach is woefully inadequate for Indian country. The Administration's **limited Indian empowerment/enterprise zone proposal could possibly help a very few tribes, but would prove counterproductive because it would dash the hopes of the many other reservations around the country which were not selected as zones, and whose people would not benefit at all.** Thus, for all of those reservations not selected, an Indian empowerment/enterprise zone approach would leave unabated the pervasive poverty and high unemployment that have perpetually defined life on those reservations.

Significantly, even those reservations that might be selected as zones under a limited Indian empowerment/enterprise zone approach would be unlikely to benefit. First, some of the zone-specific incentives contained in the Administration's proposal would have little usefulness in Indian country (*e.g.,* the low-income housing credit). More importantly, as previously noted, due to the lack of infrastructure, "double taxation" by the states and related problems, **Indian reservations simply cannot compete with even the most economically-distressed inner cities and other non-Indian communities.** In other words, given the choice, new business would in almost all instances opt to locate in non-Indian areas to avoid the unique difficulties that are inherent in locating on reservations. *Therefore, Indian empowerment/enterprise zones offering the identical incentives as non-Indian rural zones would remain unable to compete on anything close to a level playing field.*

Similarly, it is unreasonable to expect that Indian country can benefit from proposals for nationwide tax incentives (*e.g.,* an extended/expanded targeted jobs tax credit) where the tax incentives offered to Indian country are identical to incentives available in non-Indian areas as well. Again, to avoid the unique difficulties inherent in locating on reservations (*e.g.,* the higher non-wage costs resulting from infrastructure deficiencies), potential investors/employers in almost all instances would locate in non-Indian areas. Thus, by not recognizing and taking steps to address (*i.e.,* by providing incentives that contain, or constitute, an "Indian differential") Indian country's unique problems, proposals for nationwide incentives offering identical benefits in Indian and non-Indian areas would simply preserve the existing unlevel playing field.

Accordingly, it is this set of unique Indian country circumstances—highlighted by the unconscionable 56% average Indian unemployment rate—that require and justify a separate program for American Indians, such as that which the Senate last year included in H.R. 11 by adopting the Indian country tax incentives in lieu of then-pending proposals to establish a limited number of Indian enterprise zones. Fortunately, the trust responsibilities, treaty obligations and laws of the United States provide the basis for Congress to do so. Adopting a separate, reservation-based program for American Indians is consistent with the distinctive legal and political status of Indian tribes and their government-to-government relationship with the Federal government, and has been upheld by the Supreme Court (*Morton* v. *Mancari,* 417 U.S. 535 (1974)).

INDIAN COUNTRY TAX INCENTIVES ARE URGENTLY NEEDED

For almost a decade, Chairman Daniel Inouye, Co-Chairman John McCain, Senator Pete Domenici and other Members of the Senate's Committee on Indian Affairs had sought to amend the tax code to provide incentives for new private sector investment in Indian country. However, little progress was made during that period.

As Chairman Inouye noted last year, in comments applauding Congressional adoption of these tax incentives in H.R. 11, "it has been a difficult, and I must admit, an often lonely battle to compete with numerous other interests seeking changes to the tax code before the Finance Committee" and, I might add, the House Ways and Means Committee.

In 1992, I designated federal tax incentives as one of my administration's highest legislative priorities. Drawing from bills previously introduced by Chairman Inouye, Co-Chairman McCain, Senator Domenici and other Indian Committee Members, the Navajo Nation developed the initial legislative language for these particular employment and investment tax incentive proposals. Thereafter, under the bipartisan leadership of Chairman Inouye, Co-Chairman McCain, Senator Domenici and Senator Simon of the Indian Committee, with the interest and attention of Senators Baucus and Boren of the Finance Committee, and ultimately with the support of then-Chairman Bentsen and Ranking Member Packwood of the Finance Committee, the full Senate adopted the Indian country tax incentives in lieu of the then-pending Finance Committee bill provisions that would have created enterprise zones on just ten reservations.

In so doing, the Senate wisely opted for a legislative response that fit the problem, recognizing that the nationwide Indian unemployment problem warranted a nationwide, reservation-based program to address it. Subsequently, the Senate-passed provisions were accepted by the House in Conference, and enacted in the vetoed H.R. 11.

Indian Country Tax Incentives Are Consistent With Clinton Administration Goals—Having come so far in 1992, Indian country felt reasonably confident that the new Administration would take the lead in promoting these measures to help address the staggering Indian unemployment levels and the massive reservation infrastructure deficiencies that exist—uniformly—in Indian country. When I participated in President Clinton's pre-Inauguration "Economic Summit" in Little Rock, I reviewed the urgent need for Indian economic development; explained that new investment and jobs in Indian country would also spill over to provide economic benefits to adjoining non-Indian communities; and stressed that American Indians are not looking for hand-outs, but only a helping hand. Frankly, the Administration's failure to date to include these Indian country incentives in its proposals—and to focus, instead, on a very limited number of Indian empowerment zones (one) and enterprise communities (five)—has been a disappointment.

In "putting people first," the federal government could well benefit from giving priority attention *in this year's tax bill* to those citizens whom our nation historically has neglected until last—American Indians. These Indian country tax incentives offer hope throughout all of Indian country that new *private sector investment, jobs,* and *infrastructure development* may at last become a reality in some of the most destitute areas of the United States. As a result, the Indian reservation investment and employment tax incentives enjoy the support of Indian tribes across the nation and, in fact, can help to attract economic development to reservations in:

Alabama	Maine	North Dakota
Alaska	Massachusetts	Oklahoma
Arizona	Michigan	Oregon
California	Minnesota	Rhode Island
Colorado	Mississippi	South Dakota
Connecticut	Montana	Texas
Florida	Nebraska	Utah
Idaho	Nevada	Washington
Iowa	New Mexico	Wisconsin
Kansas	New York	Wyoming
Louisiana	North Carolina	

Mr. Chairman, these employment and investment incentives respond to a demonstrated need requiring urgent action. They offer an easy-to-understand, simple-to-administer, private sector-oriented approach to Indian country economic development without creating a new layer of governmental bureaucracy (*e.g.,* such as the newly-proposed "Enterprise Board"). They only cost the federal government if they work; even then, estimated costs are comparatively modest ($209 million over a five-year period according to the new Joint Committee on Taxation revenue estimate issued May 3, 1993). Indeed, the cost of the Indian country tax incentives is less than 0.8% of the $27+ billion cost of the two national investment tax credits which the Administration initially proposed (and which, I understand, the Administration now intends to withdraw and reformulate).

Significantly, the Indian country tax incentives have a *proven legislative track record* and *continuing bipartisan support* in the Congress.

CONCLUSION

American Indians cannot continue—for yet another generation—to compel our young people to leave their homes and their families because meaningful employment opportunities are lacking in Indian country. Today, these "Indian Employment and Investment" tax incentives remain as urgently needed as ever before.

In January, Chairman Inouye and Co-Chairman McCain re-introduced, as S. 211, the identical Indian country tax incentive provisions that the 102d Congress adopted in H.R. 11. Chairman Bill Richardson of the Subcommittee on Native American Affairs of the House Natural Resources Committee has introduced, as H.R. 1325, a companion bill in the House. On March 10, 1993, twelve Members of the Senate—from both parties—wrote to Secretary Bentsen to urge that the Administration include these provisions in its final tax package to be submitted to the Congress.

Mr. Chairman and Members of the Committee, the stage is set. This Committee can, in 1993, exercise the leadership to help Indian country achieve this long-sought legislative goal that, after years of frustration, we came so close to realizing in 1992. In closing, I would simply like to quote from the written statement that I submitted to the Committee last year in support of these incentives:

> Helping American Indians to help themselves is neither a Democratic issue nor a Republican issue; it's not a conservative policy or a liberal policy; it's not even a "special interest" issue. Rather, it is a "human" issue that must, and deserves to be, addressed from a **national perspective on a bipartisan basis,** and with a real sense of urgency warranted by the deplorable conditions existing in Indian country—conditions which truly are a national disgrace.

I sincerely appreciate the opportunity to submit this statement. I respectfully urge that the Committee *take the lead* on this issue by moving away from the inadequate and counterproductive Indian empowerment/enterprise zone approach, and instead including in the 1993 tax legislation the modest—but extremely important—Indian country tax incentives that the Congress in fact adopted last October.

Attachment.

United States Senate

WASHINGTON, D.C. 20510

March 10, 1993

The Honorable Lloyd Bentsen
Secretary
Department of the Treasury
1500 Pennsylvania Avenue N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

It is our understanding that the Administration is continuing to formulate its proposal for enterprise zones. Toward that end, we, as co-sponsors of S. 211, the "Indian Employment and Investment Act of 1993," urge that the Administration include in its final proposal the Indian country employment and investment tax credits contained in that bill. As you know, with your help, those identical provisions were included in last year's tax bill (H.R. 11) that President Bush vetoed.

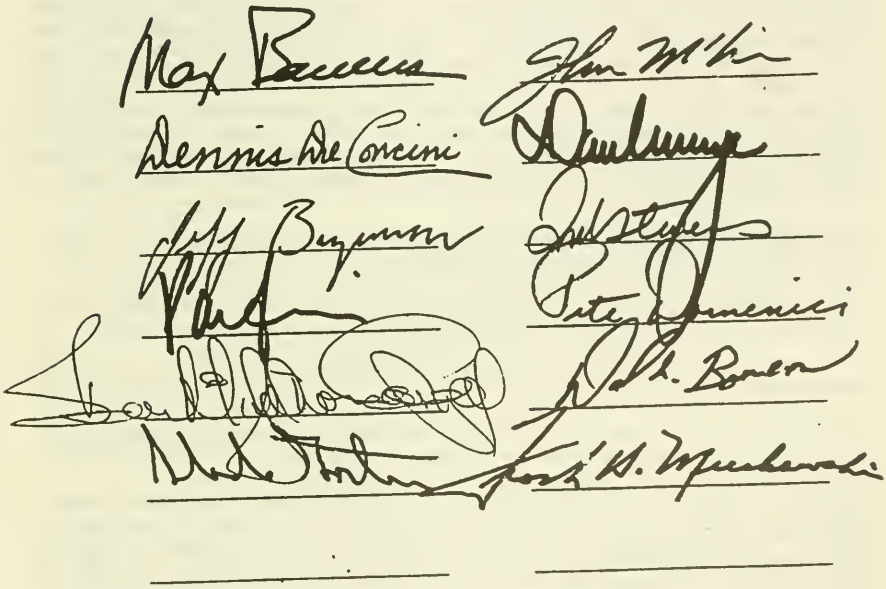
Indian reservations in 32 states throughout the nation are characterized by staggering unemployment (which, according to Chairman Inouye of the Committee on Indian Affairs, averages 56% nationwide), nagging poverty and huge infrastructure deficiencies. These and related problems unique to Indian country continue to undercut the hard work by tribal leaders in our states, and other states, aimed at encouraging economic development on Indian reservations.

Providing only for a limited number of Indian enterprise zones would help a few tribes, but would leave unaddressed the economic deprivation that defines life on all of the other reservations not chosen as zones. On the other hand, the Indian reservation employment and investment tax credits, which were adopted last year in lieu of the ten Indian zones previously set aside in the Senate bill, offer a nationwide response to a nationwide problem. They could potentially benefit all of Indian country by providing an innovative, private-sector oriented approach to attract new investment and jobs to some of this nation's most destitute areas.

Indian tribes strongly supported these comparatively modest provisions (which the Joint Committee on Taxation estimated would cost $181 million over a 5-year period) of this long-sought legislation. We urge that you consider including these provisions in the final tax package the Administration forwards to the Congress.

With best regards.

Sincerely,



STATEMENT OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction

The New York State Society of Certified Public Accountants (NYSSCPA) is the largest accounting organization in the nation representing the CPAs of a specific state. NYSSCPA membership numbers in excess of 33,000 CPAs. Our members practice in all sizes of firms and represent all types of clients in planning their business transactions and in calculating their tax liabilities. As a result, our members are able to provide enormous insight into the likely behavior of business and individual taxpayers in response to proposed changes in the tax law.

History--the 1986 Tax Reform Act

The truth of this assertion was demonstrated in 1985, when the Society submitted comments on President Reagan's tax proposals for "Fairness, Growth and Simplicity." In our analysis, we stated our fear that, "Average taxpayers will be bombarded with stories of the large tax savings of the wealthy, compared with their minor savings under the President's plan." We went on to state, "The use of the Tax Code to achieve economic and social aims has strongly influenced the structures of business and of investment patterns in this country....Repeal of current incentives will disturb these structures, perhaps seriously." The analysis listed those individuals and entities whose activities we felt would face at least some disruption. Included in this list were:

Real estate syndicators, mortgage bankers, builders and others aided by various real estate incentives;

State and local governments forced to find new sources of revenue or make hard choices concerning decreased services;

Capital intensive industries dependent on ACRS and the investment credit; and

Banks, insurance companies and other entities whose operations could be profoundly affected by the proposals.

We feel that our comments concerning the 1985 tax proposals were on the mark in many instances and that much of the negative effect of the 1985 proposals might have been avoided had they been recrafted to take into consideration analyses such as ours. We, as well as many others, believe the decline in the real estate market can be attributed in large measure to the changes in the passive loss rules enacted in 1986. This decline in real estate, in turn, seems to have lead to financial difficulties in the savings and loans and in the insurance industry. It is possible that much of our economic slump of the last few years may be traceable to the 1986 tax law changes. It is our hope that comments made concerning President Clinton's proposals will be weighed carefully to avoid the economic disruption generated by the 1986 Tax Act.

Simplification of the Tax Law

Any tax law changes that are enacted this year should be drafted to be as simple as possible. If the current tax law is not simplified, and any changes made to it made as simple as possible, our tax system is likely to eventually fall under its own weight. It is important to always remember that ours is a voluntary compliance system, and unless people understand the tax law and feel that it is reasonable and fair, many may begin to perceive that fully complying with it is not worth the effort.

Every time there have been tax law changes enacted in recent years, these changes have been referred to as "Accountants' and Lawyers' Relief Acts." While this generates chuckles and more than a few nods of agreement from the clients of tax professionals who are forced to pay increased fees, the reality is that the increased complexity of the tax law and the pace of the change have enormously eroded the profitability of most tax practices. Each tax law change requires many hours of training tax staff and of revising tax practice procedures. Additionally, in recent years many tax changes have been rather far-reaching, not necessarily grounded in sound tax policy but, rather, means of achieving revenue neutrality without government's being forced into admitting a tax rate increase is necessary.

These kinds of changes require substantial amounts of additional time to complete a tax return, and this frustrates both taxpayers and tax professionals. Often there is simply more paper to file and more taxes to pay, while the government keeps making assurances that there has not been a tax rate increase. This is a confusing situation at best and one that adversely affects tax practices and tax administration.

"Back-Door" Revenue Raising

It does seem fairly clear to us that a tax rate increase may be necessary to raise significant amounts of revenue to reduce the deficit. The maximum tax rates were probably reduced too much in 1986, since spending was not correspondingly reduced, resulting in the mushrooming of the deficit.

However, we would like to urge that Congress keep in mind that many deductions were eliminated or capped in 1986, thereby substantially diminishing the benefit of the tax rate cuts for many middle income Americans in particular. Eliminating deductions generally serves to simplify the tax code, certainly an end which we applaud. However, eliminating deductions for taxpayers who have made investment decisions, at least partly hinging on the tax law, serves to erode taxpayers' trust in the tax law and their respect for it. Thus, the imposition of the passive loss rules (albeit on a phased-in basis) on taxpayers who were able to afford the investment in certain pieces of real estate only because of the tax benefits these properties provided, permanently harmed many of these Americans economically. There have been numerous personal bankruptcies, as well as business failures, as a result of the 1986 tax law changes. The goal of eliminating tax shelters was a laudable one, but it should have been achieved in a more gradual fashion, in order to cause less economic pain. In the future, any tax legislation should seek to avoid such economic disruption by only applying to prospective transactions.

Furthermore, rather than putting limits on deductions that are otherwise allowable under the tax code, Congress should be more honest with the American people and, if the revenue is really a necessity, raise the tax rates. This makes the tax code much easier to work with and it gives taxpayers a clearer picture of the true rate of tax they are paying.

A Value Added Tax

As for considering some type of value added tax, Congress should recognize that while it may be a relatively painless way to raise vast amounts of money while leaving income tax rates untouched, it is again a fairly dishonest way of dealing with the American people. Congress would be able to point with pride to the fact that it had not fiddled with the income tax rates--or was perhaps even able to lower them. However, imposition of such a new and

regressive tax would create a vast new bureaucracy which would be expensive to establish and maintain. Furthermore, once such a taxing scheme is in place, it would become as easy to raise its rates as it was in the early days of the income tax so that soon the U.S. VAT rate could approach that of Great Britain. Instead of providing a new form of temptation for increasing spending, Congress should start making hard choices under our current system as to where spending cuts can be made and programs curtailed.

The New York State Society of Certified Public Accountants will be pleased to explain or to discuss further any of the points touched on above or discussed in our following detailed analysis of specific provisions.

SPECIFIC PROVISIONS

Investment Tax Credit

Position

We believe there may be easier and more effective ways to encourage investment in new plant and equipment than through an investment tax credit. This is particularly true if the credit is to be incremental, thereby favoring those businesses that were unwilling or unable to invest during the prior uncertain years in our economy and punishing those that went ahead and took the plunge. Furthermore, any credit that is not made permanent makes it difficult for businesses to plan their investments and spread them over a period of years in an organized, well thought-out fashion.

These problems can be addressed by not targeting the credit at either small business or incremental investments. Although the pre-1986 Act credit was quite complex, if the stimulus of a credit is deemed essential, we would favor following its approach.

Analysis

For businesses paying tax at a lower rate, a credit is more valuable than a deduction or exclusion. Thus, by its nature the investment tax credit benefits small businesses. The current proposal would go further and only make the credit permanent for smaller enterprises, but, even then, at a reduced rate. This does not appear to take into consideration the realities of the current business mix in the U.S., our global economy and the way businesses are run today.

Any credit that is provided should be allowed to all businesses and on some type of permanent basis. Our large airplane, automobile, electronics and computer manufacturers are finding it harder and harder to compete either overseas or even within our own shores. Any credit that is not available to these operations on the same basis that it is available to other enterprises--and on a permanent basis--is not targeted to take into account the reality of today's business climate. Any small manufacturers who wish to start up should be encouraged by our tax law, but they do not appear to be the wave of the future as it becomes more costly to establish such businesses and to purchase the necessary equipment to compete in a meaningful way.

The incremental nature of the credit would dramatically increase complexity. Measuring base period investments would, in many cases, require burdensome research to identify the types of investments included in the base period calculation.

In addition, it is not clear that any credit would be available for purchasing rebuilt assets, such as airplanes or boats. In fact, the proposal makes it clear that the credit would not be available for the purchase of used equipment. Another fact of life in today's economy is that much of the equipment used in businesses is

too costly to purchase new and may be even better if rebuilt than purchased new. Also, due to environmental and conservation concerns, we should generally be encouraging the rebuilding of equipment wherever possible. Thus, we feel that the law should distinguish between rebuilt and used equipment and specify that the credit is available for rebuilt assets.

The small business credit would not be available to businesses having gross receipts of more than $5 million. Thus, a business with $5,000,001 in gross receipts would be ineligible. Although a phased-out definition of small business would add complexity, such an amendment seems necessary to make the proposal fair.

Finally, the amount of the credit which is proposed would be fairly insignificant to stimulate certain investments. For three year property, the amount of the credit would only be 2.33 percent during the years in which a 7 percent credit was available to small businesses. After two years, when the credit fell to 5 percent, the credit for three year property would be only 1.67 percent. Such a small benefit does not seem to justify the additional administrative complexity that would be added. Furthermore, to generate more immediate stimulus from the credit, the carryback of unused credits to years prior to the effective date of the legislation should be allowed.

It may be that concentration on making long-term, low cost loans available to all businesses for the purchase of plant, equipment, furniture and other business assets would be a much more effective, lower cost solution to achieve the retooling of existing manufacturing concerns and the start-up of new small businesses, the creators of the greatest amount of new jobs. If a government program could be developed to encourage lenders to provide funds for this purpose, either through tax or some other incentives, it seems that it could substantially stimulate business investment in capital assets.

Permanent Extension of R&E Credit

Position

There should be government support of research and experimentation efforts. However, a tax credit does not seem to provide the necessary impetus. We strongly urge that a new means of promoting research efforts be found--particularly for start-ups.

Analysis

For many businesses that are starting up, a tax credit will provide very little benefit since the start-up may have no taxable income and, therefore, no tax liability for the credit to offset. Furthermore, the credit is tremendously complicated to calculate and the start-up will find itself incurring large professional fees to determine a credit that is of no current benefit. The proposed modifications to the credit seem to only exacerbate this problem for newer businesses. They add still more calculations that the business must make, again at a time when the business may have no tax liability for the credit to offset.

This credit is also very difficult to calculate due to the vagueness of the definition of qualified research expense. This vagueness has lead to many disputes between taxpayers and the IRS. We recognize that it may not be possible to more specifically define the term qualified research expense. However, this may be an area for Congress to make available non-traditional dispute resolution techniques.

More available government research grants and less costly loans to fund research could be the answer. These possibilities are certainly less complex. Again, the government could establish

programs to encourage lenders to provide low-cost funds for research programs. Full deductibility of research and experimentation expenses, even in the start-up phase of a business, could also provide significant benefits in a less complicated manner than the credit.

It adds to complexity that the same research expenditures can also be used, at least to some extent, to calculate deductions. If expenses do qualify for the credit, perhaps the rate of the credit should be increased to something more than the maximum tax rate, and the deductibility of the expenses should be disallowed.

Rather than requiring the amendment of 1992 returns, if a credit is enacted, effective as of July 1, 1992, the taxpayer should be allowed to include any benefits from it in the 1993 return.

Capital Gains Exclusion for Certain Small Business Stock

Position

We favor a targeted capital gains provision, such as this, to encourage very specific economic behavior. It seems to us to be more cost-effective than across-the-board cuts in capital gains rates.

Analysis

This provision, as expanded in later proposals released by President Clinton, seems to encourage the kind of venture capital investment in start-up companies that will be needed. We particularly applaud the increase in the excludable amount of the gain.

Modify Passive Loss Rules for Certain Real Estate Persons

Position

We applaud providing relief from the passive loss rules for real estate professionals. It has never made sense to limit the deductibility of losses from legitimate business activities.

Analysis

The rule, as proposed, seems to reach those real estate professionals who need this kind of relief. However, it does not spell out what would happen to their losses carried forward into 1993.

Increased Depreciation Period for Nonresidential Real Property

Position

We oppose once again extending the depreciation period for real property--this time, nonresidential real property from 31.5 years to 37 years.

Analysis

The more often depreciation periods are changed, the more complicated it becomes for smaller taxpayers to keep records and for their advisers to be able to recall all of the applicable rules without referring to volumes of reference materials.

Additionally, extending the period for the write-off of nonresidential real property seems to be directly contrary to the Administration's desire to encourage small businesses and to increase the investment in them. If anything, there should be more direct incentive for investing in business property. One way to provide this is to give more up-front tax benefits for investment in real property used in a business and to speed up the write-off of the investment in that property.

AMT Treatment of Gifts of Appreciated Property

Position

We support the exclusion from the alternative minimum tax (AMT) preference for charitable contributions of appreciated property.

Analysis

The tax law can stimulate or retard vital activities, such as maintaining educational and cultural institutions. This provision proved to be a very effective stimulus for prompting gifts to such institutions, and it should be reinstated in its expanded version that includes all charitable gifts of appreciated property.

Self-Employed Health Insurance Deduction

Position

We believe that the health insurance deduction for the self-employed should provide parity with the deduction allowed to corporate businesses and should be made permanent. Such legislation would benefit farmers, entrepreneurs, accountants, attorneys and other professionals, and tradespeople, as well as the owner/employees of S corporations.

Analysis

Absent this provision, a disparity is created between the tax treatment of owners of incorporated and unincorporated businesses (e.g., sole proprietorships, partnerships and, in this case, S corporations). An incorporated business can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for its employees, including owner-employees. By contrast, a self-employed individual operating through an unincorporated business, or a more than 2 percent shareholder in an S corporation, can only deduct the cost of health insurance for himself and his dependents to the extent that it exceeds 7.5 percent of adjusted gross income.

Prior to July 1, 1992, mainly as a vestige of Section 89 which never became effective, a self-employed individual was allowed to deduct as other than an itemized deduction up to 25 percent of the amount paid for health insurance coverage for himself, his spouse and his dependents. The proposal would reinstate this partial deduction from July 1, 1992, through December 31, 1993. Instead of making taxpayers amend 1992 tax returns to take advantage of it, we suggest that they simply be allowed to include the deduction for the whole 18-month period in their 1993 returns. This would dramatically simplify their filing burdens, while delaying the revenue cost of this provision to the Treasury and not substantially harming the taxpayer financially.

We have always been sensitive to distinctions created in the tax law between incorporated and unincorporated entities. Since 1982, with the exception of a few provisions, the rules governing qualified pension plans have created parity. We believe that the rules regarding health plans should also be reevaluated in order to eliminate major distinctions. This is particularly true in light of the dramatically increasing cost of health insurance.

We assume that this provision is drafted to be effective only through 1993 with the intention that the comprehensive health care reform bill will address this issue for payments made in later years. We urge the Administration to create parity as part of its health care reform package. We do not see any rational reason for establishing preferential treatment for health insurance coverage for a specific form of doing business. A decision as to the form of entity in which a business should operate should be made based on tax and non-tax issues other than this.

Assuming any health care reform package will contain changes in the rules regarding the deductibility of health insurance premiums, and knowing that such major changes could take a considerable time to be enacted into law, we urge that this provision be extended permanently. Then, if this particular set of rules is not addressed legislatively prior to December 31, 1993, we will not find ourselves yet again in the situation of needing to legislate an extension in the application of these rules.

Increased Tax Rates for Higher Income Individuals

Position

We generally support the need for an increase in individual tax rates to help reduce the deficit. As CPAs, we do not contend that a particular rate is right or wrong; however, we do favor open and honest rate adjustments to raise revenues, when needed, rather than hidden revenue increases, such as "floors," "ceilings," "percentage disallowances" and other mechanisms designed to disguise the fact that there has been a tax increase. Accordingly, we favor a fifth rate, rather than a maximum rate of 36 percent plus a stated surcharge. We do believe that the $250,000 threshold for the surcharge is set at too low a level.

Analysis

It is important to realize, however, that when tax rates are increased today, the rate increase is much more significant than it was pre-1986 when there were many credits and deductions available to cushion an increase in rates.

We are also concerned that the brackets at which the maximum tax rate will apply are often set much too low for those taxpayers living in high income, high cost urban areas. Clearly, a married couple filing a joint return that has $140,000 in taxable income has a very different standard of living in New York City, Los Angeles or Washington, D.C., compared to what they would have at this income level in Syracuse or Topeka. We think the cut-offs proposed by this Administration are more realistic than those which have been enacted in the last few tax laws. However, we would like to see more attention given to the discrepancies in the costs of living in the various areas of the U.S. It should be possible to come up with a way of graduating tax rates based on where a taxpayer lives, similar to the concept the IRS uses in fixing its per diem travel expense allowances for various metropolitan areas.

We would also recommend that Congress reinstate full deductibility of itemized deductions and personal exemptions, even if this means a slight additional increase in the maximum individual tax rates. It is much more difficult for taxpayers to accurately predict their tax liabilities when it is necessary to factor in these phase outs.

Provisions to Prevent Conversion of Ordinary Income to Capital Gain

Position

The proposal, in general, attempts to prohibit the conversion of ordinary income to capital gain. It would, specifically, tax net long-term capital gain at ordinary income rates to the extent the taxpayer elects to take the gain into account in determining investment income for computing the limitation on the deductibility of investment interest. We oppose this proposal, at least to the extent it redefines investment income, in that it adds enormous complexity for the sake of accelerating tax revenues.

Analysis

Taxpayers who choose to exclude their net long-term capital gains income from determining their net investment income will simply defer the time at which they can use their investment interest

expense. Any investment interest that is limited as a result of the investment income limitation will carry forward and can be used in a later year when sufficient investment income is generated.

To the extent a taxpayer tries to avoid this new limitation, he or she will be forced to use alternate financing arrangements, such as home equity loans, that are more expensive than borrowing against securities. This will be detrimental to the securities industry in that it will reduce the available business. It will also allow taxpayers who use alternate financing arrangements to circumvent the margin requirements.

The provision may also discourage long-term investment in small capitalization stocks since these usually generate no investment income other than long-term capital gains. This is certainly contrary to the proposals in this bill which would provide preferential capital gains treatment to taxpayers who invest for the long term in small capitalization companies.

Reduce Deductible Portion of Business Meals and Entertainment

Position

We strongly oppose the current disallowance of 20 percent of the deduction for business meals and entertainment. We think increasing the nondeductible amount to 50 percent is very bad tax policy.

Analysis

The disallowance of legitimate business deductions is simply a hidden tax increase--something we have indicated several times that we greatly oppose. We feel that Congress should be honest with the American people as to the true tax rate which is imposed on them. Furthermore, we think it is bad economic and tax policy for businesses to be hindered in their spending decisions by the tax law. Additionally, disallowance provisions, such as this one, add substantial complexity to the tax law.

This proposal also does not take into account that different sizes and types of businesses operate differently. Big businesses create goodwill primarily through institutional advertising while small businesses spend much more, proportionally, on business entertaining to create goodwill with existing customers and to woo new ones. Since small businesses are the greatest creators of new jobs in our economy, our tax law should serve to encourage their efficient operation. Proposals such as this one have the opposite effect--increasing recordkeeping burdens, accounting fees and tax bills.

Further, this increase in the limitation will have the effect of curtailing entertaining at restaurants, resulting in decreased revenues, leading to less income tax revenues, less local sales tax revenues, and less employment.

Deny Deduction for Club Dues

Position

We also oppose disallowance of this deduction.

Analysis

In many communities, the accepted way of building customer relations is through entertaining at clubs--especially for the smaller business. In certain towns across America, big companies have corporate dining rooms on the premises. Other businesses must either use the country club or the local diner to entertain their business contacts. Therefore, the club dues a company pays are often business necessities. Disallowing such deductions again makes it harder for businesses to conduct their affairs in a manner that makes sense, given today's life styles. Certain clubs provide

the right atmosphere to engage in serious business discussions to a much greater extent than any office setting or restaurant. Furthermore, at a golf, tennis or exercise club, it is possible to establish a different level of business camaraderie than it is in an office setting.

Our tax law should be structured to encourage the efficient and profitable operation of businesses. The more profitable they are, the more tax revenues that will be collected. If club membership contributes to this end, it should be favored by the tax law instead of resulting in one more hidden tax increase.

It is important to keep in mind that the law already requires that more than 50 percent of the business use of the club be proved before any portion of the club dues are deductible.

Require Securities Dealers to Mark to Market

Position

While we recognize that this is the way business is actually conducted in the securities industry, we do not support the idea that taxable income should be accelerated through mark-to-market concepts.

Analysis

Even though requiring securities dealers to mark their inventories of securities to market will currently result in additional taxable income since the securities markets are strong, the Treasury must understand that some day this provision could actually be a revenue loser, if the markets decline dramatically. Furthermore, the income required to be recognized by a securities firm under this proposal could well disappear in the succeeding taxable year. The only time such a mark-to-market concept has been applied previously in the tax law is with respect to regulated futures contracts. And this was in exchange for favorable capital gains treatment of these contracts.

It does seem to us that Congress should now deal with the problems presented in the financial industry by the Arkansas Best decision. While the mark to market proposal takes into account the way the securities industry actually operates, so should other provisions of the tax law. In the global economy of today, there are enormous amounts of hedging of currency and interest rate fluctuations. This is no more than prudent business practice. If there are losses in these hedging positions, the losses should not be deemed capital but should, instead, be treated by the tax code as ordinary business deductions. This is not necessarily the conclusion the IRS will reach after Arkansas Best. There is a real need for clarification of the tax law in this area.

If it were necessary for Congress to specifically require marking to market of securities dealers' inventories in exchange for relief from Arkansas Best, we could support such a trade-off.

Reporting Rule for Service Payments to Corporations

Position

We oppose this provision as creating vast amounts of additional paperwork that provide no meaningful information to the government.

Analysis

Corporations use many different year ends--not simply the calendar year end. All 1099s provided to them would be on a calendar year basis. Such 1099s will simply serve to create confusion among the corporate recipients, mandate substantial additional filings for the payors and give the IRS very little additional information for

matching purposes. The paperwork burden created by this proposal is in no way justified by the miniscule benefit that it would produce in the compliance area--presumably only the ability to match the 1099s filed for calendar year corporations against the income they report.

Raise Standard for Accuracy-Related and Preparer Penalties

Position

We disagree with the need for this proposal.

Analysis

Just a few years ago, Congress passed the Improved Penalty Administration and Compliance Tax Act. The Act was the product of an unprecedented collegial process, initiated by Congressman Pickle, involving the tax writing committees, the IRS, the accounting profession, the Bar and other interested parties.

In our view, the current proposal is the type of tinkering which has crippled penalty provisions in the past and would lead to reduced, rather than improved, compliance. Furthermore, reasonable basis has never been a satisfactory standard in that it is extremely difficult to define. If a taxpayer makes adequate disclosure and the IRS is put on notice thereby, there is sufficient opportunity for the Service to challenge the position.

Modify Tax Shelter Rules for Purposes of the Substantial Understatement Penalty

Position

We disagree with the need for this proposal.

Analysis

Unlike the prior proposal, the provision at which this proposal is aimed was not changed in 1989. The section at issue contains a penalty to deter tax shelter investments.

We submit that the growth of tax shelter investments seems to us to have been effectively halted--both by the provisions of the 1986 Act and by our clients' experiences in the later years of their tax shelters. Many times, not only did they lose their entire investment, but they found themselves liable on notes for many years while picking up phantom income for tax purposes. Often, on audit, they faced not only enormous tax liabilities, but substantial penalties and interest computed at the very high rates of the Eighties.

Furthermore, this provision seems to add no real teeth to the law. If the taxpayer can indeed show that the reasonably anticipated tax benefits from the shelter did not significantly exceed the reasonably anticipated pre-tax economic profit from the tax shelter, then it is likely that there would be no deficiency and, therefore, no penalty.

Statement of the Price Waterhouse Royalty Coalition

I. INTRODUCTION

This testimony is submitted by Price Waterhouse on behalf of a broad-based coalition of companies formed to advocate the retention of current-law treatment of foreign royalties.

Reflecting the trend to global markets, the companies in our coalition relied on foreign operations for 41 percent of worldwide gross receipts, totalling over $250 billion in 1992. These companies invest billions of dollars in the United States developing valuable intangible assets that must be utilized in world markets to recoup development costs. Coalition companies employ 740,000 people in the United States, including 74,000 in R&D-related activities (89 percent of worldwide R&D employees) and spent almost $11 billion domestically on R&D.

Competition in global markets is fierce—the companies in our coalition had fewer employees last year, both in the United States and abroad, than they did 10 years ago. Our long-term survival requires global operations designed to maximize economies of scale and economic efficiency. By competing globally for market share, we preserve high-quality jobs in our U.S. headquarters. Moreover, foreign affiliates are crucial to U.S. exports—in 1992, over 60 percent of our exports were sold by our foreign affiliates.

Every company in the Price Waterhouse Royalty Coalition supports the President's broad economic policy goals and objectives, namely to build an environment for economic growth focusing on the creation of new jobs, long-term economic investment, and reducing the federal budget deficit. However, we believe that the specific proposal to change the tax treatment of foreign source royalties is inconsistent with these economic goals for the following reasons:

- The royalty proposal would reduce domestic R&D and could provide an incentive for U.S.-based multinational corporations to move R&D and other jobs overseas. Royalties from the license of intangible property to overseas users is an important source of well-paying U.S. jobs in the area of R&D, marketing, management, information systems, and other administrative areas that support the development of intangible property.
- Business and competitive circumstances often dictate that U.S.-based MNCs perform significant activities abroad involving the use of intangible assets (such as manufacturing, distribution, and technical support) in order to penetrate and survive in foreign markets; it would be counterproductive for U.S. international tax policy to discourage such activities.
- The royalty proposal would increase the over-taxation of foreign income of U.S.-based MNCs.

II. THE ADMINISTRATION'S ROYALTY PROPOSAL

The Administration has proposed including all foreign source royalty income in the separate foreign tax credit limitation category for passive income (i.e., the "passive basket"). Treasury's Greenbook [1] provides the following rationale for the royalty proposal:

> The treatment of substantial portions of foreign source royalty income as general limitation income for foreign tax credit limitation purposes . . . can result in a *tax preference* for licensing of intangible property to a foreign person for use in production activities abroad. . . . In contrast, royalties or other income received for the use of intangible property in domestic activities generally cannot be similarly sheltered. (Emphasis added).

Treasury maintains that the royalty proposal will encourage expanded use of intangible property in domestic activities (instead of foreign activities), thus leading to U.S. job creation and growth at the expense of foreign job creation and growth. [2] On the surface, such reasoning has appeal. Indeed, other factors being equal, we agree that the U.S. tax system should not promote foreign-based activity at the expense of U.S.-based activity. However, on closer analysis, the royalty proposal could produce results at odds with the Administration's broad policy goals, for the reasons set forth below.

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[1] *See* "Summary of the Administration's Revenue Proposals" (Department of the Treasury, February, 1993), at page 58.

[2] *See* also Department of the Treasury memorandum titled "Administration Proposal on the Tax Treatment of Royalties" dated April 14, 1993 ("April 14 Treasury memorandum").

III. FOREIGN ACTIVE BUSINESS OPERATIONS ENHANCE U.S. JOBS AND U.S. ECONOMIC GROWTH

Three decades ago, U.S. corporations accounted for over half of all multinational investment in the world, our nation produced about 40 percent of world output, and we were the world's largest lender of capital. Tax policy makers felt little need to analyze how the U.S. tax system affected the competitiveness of U.S. companies in world markets.

Our economy is no longer so dominant that global competition can be ignored in formulating tax policy. U.S. corporations now account for less than one-third of multinational investment, the U.S. economy produces less than 30 percent of world output, and we are the world's largest debtor. Three decades ago, 18 of the world's 20 largest corporations were headquartered in the United States; today, only nine U.S. corporations rank in the top 20.

Arguments that we must discourage U.S. investment abroad to protect domestic employment are obsolete. In an increasingly open economy, discouraging U.S. companies from producing in the most efficient locations will not protect U.S. jobs; instead, these jobs will go to foreign-based multinationals with lower costs. Indeed, the evidence suggests that multinational investment promotes exports: two-thirds of U.S. merchandise exports were associated with U.S. multinationals; and the industries that are most active overseas tend to be the same industries that are the most effective exporters. In short, global investment strategies are critical to the competitiveness of the U.S. economy.

Thus, any proposal designed to prevent U.S. companies from operating internationally would be counter-productive to the Administration's broad policy goals. Recent studies confirm that increased foreign business activity enhances the level of U.S. employment and overall U.S. economic growth; and that sales by foreign affiliates of U.S.-based MNCs come at the expense of foreign competitors rather than U.S. exporters.

Some have argued that overseas investment by U.S. multinationals represents a drain on investment at home. Yet, over the last decade, foreign income has *exceeded* foreign investment in U.S.-owned foreign corporations. Thus, the growth in U.S. direct investment abroad has been *financed internally and not by outflows of capital* from the United States.

IV. BUSINESS PRACTICES AND NECESSITIES DICTATE FOREIGN ACTIVITY

U.S.-based MNCs derive active foreign income purely because business considerations, rather than tax motivations, require the use of U.S.-developed intangibles in geographic proximity to foreign markets.[3] U.S. companies license intangibles abroad for a multitude of business reasons. Some are as basic as local-content requirements that necessitate that at least a portion of such products sold in a foreign country be produced in that country. Thus, royalties often support and promote exports of U.S. manufactured goods.

For example, U.S. exporters of heavy equipment, such as power generation equipment and locomotives, are often forced by their customers to engage local suppliers for the low-value added portion of a particular product in order to meet local content preferences or requirements of purchasers. To meet this request for local content, the local suppliers need access to the U.S. manufacturer's specifications and technical expertise. These suppliers, sometimes referred to as manufacturing associates, pay substantial royalties for access to the U.S. exporter's technical information which enhances the exporter's return. Such royalties, of course, are a critical part of the overall economic return in what is fundamentally an export activity. Without the requisite local content, the export order often would not be obtained. The license in this case is not a vehicle for giving technology to a foreign producer. Rather, the license preserves the technology and controls its use so that the U.S. producer can protect its technology for future exports.

For many industries, it simply is not feasible to supply foreign markets by export alone. The unit cost of shipping many of the products produced by companies in our coalition is extremely high. The added costs of transporting such products across oceans—including the shipping costs, foreign duties, and other expenses—would make it impossible for U.S. companies to compete with foreign companies producing

[3] Moreover, current U.S. tax rules (see Code sections 482 and 367(d), discussed infra) effectively *require* a U.S.-based MNC to make its intangibles available to foreign affiliates by a license requiring royalties reflective of the ongoing value of the intangible. Failure to comply with these and related rules can result in the imposition of substantial penalties. Additionally, as discussed, *infra*, the "look-through" rules of Code section 904(d)(3) encourage royalty and other deductible payments to reduce foreign income taxes.

those products locally. For many consumer goods, particularly food products, it would, simply not be practical to ship products abroad, due to spoilage and other factors. Foreign licensing also is required where, for example, FDA regulations preclude the manufacture and export of drugs that have not been approved in the United States.

In addition, many foreign jurisdictions continue to discriminate in favor of local manufacturers in terms of granting early product approvals and favorable in-market pricing. There can be significant duty advantages to supplying products destined for the EC from a European location. Maintaining an EC manufacturing presence also permits the exercise of EC patent rights and, thus, avoids possible compulsory licensing.[4] Finally, there are instances where a company will license it's products to a third-party abroad in order to gain access to that party's products (i.e., cross-licensing arrangements) or to otherwise establish a business relationship with that party.

Treasury's Arguments are not Realistic

In an example included in the April 14 Treasury memorandum, a U.S.-based MNC faces the choice of exploiting a valuable U.S.-created manufacturing patent in the United States or, alternatively, in a foreign country. Specifically, its choice is whether to construct a plant in the United States and use the patent in the plant to generate U.S. source income, or to have its foreign subsidiary construct the plant overseas and, licensing the patent from the United States, to derive foreign source remanufacturing and sales income. Under the example as presented, the two choices appear to be mutually exclusive.

However, Treasury's notion that U.S. companies have two alternatives—to manufacture and sell in the United States or to manufacture and sell abroad—is unrealistic. In fact, if it is profitable to manufacture and sell in the United States, companies will do so. Moreover, if a valuable U.S.-developed intangible can be successfully exploited both in the United States and abroad, there is nothing in the current tax rules that would prevent a taxpayer from exploiting the intangible in both locations.

Statistics Show Foreign Income Bears Higher Tax Burden Than U.S. Income

Data suggests that U.S.-based MNCs do not operate abroad because of U.S. tax incentives; indeed, current law provides an overall disincentive for U.S. companies to operate abroad. According to statistics released recently by the General Accounting Office (GAO), worldwide tax as a percentage of worldwide income of U.S.-based MNC's (37.1 percent) far exceeded U.S. tax as a percentage of U.S. income (32.9 percent) for accounting periods ending in 1989.[5] This data demonstrates that, while aggregate U.S. income is subject to an effective tax rate less than the U.S. statutory rate, foreign income is subjected to a rate in excess of the U.S. statutory rate. Thus, foreign income of U.S.-based MNCs is subject to a higher level of taxation than U.S. income.

A recent Price Waterhouse study found that a U.S. multinational manufacturing in Italy and selling into Europe through a Swiss sales subsidiary would pay an effective tax rate of 35.2 percent as compared to an average effective tax rate of 29.2 percent if the European operation had been owned by a Canadian, French, German, Japanese, Dutch, or British parent. The higher effective tax rate for the U.S. multinational—ranging from four percentage points in the case of Germany to 10 percentage points in France—is tantamount to a surtax that foreign-based multinationals do not bear.

This higher overall tax burden borne by U.S. multinationals on foreign income is explained in large part by the bias in our current tax system in favor of over-taxing foreign income. For example, the current rules mandating the allocation of interest

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[4] In many less developed countries, maintenance of foreign-owned patents requires proof of actual production or exploitation of the patented subject matter within those countries. For the most part, these patent "working" requirements can not be met simply by exporting finished products from another country. Failure to meet these requirements may subject the U.S. company to sanctions or otherwise put the company's operations in that country into jeopardy.

[5] US General Accounting Office, *1988 and 1989 Company Effective Tax Rates Higher than in Prior Years*, August 1992, GAO/GGD–92–111. Foreign tax as a percentage of foreign income is higher than worldwide tax on worldwide income (37.1 percent) because this percentage is a weighted average of U.S. tax as a percentage of U.S. income (32.9 percent) and foreign tax as a percentage of foreign income.

expense[6] and state income taxes[7] against foreign income frequently result in the imposition of "residual" U.S. tax on foreign income that has already borne foreign income tax at a rate higher than the U.S. statutory rate.

V. THE ROYALTY PROPOSAL WOULD INHIBIT U.S. EMPLOYMENT AND ECONOMIC GROWTH

The proposal would discourage research and development (R&D) activity in the United States and, in some cases, encourage shifting research and investment outside of the United States.

U.S. companies with excess foreign tax credits would seriously consider increasing the development of intangibles overseas in countries where intangibles-related income is taxed more favorably than in the United States.[8] This would entail the removal of R&D activity and related jobs to foreign countries. This would be especially likely for those U.S.-based MNCs that frequently are in an excess foreign tax credit position (due, for example, to the over-allocation of U.S. interest expense to foreign income) and which for business reasons are required to conduct active business operations involving the use of intangibles in foreign markets.

The royalty proposal would further erode the ability of U.S.-based MNCs to compete against foreign multinationals in overseas markets.

As noted above, foreign income is more heavily taxed than U.S. income. Adoption of the royalty proposal would increase the level of over-taxation. The net result would be a further erosion of the ability of U.S.-based multinationals to compete in foreign markets against foreign-based multinationals that do not shoulder a similar home-country tax burden.

VI. THE PROPOSAL REPRESENTS UNSOUND TAX POLICY

The current foreign tax credit limitation provisions are far more complex and restrictive than those of other countries. However, a mitigating feature is that active business income is generally included in the overall or "general" basket. Moreover, items of non-movable active income derived from the same business are almost never subject to separate limitations. The look-through rules of section 904(d)(3) of the Code generally ensure this result for royalties paid between members of a U.S. group by "basketing" these royalty payments with reference to the underlying earnings out of which these royalties are paid.

The royalty proposal would carve out one slice of active income generated from an integrated business activity for separate treatment. Developed intangible assets used by members of an affiliated group engaged in an active integrated business are as "active" in nature as tangible assets used in the active integrated business. This "active" characterization is equally applicable regardless of where in the group (i.e., in which entity and in which geographic location) the asset is employed, and regardless of the characterization of the income derived from the use of the intangible in the business (*e.g.*, sales income, royalty or rental income).

The proposal to carve out a slice of active income and tax it as passive income is inappropriate as a matter of tax policy for the following reasons:

Active vs. Passive Income

Under the Administration's proposal, foreign income taxes paid on a slice of active foreign income could not be credited against tax on the active income derived from the same integrated business. Some may argue that this "schedular" approach is appropriate because current law permits undesirable "averaging." However, this argument ignores "the integrated nature of U.S. multinational operations abroad"[9] as recognized in 1986 by Congress when it created the current treatment of royalties. Thus, Congress validated the notion that the foreign income taxes paid on the active

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[6] Under section 864(e) of the Code, interest incurred by a US consolidated group (including financing subsidiaries engaged in unrelated businesses) is allocated to all of the income—domestic and foreign—of the group, including income from foreign subsidiaries. However, interest expense of a foreign subsidiary, in effect, is allocated only to its own income. This results in the over-allocation of U.S. incurred interest expense to foreign source income, thus inappropriately reducing the foreign tax credit.

[7] The regulations require that state income taxes be allocated to, foreign income. This reduces the foreign tax credit, notwithstanding that state income taxes do not relate legally or conceptually to the generation of foreign income. Moreover, no foreign government allows a deduction for income taxes paid to any state.

[8] Ownership of the intangibles developed through these offshore R&D activities would then rest with the foreign affiliate(s), thus eliminating the requirement to make royalty payments into the United States.

[9] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, May 7, 1987, (the "1986 Bluebook") at 862.

income of the business relate conceptually to all of the active income from the business derived by the U.S. parent. Moreover, Congress believed that "averaging" only would be inappropriate "when it would distort the purpose of the foreign tax credit."[10]

Branch vs. Controlled Foreign Corporation (CFC)

The royalty proposal frequently would have the effect of imposing a higher effective U.S. tax rate on income from an active business operated in corporate rather than branch form. Under current law, the inclusion of royalty and other types of income received from CFCs in the overall basket is intended to equate the U.S. tax treatment of CFCs with foreign branches. The Report of the Senate Finance Committee to the 1986 Tax Reform Act (Senate Report) states:

> The look-through rules are intended to reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (or through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation or other related person.[11]

U.S. international tax policy has recognized the merits of treating branches on a par with CFCs, and vice-versa. The royalty proposal would undercut the ability of many U.S.-based MNCs to operate abroad through CFCs even though the operational needs of the foreign business may weigh in favor of corporate, rather than branch form.

Discourages Foreign-Tax Deductible Repatriations

The effect of the royalty proposal runs counter to a fundamental U.S. tax policy goal of encouraging companies considering ways to reduce their overall tax burden to first seek methods for reducing foreign taxes. In this regard, the Senate Report states:

> The committee bill subjects interest, rents, and royalties to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation, or other related person . . . Under the foreign tax credit system, the payment of [deductible] interest, rents, and royalties by controlled foreign corporations and other related foreign corporations whose dividends carry a deemed-paid credit may . . . reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends.[12]

Increase in Royalty Payments to U.S. Parents Since 1984 is Consistent with Congressional Intent—Not an Abuse

Some have argued that the rapid rise in net royalties received from foreign affiliates by U.S. parents is indicative of a "tax abuse" which merits adoption of the Administration's royalty proposal. This view ignores Congressional intent as indicated by the legislative history of the changes made to section 367(d) in 1984 and to section 482 in 1986. In fact, section 367(d) was designed to ensure that royalties would be paid for the use of U.S.-developed intangibles by foreign affiliates, instead of transferred, without consideration, as a contribution to capital:

> In response to the substantial tax advantages available to taxpayers if they could transfer intangibles . . . without the payment of any royalty . . . , Congress amended section 367(d) in 1984 to provide that . . . a transfer of intangibles to a foreign corporation . . . would be treated as a sale of the intangibles . . . amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use or disposition of the property.[13]

In 1986, Congress amended section 482 to increase the amount of royalties paid with respect to the transfer of intangibles in cases where these royalties were deemed to be inadequate. In the legislative history of the 1986 Act, the Joint Committee on Taxation stated:

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[10] Ibid.
[11] S. Rept. No. 99–313, 99th Cong., 2d Sess. 314 (1986). *See also* the 1986 Bluebook at 866.
[12] Ibid.
[13] The 1986 Bluebook at 1012.

> Congress was concerned that the provisions of sections 482, 367(d), and 936 . . . may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to the intangible in these situations.[14]

As a result of the changes to sections 367(d) and 482 in 1984 and 1986, respectively, it is not surprising that royalty payments from foreign affiliates increased more rapidly than foreign direct investment after 1984. Rather than a "tax abuse," this result is precisely what Congress intended. According to the most recent data from the Commerce Department's Bureau of Economic Analysis, royalties from unrelated foreign parties have doubled from $1.9 billion in 1986 to $3.8 billion in 1991. If the growth in foreign royalties after the 1986 Act were tax motivated, one would not have expected a large increase in royalties from unrelated parties. Other factors, such as the explosive growth of U.S. software and motion picture licensing to foreign markets appears to be an important explanation for the growth in foreign-source royalty income. For example, overseas revenues from films and ancillary activities nearly tripled from $2.4 billion in 1986 to $6.3 billion in 1991. In addition, foreign sales and services by U.S.-based computer software companies increased from $43.9 billion in 1985 to $88.8 billion in 1991, a 100 percent increase that also in part explains the increase in foreign-source royalties.

The growth in international joint ventures in recent years also may have contributed to the rise in royalty payments. Increasingly, U.S. companies joint venture with foreign partners to gain access to foreign markets. In these arrangements, the U.S. partner frequently contributes valuable intangibles while the foreign partner contributes financing as well as manufacturing and distribution capabilities. Such joint ventures have provided U.S. companies with a wider range of options for maximizing the value of their intangible assets in foreign markets. It should be noted that the growing use of international joint ventures has occurred in spite of formidable tax disadvantages for U.S. companies participating in such ventures.[15]

VII. SUMMARY

We support the Administration's broad policy goals to build an environment for long-term economic growth. The royalty proposal runs counter to these goals because it threatens the competitiveness of U.S.-based MNCs and U.S. jobs.

The royalty proposal would discourage domestic research and development activity. This would mean less investment in the United States. The royalty proposal would further erode the ability of U.S.-based MNCs to compete against foreign-based MNCs in overseas markets. For these reasons, as well as the tax policy reasons stated above, we urge the Administration and the Committee to reconsider the royalty proposal.

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[14] Ibid. at 1014.

[15] Robert J. Patrick, "A Review of U.S. Tax Laws Applicable to Cooperative International Business Ventures," Tax Notea International, (March 1990).

STATEMENT OF THE PUERTO RICANS IN CIVIC ACTION

Thank you for allowing us to present testimony which will have a direct impact upon the political and economic future of the 3.5 million U.S.citizens in Puerto Rico.

These are great days for our organization. We are seeing the successful result of our hard and persistent work to explain to the United States government, the real truth behind Section 936. Since 1986 we have been coming to Congress to tell you that Section 936 is producing too few jobs in P.R at a huge cost to the U.S. Treasury.

Section 936 workers represent only a small portion of the Puerto Rican economy. According to Puerto Rican Government statistics, they comprise only 12% of the total work force on the island. It not only carries outrageous costs, but it is also highly ineffective. As a physician, Puerto Rico's persistent unemployment rate in excess of 15% and a growing public sector tells me that I am dealing with a sick economy.

Section 936 is largely the cause of this sickness because it has obstructed P.R. from a strategy of economic growth where our productive people could earn their own way. It has stopped us from growing like the rest of the 50 states.

Many people said that our grassroots organization would be crushed by the propaganda and lobbying power of the pro-936 machinery and their unlimited economic resources to protect their 3 billion tax break.

As a matter of fact, part of the $3 billion tax break provided by Section 936 has been used to hire experts inside the Washington beltway to defend Section 936. One of the studies to support Section 936 has been done by a distinguished economist of Price Waterhouse who worked for Congress and at the time defended a wage credit formula as a substitute for Section 936.

But we have persisted. We visited you frequently, we mailed you the facts.. We faxed you the facts. We presented our studies on Section 936, and you heard us.

This exercise in democracy is the most wonderful example of what the United States is all about. Many tried to discourage us by comparing our quest with David and Goliath, but your actions prove that the common individual is important to the United States and will be heard.

For this reason we thank many members of this Committee. We thank Congressman Rostenkowski, Congressman Stark, Congressman Pickle, Senator Pryor, and many others. We also thank President Clinton, for including the economic changes that we have been advocating in his agenda for change. We particularly thank your wonderful staff for the many hours spent with us. We commend you for not expecting us to settle for a tax credit program in lieu of the American dream.

GOVERNMENT STUDIES CONFIRM FINDINGS

And when you ordered your own studies, these confirmed our findings ! The proponents of 936 now have to answer to those concerned with the horrendous deficit and our incredible health care costs. They can no longer defend rationally why almost 50% of the Section 936 tax benefits go to 60 drug companies that only provide 18% of the jobs provided by all Section 936 corporations.

They can no longer defend in a plausible way the fact that the tax benefits have almost tripled since the 1970's, while the number of jobs provided has remained relatively stagnant in the same period.

WE AGAIN EXPRESS OUR GRATITUDE FOR THE SUPPORT TO OUR REQUEST THAT THE PRESENT FAILED ECONOMIC MODEL IN PUERTO RICO BASED ON SECTION 936, WITH ITS HIGH PRESSURE, TAX BENEFIT DRIVEN, AND BIG BUCKS POLITICS THAT SURROUND IT, BE REPLACED WITH A SOUND DOMESTIC ECONOMIC POLICY WHICH WILL BRING BENEFITS TO ALL THE CITIZENS OF THE UNITED STATES INCLUDING THOSE LIVING IN PUERTO RICO.

THEREFORE, WE SUPPORT PRESIDENT CLINTON'S PROPOSAL TO CHANGE SECTION 936.....but we must insist that any proposal seriously considered as alternative to Section 936, meet the following conditions:

PUERTO RICO MUST BE INCLUDED IN THE NATIONAL DOMESTIC POLICY PLAN AND NOT AS IF IT WERE A SEPARATE ENTITY FROM THE UNITED STATES.

Since Puerto Ricans are United States citizens and P.R. is part of the United States, PUERTO RICO WOULD BENEFIT IF TREATED AS AN INTEGRAL PART OF A NATIONAL GROWTH AND JOB CREATION STRATEGY, just as we have been part of the national defense strategy since all World Wars and during the Cold war.

The policy of the Clinton Administration and the 103rd. Congress towards Puerto Rico must be the same as it is for the nation as a whole.

For example:

- We do not believe that a gradual phase-in of a wage credit or giving a 936 company an alternative under the old system will help since it will only create another special tax treatment for who knows how many years.

- Congress should phase-in the wage credit system immediately and only for two or four years when it could again be re-evaluated. The target jobs tax credit, which is the only wage credit in the code, has been reviewed, improved and re-authorized every one or two years.

- Puerto Rico needs to be considered as a possible site for an enterprise zone. The enterprise zone proposal in last year's H.R.11 bill include wage credits, reduced capital gains taxes, lower depreciation rates, and new investment tax credits.

SECTION 936 MUST NOT HIDE BEHIND THE STATUS QUESTION

You probably know that our grassroots organization is mostly comprised of people who desire statehood for moral, political, and economic reasons, and our reasoning is sound. However, let me assure you that I strongly believe that 936 should be phased out regardless of Puerto Rico's political status, because it represents an unfair and unnecessary burden on the U.S.taxpayer and the U.S.Treasury.

And please, do not be distracted by the spin doctors who can't find a way to defend their case and now claim that our interest in this matter is related to our push for statehood. This is just another argument to distract the discussion from the real issues.

Rational managed change in the Section 936 program is what this is really about. Please be assured that Puerto Rico's self determination process will turn on much more fundamental issues than on what you do on Section 936.

In our view, this Committee and the Congress must not become unduly preoccupied with Puerto Rico's political status issue in connection with its evaluation of President Clinton's proposal.

The President's position should be considered on its merits as part of an overall national economic recovery program to which Puerto Rico must be willing to contribute, and from which Puerto Rico must benefit along with the rest of the nation. You must reject the notion that the interests of Puerto Rico and those of the Nation are at odds.

However, we would be remiss not to say, that until the people of P.R. achieve real self determination and establish a more perfect relationship with the Federal government, we will have no basis for knowing if the so called benefits of 936 were worth the price we have paid by remaining a territory, subject to Federal law and policy promulgated without our democratic participation.

We were appalled to see the pro-936 components organize and practically force the workers in P.R. and their political leaders to march in their favor. But, although we thought that all that could be done and said about Section 936 had been said, we recently discovered a new outrageous fact:

SECTION 936 TEMPORARY EMPLOYMENT

We have strong reasons to believe that more than 1/3 of the 18,000 workers in pharmaceutical companies work under temporary job services, a practice that we understand is also being widely used in the United States.

Some of these "temporary work" companies in Puerto Rico have even put up shop right next to the areas where these corporations operate. This constitutes a cruel economic and mental abuse with the workers and their families !

Considering the fact that these companies are not paying federal taxes and that they are making excessive profits in their drug prices, we ask you to order an investigation into this matter and find a way to put a stop to this.

This is an easy way out of having to pay employee benefits, curtailing labor rights and bypassing unions. These workers might even be collecting federal unemployment between jobs. This might be legal, but it is definitely immoral and you owe it to your constituents to look into this.

RESULTS OF THE SPECIAL TAX TREATMENT

And what has been the result of pursuing economic development based on federal tax exemption ? Today P.R. stands at the bottom of the economic ladder, compared to the 50 states.

The most significant impact Section 936 has on the island is that this supposed great economic credit given to us by Washington is also the reason given for denying the loyal U.S. citizens in P.R. greater or even equal access to other Social and economic development programs.

We are denied full participation in such important programs as Medicaid, Social Security and the JOBs program, which provide training and child care funds for parents of poor children. In other words, Section 936 is taking money out of Puerto Rico's citizens pockets and replacing those dollars as 936 company profits.

While Congress has denied the 3.5 million U.S. Citizens in Puerto Rico the full participation in these programs, it instead has provided two federal tax credits. Section 936 provides a tax credit for US corporations and Section 933 provides tax exemption for individuals and island corporations.

In doing so, Congress has forced Puerto Rico to follow an economic development program different from the economic strategies by the 50 states, and which has not worked.

LACK OF PROPER HEALTH CARE

As a result of this lack of assistance, the island's health care system is in shambles. We insist that any change in Section 936 must be accompanied by improvements in our health system and assistance to the needy. We don't want you to forget that the taxes that these companies will bring to the United States' treasury will come from business generated in Puerto Rico.

We continue to sustain the following positions on Section 936:

I. 936 IS NOT CRITICAL TO PUERTO RICO'S ECONOMY AND ANY CHANGE WILL NOT CAUSE THE ECONOMY TO COLLAPSE.

Section 936 has existed for almost 25 years and yet, its workers represent a small portion of the Puerto Rican economy. The level of unemployment on the island continues too high at 18% . Over the last twenty years the rate of unemployment has fluctuated between 13 - 17%. These facts don't speak out in favor of Section 936.

As a matter of fact much of the labor intensive portion of the manufacturing process of 936 companies is now being done through twin plant operations in the Dominican Republic and other Caribbean countries which increases the tax free profit margins for the companies but reduces employment in Puerto Rico.

To sustain our position, we would like to include for the record, the testimony offered to the Puerto Rico Senate on March 3, 1993 by Marcos Rodriguez, President of the Puerto Rico Government Development Bank.

Mr. Rodriguez said: " I can assure you that not even in the worst of cases would the impact be as damaging as the studies that have been done in the past have projected. They all suffer from the same flaw:

They seem to respond to the public and private interests that commissioned the studies and they foresee the disappearance of 100% of direct jobs in 936 companies, and even the indirect jobs. These merchants of doom, who freely make inflammatory statements to the press and legislative committees like this one, are not serving Puerto Rico well."

" The results of our preliminary analysis indicate that more than 75% of the direct jobs in 936 companies would not be affected as a result of a replacement of the existing incentives with a wage credit of at least 65% as proposed by President Clinton."

And he concluded: ".... contrary to what persons and entities may have testified before the committee, Puerto Rico will not sink. And frankly, it doesn't have to get on its knees, either."

II.ALMOST ALL OF THE 936 COMPANIES WILL NOT LEAVE PUERTO RICO IF SECTION 936 IS SIGNIFICANTLY CHANGED.

According to data available from the P.R.Government Development Bank:

a) 37,651 direct jobs, or 36.2 of total employment, are with companies whose tax benefits would not change under the Clinton proposal.

b) 21,258 jobs, or 20.4% are with companies whose tax benefits would be affected by less than 25%.

c) 24,553 jobs, or 23.6% are with companies whose tax benefits would be affected between 25% and 50% .

d) 20,599 jobs, or 19.8% are with companies whose tax benefit would be affected between 50% and 75%.

The truth, Mr. Chairman is that the wage credit proposal will reduce somewhat the extraordinary U.S.taxpayer subsidized profits enjoyed by a few corporations in P.R., and not affect the vast majority of the Section 936 corporations.

Pharmaceuticals are not going to leave P.R.! It would make no business sense to close these facilities down and build entire new facilities elsewhere at a great cost. The Pharmaceutical companies make their investment back after only 15 months and still need to have FDA approval for their products in the U.S.

So, despite the many different voices you will hear today, we all know that change is inevitable, that we live in a new era of change, and that Puerto Rico can not exempt itself any longer from that change. We are ready for that change and grow with the rest of the nation, and addressing the Section 936 issue is a critical first step in the right direction.

Puerto Rico cannot be excluded from national policy debates and then be treated as "special", out of mis-directed paternalism, that tends to condemn the patriotic people of this island to the political and economic twilight zone.

The Clinton Administration and Congress will be doing the right thing by defining a national economic strategy which includes Puerto Rico. That is the promise of America, and the loyalty of U.S.citizens of Puerto Rico to this country includes our belief that the United States of America will keep her promise of democracy and equality.

Mr.Chairman that concludes my testimony. For the record I would like to submit the following additional items:

1. Copy of the testimony of Mr. Rodriguez-Ema's, President of the P.R. Government Development Bank, before the P.R. Senate Labor Committee.

2. Copy of Mr. Peter Merrill's work : The Possessions Tax Credit and Puerto Rican Economic Development.

3. A paper by Mr. Alexander Odishelidze expressing some interesting views on Section 936 which the Committee should consider.

4. A copy of a March 24, 1993 Editorial on Section 936 which appeared in the Washington Post and copy of my response to that Editorial.

5. Newspaper articles which help support our comments.

The Vice President of our organization, Attorney Luis Costas, a foremost expert on Section 936 is available to answer your technical questions.

STATEMENT OF PUERTO RICO MANUFACTURERS ASSOCIATION

Mr. Chairman and distinguished members of this committee, we are pleased to have the opportunity to come before you today to raise the issue of fairness in regard to the proposed change of Section 936 of the U.S. Internal Revenue Code.

The Puerto Rico Manufacturers Association is a trade organization that represents more than 1,800 members, who employ approximately 200,000 workers in the production and service sectors of Puerto Rico's economy.

We'd like to start by posing a question, which hopefully will be answered to your satisfaction today. Is it fair to close the door of economic opportunity for the people in Puerto Rico?

In our estimation that is exactly what the proposal of the Clinton Administration will accomplish. In order to come to that conclusion you have to view Section 936 for what it has become. Section 936 is the stimulus for a core sector of our economy, a generating force that has impact on every other component of economic activity. The macroeconomic arguments to support that fact have been presented to you repeatedly whenever the Congress has looked at the impact of Section 936.

Today, therefore, we would like to focus on the arguments relating to fairness that have not had wide consideration in the past.

First, there is a tendency to see Section 936 as an issue involving large multinational corporations and the U.S. Treasury. In that context we are talking about an issue that involves only tax revenues. That is an unfair view when the very basis of our economy is built on that incentive program. When taking that view, however, it is easy to look at this source to increase revenues for the Treasury at a time when the nation is being asked to make sacrifices.

Second, we must look at Puerto Rico's ability to make the sacrifice being asked of it and what impact that will have on the ability of our people to progress in the future. What has been proposed is nothing short of a complete dislocation of the economy of Puerto Rico in disproportion to anything being asked of our fellow American citizens on the U.S. mainland. That would clearly be unfair. In regard to the ability to make the sacrifice, the following table presents a fair comparison of the Puerto Rico economy in relationship to the U.S. economy.

ECONOMIC INDICATORS, UNITED STATES AND PUERTO RICO

Economic Indicator[1]	United States	Puerto Rico	Percent PR/US
Gross Domestic Product (billions of $)	5,950.7	34.0	0.57
Gross National Product (billion of $)	5,961.9	23.6	0.40
Personal Income (billions of $)	5,058.1	22.7	0.45
Population in millions	256.0	3.6	1.41
Civilian Unemployment Rate	7.4	16.7	225.7
Per Capita:			
Gross Domestic Product ($)	23,299.0	9,530.0	40.90
Gross National Product ($)	23,343.0	6,626.0	28.39
Personal Income ($)	19,805.0	6,360.0	32.11

[1] Source: U.S. Department of Commerce, Bureau of Economic Analysis, BEA 9, March 1993. Puerto Rico Plannings Board, Statistical Appendix, Informe Económico al Gobernador 1992. Data for the U.S. corresponds to 1992 natural year while data for Puerto Rico corresponds to 1992 fiscal year.

The table demonstrates that Puerto Rico's economy represents approximately half of one percent of the U.S. economy in gross domestic product and has an unemployment rate that is 225.7% of the unemployment rate in the U.S.

In real and human terms, these statistics mean that 58.9% of the population in Puerto Rico lives under the poverty level, according to the Puerto Rico Planning Board. The agency, which compiles Puerto Rico's official economic statistics, recently found that in the 18 towns that make up the island's central mountain region, the number of people living under the poverty level jumps up to 72.8%.

Clearly, a society that still lags far behind the nation under the best of circumstances cannot afford to make additional sacrifices of any kind. Yet, the proposal from the Clinton Administration, which seeks revenues of $240 billion from Puerto Rico sources over four years, will place a severe burden on the economy of Puerto Rico and its people, as the following table indicates.

IMPACT OF CLINTON ADMINISTRATION'S $240 BILLION REVENUE PROPOSAL

Economic indicator [1]	P.P. relative share	P.R. share value in billions of dollars
Gross Domestic Product, billions of $	0.0057	1.37
Gross National Product, billions of $	0.0040	0.95
Personal Income, billions of $	0.0045	1.08

[1] Note: Share value is obtained by multiplying Puerto Rico's relative share in the corresponding economic indicator by the total value of the Clinton Administration revenue raising proposal of ***$240.4 billion covering the 1994–1997 period*** as specified in the Budget Address to Congress—Appendix Table 6.

In fact, the table shows that the Clinton Administration revenue raising plan will cost Puerto Rico $1.37 billion in gross domestic product and $1.08 billion in personal income. That dollar impact is significant to an economy with a gross domestic product of only $34 billion and it will undoubtedly force several thousand more Puerto Rican families below the poverty level because of the substantial loss of economic activity.

More importantly, however, those who have struggled out of poverty will lose the opportunity to continue on that path and lose the ability to lift others out of poverty as well. That would be extremely unfair.

Puerto Rico decided a long time again, back in the 1950s, that the best vehicle for achieving that objective was industrialization. It grew through the period of simple assembly operations to develop an impressive base of industrial skills. The establishment of Section 936 as an incentive for development attracted increasingly sophisticated operations in high technology industries that further enhanced those skills and created a managerial, technical and professional base.

For example, labor statistics indicate that the number of high technology manufacturing jobs on the island rose by about 10,000 to nearly 60,000 over the past decade. That was, in fact, the most dynamic area of employment growth in the economy.

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For example, labor statistics indicate that the number of high technology manufacturing jobs on the island rose by about 10,000 to nearly 60,000 over the past decade. That was, in fact, the most dynamic area of employment growth in the economy.

At the same time, meeting the infrastructure demands of that growth has put Puerto Rico out of the market for low wage, labor intensive development. The cost of operations in transportation, energy, water and labor have made Puerto Rico less attractive to those industries that cannot produce high value-added products.

The advance of high technology operations has, therefore, transformed Puerto Rico from a low skill, labor intensive industrial environment into a capital intensive economy where skills are constantly being challenged to produce higher quality. The dynamics of that development process now allows the people of Puerto Rico to compete and grow as new technologies open the industrial opportunities of the future.

Today, Puerto Rico does not compete, it cannot compete, for what used to be known as sweatshop operations. We have grown beyond that point. Yet, the Clinton Administration proposal to change the incentive program from an income-based tax credit to a wage-based tax credit would force Puerto Rico back in time to compete again on that basis for jobs.

Therefore, based on the Clinton Administration plan, it appears that America is being asked to share evenly in a monetary sacrifice, while the people of Puerto Rico will be pushed further into the abyss of poverty. That is no minor change to increase

revenues. It, in fact, changes the structure of our economy in a way that will keep Puerto Rico from participating in the industrial development of the future. That would be exceedingly unfair.

Today, Puerto Rico ranks among the most attractive sites in the world for industrial investment because of a combination of factors, the most important of which is a reasonable potential for growth based on the income incentives of Section 936. Until a better system is in place to fulfill that essential development function, Puerto Rico can ill-afford to make new sacrifices. For example, it must be asked how a wage credit will function as an incentive to attract the new industries that are springing up in biotechnologies? Such industries are highly capital intensive, but while they employ relatively few people directly, they represent promising new core industries with substantial spinoff in supporting economic activity and employment.

The proposal under your consideration will effectively close the door to such progress by making further high technology development unfeasible for the future. To call upon the people of Puerto Rico to sacrifice their future in that way will be the most unfair act of all.

We know this body could not act in such a manner because it is against the tradition of fairness that constitutes the American way of life that we all cherish.

Thank you for the opportunity of appearing before you today.

STATEMENT OF SEMICONDUCTOR INDUSTRY ASSOCIATION

The Semiconductor Industry Association (SIA) is comprised of U.S. semiconductor manufacturers. Its member companies account for 85 percent of U.S. semiconductor production and employ over 200,000 Americans. Members of SIA are greatly impacted by the President's tax proposals and wish to convey our concerns to the Members of the Senate Finance Committee.

Semiconductors are the heart of America's high-technology industry, account for $25.5 billion in worldwide sales and are the heart of the U.S. electronics industry which employs over 2.4 million Americans. While we appreciate President Clinton's attempt to increase capital investment by domestic industries, the fact remains that the President's economic proposals will not help the U.S. semiconductor industry. SIA urges the Administration and the Congress to develop additional means of encouraging capital investment in semiconductors.

The industry faces intense foreign competition, including the use of unfair trade practices and foreign government promotion. For example, the Japanese government allows Japanese companies extremely rapid depreciation on semiconductor manufacturing equipment (almost complete expensing in the first year). The semiconductor industry is extremely capital intensive—U.S. producers invest 14 percent of sales in new capital equipment—so U.S. government tax policy has a significant impact on the industry's global competitiveness.

President Clinton emphasized the role of government in preserving America's high-technology industry. The President has also proposed, as part of his economic agenda, a temporary investment tax credit (ITC), a permanent research and experimentation (R&E) credit, and alternative minimum tax (AMT) depreciation reform. Unfortunately, these initiatives, as proposed, generally would not improve the competitive position of the U.S. semiconductor industry. Moreover, the President's proposals to eliminate deferral of U.S. tax on certain foreign subsidiary manufacturing income and revise treatment of foreign royalty income would damage the international competitiveness of the industry.

The proposed ITC applies only to increases in investment spending. However, since most U.S. semiconductor companies have continued to invest during the recent recession, much of this industry's future investment would be ineligible for the ITC, diminishing the stimulus potential of the credit. Equipment with shorter economic lives, like high-tech assets, also receive a lower ITC rate under the proposal. In addition, because the ITC would lapse after two years, it would do nothing to stimulate capital investment after 1994.

Likewise, a number of semiconductor firms will receive little benefit from the proposed R&E credit. The R&E credit would be limited to R&E spending above a threshold level that is based on the ratio of R&E spending to sales during the 1984–1988 "base period." During this period, however, many high-tech companies maintained their R&E investments despite declines in sales due to Japanese companies illegally "dumping" their products in the United States. Thus, the R&E to sales ratio threshold for these companies is disproportionately high. Because only R&E spending above this threshold would be eligible for the credit, many high-tech companies would be unable to use most or all of the credit. The semiconductor industry spends about 12 percent of its sales each year on R&E activities.

The Administration's AMT reform proposal also does little for the U.S. semiconductor industry. For example, making AMT depreciable lives the same as regular tax depreciable lives may provide quicker AMT depreciation to certain industries. However, under current law, the depreciable life of semiconductor manufacturing equipment is five years for both regular tax and AMT purposes even though the true economic life of semiconductor manufacturing equipment should entitle it to three year depreciation. Unless the tax law is changed to allow three year depreciation for semiconductor manufacturing equipment, the Administration's proposal to make AMT depreciable lives the same as regular tax depreciable lives would not be beneficial. This proposed change in the depreciable life of semiconductor manufacturing equipment has widespread support in Congress and Senators Baucus and Packwood plan to reintroduce legislation to make this change.

The U.S. semiconductor industry would be adversely impacted by the proposed elimination of deferral of U.S. tax on certain foreign subsidiary manufacturing income. Under this proposal, our foreign competitors, who benefit from generous tax deferral regimes and tax-saving treaties that allow them to repatriate low-taxed earnings without additional tax, would have a serious competitive advantage over U.S. firms. Our foreign competitors would also have an advantage if the revised foreign royalty income proposal is adopted. Treating this income as earned from passive sources would be detrimental to the competitiveness of this industry.

Since the Administration's three key tax incentive proposals do not address the needs of the U.S. semiconductor industry, it is vital for the economic health of this industry as well as the economic and national security of the country that an additional means of encouraging capital investment in semiconductor manufacturing be enacted. SIA urges the Committee to support three-year depreciation of semiconductor manufacturing equipment.

Statement of Tax Executives Institute, Inc.

BACKGROUND

Tax Executives Institute is the principal organization of corporate tax professionals in North America. Our approximately 4,800 members represent more than 2,400 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. TEI is firmly committed to maintaining a tax system that works—one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the IRS can effectively perform its audit function. TEI is pleased to submit the following comments on the international provisions of President Clinton's Proposals for Public Investment and Deficit Reduction (S. 876 in the Senate and H.R. 1960 in the House).

OVERVIEW

Seven years ago, when the Tax Reform Act of 1986 became law, a "compact" was reached between the government and taxpayers. At that time, the tax base was broadened and several tax incentives were eliminated in exchange for a lowering of the rates and a generally simpler tax system (especially for individuals). One of the promised consequences was stability—something that is absolutely essential to business. To plan, one has to know what the rules are and what they will be. Of course, there was a price that the business community had to pay for the promised stability: although the 1986 Act was revenue neutral overall, it exacted $120 billion in additional taxes over five years from the corporate community. It also imposed compliance burdens out of all proportion to the tax policies supposedly served by the underlying statutory provisions.

The 1986 Act exacted a particularly severe cost from U.S. multinational corporations because the fundamental changes were in large part paid for by changes in the international area. Taken together, the 1986 Act changes—including the interest allocation rules, the increase in the number of foreign tax credit limitation "baskets," and the introduction of the passive foreign investment regime, exacted a heavy tax and compliance toll and severely affected the ability of U.S. companies to compete effectively overseas.

Now the President proposes in S. 876 to make additional changes in the international area that would add unnecessary complexity to the Internal Revenue Code and diminish the ability of U.S. business to effectively compete abroad. Consider, for example, the proposal to tax in advance of repatriation to the United States cer-

tain accumulations of foreign earnings deemed to be "excessive." The proposal states that a change is needed to prevent the "excessive accumulation" of foreign earnings. There are, however, already two overlapping sets of anti-deferral rules, one that was enacted in 1962 called Subpart F and the second, relating to "passive foreign investment companies" (PFICs), which was enacted in 1986 to do the very thing the President's proposal is intended to do: end the deferral of tax on passive assets. In other words, in terms of tax policy, the proposal is redundant. In terms of tax administration, it is tremendously complicated. Rather than end the redundancy and streamline the law, the President's proposal would add another layer of rules and another layer of costs and, we submit, garner very little revenue for the government. Although provisions such as the allocation of 100 percent of a company's research and experimentation expense to the place of performance would bring some much needed stability to that area, the President's international proposals, on balance, will seriously impede the competitive ability of U.S. companies.

In the ensuing sections of this statement, TEI sets forth its views on specific international tax proposals contained in the President's economic package.

ALLOCATION OF RESEARCH AND EXPERIMENTATION EXPENSES

1. *President's Proposal.* Treas. Reg. §1.861–8(e)(3) generally provides that research and experimentation (R&E) expenses may be allocated to domestic and foreign source income based on either the taxpayer's relative amounts of domestic and foreign source gross income or the taxpayer's relative gross sales receipts from domestic or foreign sources. If the sales method is used, the taxpayer must first allocate 30 percent of its R&E expense to gross income from the location where most of its R&E activity is conducted. Since 1981, the regulation has been modified eight times by temporary legislation. The most recent statutory rule permits the taxpayer to allocate 64-percent of U.S.-based R&E expense to domestic source income and 64-percent of foreign-based R&E expense to foreign source income. The statutory rule expired on June 30, 1992, but a Treasury announcement permits the taxpayer to continue using the 64-percent allocation rule until the end of 1993.

Section 2311 of the President's proposal would allocate 100 percent of the R&E expense to the place of performance of the R&E. The proposal would apply to taxable years beginning after December 31, 1993.

2. *TEI Position.* TEI agrees that a permanent solution to the allocation of R&E expense is warranted. The on-again, off-again effect of the frequent statutory modifications has been counterproductive to fostering U.S.-based research. As the summary of the President's proposal states, "A direct allocation of United States-based R&E expenses to domestic source income encourages taxpayers to conduct R&E in the United States." The allocation rules under the Treasury regulations represent a clear disincentive to the performance of R&E activities in the United States. It is time for Congress to simplify the R&E allocation rules and make them permanent. Simplicity and permanence would reduce the compliance costs associated with the complex, changing rules. We believe that the President's proposal would accomplish these goals.

TEI therefore recommends adoption of the rule to allocate R&E expenses to the place of performance.

TREATMENT OF ROYALTIES AS PASSIVE INCOME FOR FOREIGN TAX CREDIT PURPOSES

1. *President's Proposal.* To ensure that the foreign tax credit offsets only the U.S. tax on the taxpayer's foreign source income, section 904 of the Code prescribes a statutory limitation formula. This foreign tax credit (FTC) limitation is calculated separately for certain categories—or "baskets"—of income, including passive income. Passive income generally includes rents, royalties, interest, and other types of income defined in section 954(c) of the Code (generally referred to as "foreign personal holding company income"). There are two exceptions for royalty income: (i) certain royalties received from foreign affiliates are categorized on a "look-through" basis that often results in the royalties being treated as general limitation income; and (ii) royalties received from an unrelated party in the active conduct of a trade or business are excluded from the passive basket.

Section 2312 of the President's proposal would provide for the treatment of all foreign source royalty income as income in the separate basket for passive income. An Administration's briefing paper on this issue states that the change is necessary to eliminate the tax incentive to produce goods abroad. The Administration also states that the proposal "will prevent taxpayers from sheltering low-taxed or untaxed foreign royalties from U.S. tax by offsetting the U.S. tax on those royalties with foreign taxes paid on other business income (this is called 'cross-crediting')." The provision would apply to taxable years beginning after December 31, 1993.

2. *TEI Position.* In 1986, Congress greatly expanded the categories of income that must be segregated into FTC "baskets." To prevent taxpayers from avoiding these limitations, it also expanded the types of income subject to section 904(d)(3), which prescribes "look-through" rules to preserve the character of income when it is earned through related parties.[1] In enacting the 1986 amendments, Congress concluded that the overall limitation was consistent with the integrated nature of U.S. multinational operations and that the averaging of foreign tax rates generally should be allowed. It recognized, however, that cross-crediting should not be allowed when it would distort the purpose of the FTC limitation.[2] It provided a separate FTC basket for passive income because of its concern that passive investments can often be quickly shifted or easily made in low or no tax jurisdictions.[3]

TEI submits that allocating royalties from a related party to the passive basket would undermine the policy decisions made when the 1986 Act was enacted. Moreover, the proposal would actually serve as a disincentive to companies to repatriate their earnings and would exacerbate double taxation by creating excess FTCs that may never be offset against U.S. income.

The look-through rules embodied in section 904(d)(3) recognize that royalties received from a related party should retain the character of income out of which the royalty was paid. Interest, rents, and royalties received from a related party are all payments of the earnings of a foreign affiliate. Realization that the "form" of the repatriation should not lead to a different characterization under the FTC rules led the American Law Institute to conclude in 1986 that royalties passing from one member of an affiliated group to another have the same character and should be treated as non-passive income, unless the underlying income of the related party is passive. In such circumstances, the royalty is just one part of an integrated enterprise.[4]

In enacting the expanded look-through rules in 1986, Congress also recognized that interest, rents, and royalties often serve as alternatives to dividends as a means of removing earnings from a foreign affiliate. Congress determined that such income should be treated at least as favorably as dividends eligible for the deemed paid credit so that payment of the former would not be discouraged, stating that because interest, rents, and royalty payments are generally deductible in foreign countries (while dividends are not), they "reduce foreign taxes of U.S.-owned foreign corporations more than dividend payments do."[5] In other words, "cross-crediting" is neither abusive nor the unintended result of the 1986 Act changes. It is a perfectly legitimate means of ensuring the proper operation of the Code's foreign tax credit provisions.[6]

Now comes the Administration to argue that treating all foreign source royalty income as passive is necessary to eliminate the "tax preference" for licensing intangibles to a foreign person for use in production activities abroad. This argument, however, defies common sense, and ignores the manner in which companies conduct business. For economic, non-tax business reasons, many businesses must produce their products close to the place of sale. A manufacturer of processed foods, for example, will license his patent on the products to an overseas subsidiary to preserve freshness, to adapt to local market conditions, or to avoid the high cost of shipping those products for sale into that region. Forcing such a company to make an uneco-

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[1] From 1984 (when section 904(d)(3) was enacted) to 1986, a limited "look-through" rule applied to dividends, Subpart F income, and interest.

[2] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 862 (1987) (herinafter cited as the *"1986 General Explanation"*).

[3] *Id.* at 863.

[4] American Law Institute, *International Aspects of United States Income Taxation* 247 (May 14, 1986) (hereinafter cited as the *"ALI Report"*).

[5] H.R. No. 99–426, 99th Cong., 1st Sess. 341 (1985) (hereinater cited as the *"House Report"*). *See also 1986 General Explanation at 866.* Moreover, Congress concluded that the look-through rule for royaltiea reduces the disparity between the tax treatment of branches and subaidiaries:

> Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (aa through a foreign branch) and the amount of income subject to a particular limitation where a taxpayer earna income abroad through a controlled foreign corporation.
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> *1986 General Explanation* at 866.

[6] The Administration haa cited the increase in royalty payments since 1986 as supporting the need to change the treatment of royaltiea. It fails to recognize, however, that in 1986, Congress enacted section 367(d) to require the recognition of gain on the transfer of intangible property from a U.S. person to a foreign corporation in a tax-free exchange and amended section 482 to require that transfers of intangible property by commensurate with the income attributable to the tangible. The increase in royaltiea paid since 1986 may be linked to these changes, rather than to any tax-avoidance motive that the Administration may justifiably seek to curb.

nomic—and uncompetitive—decision to avoid the receipt of passive basket income would be counterproductive. The proposal thus represents—not the removal of an incentive to operate abroad—but rather, the use of the tax laws to discourage what is sensible from a business standpoint. Moreover, treating all royalty income as passive might cause companies to locate their R&D activities abroad, thereby frustrating the policy underlying the President's proposal concerning the allocation of R&D expenditures.

The Administration also argues that the provision is necessary to prevent the cross-crediting of high-taxed income with low-taxed royalties. This argument assumes that corporations operate abroad solely for tax-related reasons. This is simply not true. Businesses operate overseas for myriad reasons, not the least of which may be operating efficiency. The cross-crediting argument also ignores the fact that multinational corporations generally conduct their business on a worldwide basis. In 1977, a task force chaired by Congressman Rostenkowski concluded that the averaging of foreign taxes was frequently appropriate, explaining—

> Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.[7]

Although Congress has rejected the enactment of one overall FTC limitation, it has generally restricted the separate FTC limitations to classes of income that are "movable."[8] Because the source of royalty income depends upon the country in which the use of (or right to use) the intangible arises, the source is not "movable" in the same sense that other income may be.[9] Moreover, to the extent the provision is motivated by a perception that taxpayers operate overseas purely for tax-related reasons, it is misdirected. The proposal will increase the cost of repatriating funds through dividends from high-withholding tax jurisdictions and thus encourage taxpayers to reinvest their foreign earnings in active foreign operations.[10]

TEI therefore recommends that royalties should not be treated as passive income for purposes of the foreign tax credit limitation.

CURRENT TAXATION OF CERTAIN EARNINGS OF CONTROLLED FOREIGN CORPORATIONS

1. *President's Proposal.* The United States generally does not tax the foreign income of foreign subsidiaries of U.S. corporations when earned. Rather, the tax on foreign income is "deferred" until the income is repatriated through the payment of dividends to the parent corporation. There are, however, several exceptions to the deferral rule. Under Subpart F of the Code, certain types of income received by controlled foreign corporations (CFCs) are currently taxed as a constructive dividend to U.S. shareholders. Subpart F income is generally income that is considered "movable" from one taxing jurisdiction to another and that is subject to low rates of tax.

The passive foreign investment company (PFIC) rules overlap with the Subpart F rules to tax active overseas business operations. The PFIC rules were enacted in 1986 to remove the economic benefit of tax deferral and the ability to convert ordinary income into capital gain which was available to U.S. investors in foreign investment funds. Unfortunately, the definition of a PFIC is so broad it has resulted in the classification of many corporations with active businesses (and substantial passive income or assets) as PFICs—even in situations where the foreign corporation is subject to high rates of tax.

Section 2301 of the President's proposal would require 10-percent U.S. shareholders of certain CFCs to include in income currently their pro rata shares of a specified portion of the CFC's current and accumulated earnings. The proposal would apply to a CFC—including a CFC that is a PFIC—holding passive assets that represent 25 percent or more of the value of the CFC's total assets. The portion of current and accumulated earnings subject to inclusion ("includable earnings") would be

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[7] House Committee on Ways and Means, *Recommendations of the Task Force on Foreign Source Income*, 95th Cong., 1st Sess. 35 (March 1977).

[8] *See House Report* at 333.

[9] *ALI Report* at 342.

[10] With respect to royalties from unrelated parties, the ALI Report concludes that for self-developed intangibles, licensing "can be said to merely one of the many techniques for realizing a return on the resulting asset and should not be differentiated from the use of the property by, for example, a foreign subsidiary the utilizes the property in carrying on its own business." *ALI Report* at 342. Again, because the source of the royalty is not "movable," the ALI Report concludes that the royalties should be left in the general limitation basket. *Id.* We submit that royalties received in the active conduct of a trade or business should not be relegated to the passive limitation basket.

the lesser of (i) total current and accumulated earnings and profits, or (ii) the amount by which the value of the CFC's passive assets exceed 25 percent of the value of its total assets. The proposal would generally be effective for taxable years of CFCs beginning after September 30, 1993 and to taxable years for U.S. shareholders to which or with which such taxable years of CFCs end. The proposal would provide for a phase-in of the amount subject to current inclusion over a five-year period.

2. *TEI Position.* TEI strongly objects to the proposal to tax in advance of repatriation to the United States certain accumulations of foreign earnings deemed to be "excessive." As a policy matter, the Institute disputes the need to overlay another type of regime on top of Subpart F. The PFIC provisions—which themselves are a prime example of legislative overkill—were enacted to prevent the very situation that the Administration now seeks to address: to eliminate deferral on passive assets. We submit that the last thing the tax system needs is another regime that, in terms of tax policy, is wholly redundant. In terms of administration, the President's proposal is tremendously complicated. It would add needless complexity to an already complex area and reduce the ability of U.S. multinationals to compete abroad. In addition, to the extent it imposes U.S. tax on earnings derived from active business operations, the proposal is unprecedented and constitutes a drastic departure from the policy underlying the existing exceptions to deferral which tax passive or easily "movable" income.

Moreover, we question whether the proposal would encourage companies to invest in facilities in the United States since corporations investing overseas generally tend to "plow back" the resulting profits in the business of that foreign affiliate. In reality, the provision could perversely act as an inducement to invest in active manufacturing facilities abroad to reduce a company's passive assets. The provision will not stop international expansion, although it may make U.S. companies less able to compete with their foreign competitors.

The Institute also objects to the effective date of the provision. The proposed bill would be effective for taxable years of CFCs beginning after September 30, 1993 and to taxable years for U.S. shareholders to which or with which such taxable years of CFCs end. Thus, the provision will be effective for many companies for the 1993 taxable year. As a practical matter, this is insufficient lead time for large multinationals who must gather information from their subsidiaries in order to prepare their tax return. A September 30 effective date is simply impractical.

Finally, TEI objects to the provision to the extent that it would tax retained earnings and assets of foreign subsidiaries from prior years. Such retroactive application of the tax laws would be unwarranted and quite frankly inequitable. The retroactive effective date would also be unprecedented; when similar provisions (such as section 956's investment-in-U.S.-property regime or the Subpart F rules) were enacted, the statute applied prospectively to future investments. The same policy should be followed here.

TEI therefore opposes the repeal of deferral for "excessive" earnings of controlled foreign corporations.

TRANSFER PRICING INITIATIVE

1. *President's Proposal.* Section 6662 of the Code imposes a penalty of 20 percent of the amount of any understatement of tax attributable to "substantial valuation misstatements." Under section 6662(e), the penalty is imposed either (i) when the transfer price adjustments in any one taxable year exceed $10 million, or (ii) when the transfer price or adjusted basis for property or services exceeds 200 percent or more (or is 50 percent or less) of the amount ultimately determined to be the "correct" transfer price. This so-called section 482 penalty is increased to 40 percent of the understatement if there is a "gross valuation misstatement," which is defined as adjustments exceeding $20 million, or 400 percent or more (or 25 percent or less) of the "correct" transfer price. Under section 6664(c), the penalty does not apply to any portion of the understatement if the taxpayer has reasonable cause for the position taken and acted in good faith with respect to that position.

Section 2322 of the President's proposal would amend section 6662(e) to reduce the threshold for imposition of the 20 percent penalty from $10 million to the lesser of $5 million or 10 percent of gross receipts. For imposition of the 40 percent penalty, the threshold would be the lesser of $20 million or 20 percent of gross receipts.[11]

[11] The President's proposal would not affect the application of the 200 percent/400 percent tests.

In addition, the President's proposal would amend section 6662(e) to provide that the reasonable cause and good faith exception will be satisfied only if the taxpayer provides contemporaneous documentation demonstrating the application of one or more reasonable transfer pricing methodologies to the taxpayer's controlled transactions. In order for the application of the transfer pricing methodologies to be reasonable, any procedural or other requirements imposed by regulation must be observed and documented. In addition, methods other than those specifically prescribed in the regulations may be reasonable if the taxpayer establishes that, at the time of the transaction, the prescribed methods will not be likely to lead to an arm's-length result and that the so-called fourth method actually applied was likely to lead to such a result. The provision would be effective for taxable years beginning after December 31, 1993.

2. *TEI Position.* TEI strongly opposes the reduction of the $10 million threshold under section 6662(e)(1)(B)(ii). Quite frankly, the section 482 penalty violates fundamental principles of what penalties should and should not be.[12] We submit that the ill-advised policy that led to the enactment of section 6662(e) in 1990 should not be compounded by reducing the $10 million threshold; rather, the statute should be repealed.

Penalties should be enacted to encourage compliant behavior and to punish taxpayer misconduct. To be effective in deterring culpable behavior, the penalty must warn taxpayers in advance that they will be held to a certain standard of conduct and the operative standard must be clearly defined and attainable. In reforming the Code's penalty regime in 1989, Congress recognized that penalties were being unevenly and unfairly assessed under old section 6661 (the substantial understatement penalty), among other provisions. H.R. Rep. No. 101–247, 101st Cong., 1st Sess. 1393 (1989) (hereinafter cited as the "1989 House Report"). Congress also confirmed that the mechanical assertion of penalties is simply wrong. See 1989 House Report at 1405 ("In the application of penalties, the IRS should make a correct substantive decision in the first instance rather than mechanically assert penalties with the idea they will be corrected later.").

We submit that the section 482 penalty undermines the integrated penalty reform provisions that Congress enacted in 1989. As Congress recognized at that time, imposing a penalty where the standard of conduct is unknown or unknowable (such as the highly fact-intensive transfer pricing area) unfairly penalizes taxpayers without advancing the fundamental goal of increasing compliance. The section 482 penalty represented bad tax policy when it was enacted in 1990 and it represents bad tax policy now.[13] Sections 6662(e) and (h) should therefore be repealed. At a minimum, the President's proposal to lower the $10 million threshold under section 6662(e)(1)(B)(ii) should be rejected.

Absent repeal of the statute, TEI supports the enactment of a realistic de minimis rule, based on a percentage of total intercompany sales. The President's proposal recommends such a test, based on the gross receipts of the taxpayer. It misguidedly ties the provision, however, to the dollar threshold test, providing that the penalty would apply to a net section 482 adjustment that was the lesser of $5 million or 10 percent of gross receipts (or $20 million or 20 percent of gross receipts). Such a provision ignores the size and multitude of intercompany transactions that must be monitored by multinational corporations. We submit that in circumstances where the total net section 482 adjustments are insubstantial in relation to the value of the taxpayer's total gross intercompany transactions, no penalty should be asserted. The dollar thresholds under sections 6662(e) and (h) of the Code should therefore be eliminated or the test changed to the greater of $5 million/$20 million or 10 percent/20 percent of gross receipts.

With respect to the contemporaneous documentation provision, the President's proposal essentially codifies the reasonable cause and good faith exception set forth in the recently proposed section 6662 regulations (which require contemporaneous documentation to escape the section 482 penalty). The Institute generally supports the codification of a specific reasonable cause exception. We believe, however, that significant questions remain about the proposed standard, especially to the extent it becomes the exclusive means of escaping the section 482 penalty.

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[12] *See* IRS Commissioner's Executive Task Force, *Report on Civil Penalties* (1989), *reprinted in* BNA's Daily Tax Report No. 35 (Feb. 23, 1989) (Special Supplement).

[13] Engrafting and *ad hoc* penalty on the integrated substantial understatement penalty led the Treasury Department to oppose enactment of the section 482 penalty in 1990. *See* Testimony of Kenneth W. Gideon, Assistant Secretary of the Treasury for Tax Policy, *reprinted in Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Companies Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 101st Cong., 2d Sess., July 10 and 12, 1990.

The determination of the "correct" transfer price between related parties is an inherently factual, complex undertaking. Recent court cases demonstrate that highly trained economic experts may substantially disagree on the proper pricing method in a particular factual setting. The recent temporary section 482 regulations themselves acknowledge that there is rarely any single, unassailable "right" answer.[14] In these circumstances, the section 482 penalty should not be routinely applied; rather, it should be limited to instances of truly culpable behavior.

TEI submits that the reasonable cause exception should encompass safe harbors or presumptions of good-faith conduct. We recommend that the contemporaneous documentation requirement in the President's proposal be recast as a safe harbor from assertion of the penalty. In other words, a taxpayer should be entitled to a presumption of reasonable cause and good faith where it can show that it has adopted a business policy designed to establish arm's-length prices between related parties, produces contemporaneous documentation showing how the transfer price was set, and verifies that the business policy was in fact followed. Such a provision would serve two purposes: (i) it would mitigate the severe underpayment penalty that may result from second-guessing a taxpayer's analysis and interpretation of complex factual data; and (ii) it would clarify the definition of "contemporaneous documentation" (which is undefined in both the President's proposals and the section 482 penalty regulations).[15]

Having contemporaneous documentation of transfer prices, however, cannot and should not be the sole means of satisfying the reasonable cause exception. Other safe harbors should be available. For example, if a taxpayer's pricing methodology has been continuously reviewed by the IRS for a certain number of years and found acceptable, reasonable cause and good faith should be deemed to exist. The reasonable cause and good faith standard should also be deemed satisfied for the amount of any timely, voluntary, self-assessed adjustment. Thus, where a taxpayer voluntarily self-assesses a net section 482 adjustment by filing an amended return, brings the adjustment to the attention of an IRS agent during an audit, or otherwise corrects an error through its normal accounting procedures, no penalty should be assessed. TEI believes that self-assessment upon the discovery of an error is evidence of good faith compliance that should negate any otherwise applicable section 482 penalty.

TEI also believes that taxpayers who wish to use the so-called fourth method for establishing transfer prices should not be required to prove the inapplicability of the other prescribed methods in order to avoid the section 482 penalty. Establishing the inapplicability of a pricing method effectively requires the taxpayer to prove a negative, that no other pricing methodology produces an arm's-length price, and creates the presumption that the use of an "other" method is inherently wrong. This is a difficult, if not impossible, burden to meet.

In sum, TEI recommends that section 6662(e) and (h) of the Code be repealed. At a minimum, the President's proposal to lower the $10 million threshold should be rejected. In addition, the President's proposal should be revised to codify a "contemporaneous documentation" standard as a safe harbor, i.e., as one means of satisfying the reasonable cause and good faith exception of section 6662(e). Finally, the proposal should be revised to eliminate the requirement that a taxpayer disprove the applicability of the other prescribed methods to establish reasonable cause.

EARNINGS STRIPPING RULES

1. *President's Proposal.* Section 163(j) was added to the Code in 1989 to prevent the possible erosion of the U.S. tax base by the use of excessive deductions for interest paid by a taxable corporation to a tax-exempt related party. In enacting the earnings stripping provision, Congress was primarily concerned with the thin capitalization of corporations. The current provision limits the U.S. interest deduction when (i) a corporation's debt-to-equity ratio exceeds 1.5 to 1; (ii) the interest is paid to a related party who is exempt from U.S. taxation; and (iii) the corporation has

[14] *See* Temp. Reg. §1.482–1T(d)(2) (permitting a range of arm's-length prices to be used under all methodologies).

[15] The Institute has grave concerns about the codification of the contemporaneous documentation requirements now set forth in the proposed section 6662(e) regulations. Section 2322 of the President's proposal would require the documentation to be in existence at the time the return is filed and that the data be produced within 30 days of an IRS request. Because of the time required to gather the necessary data, taxpayers may not be able to complete an economic study by the return filing date. We suggest that, at a minimum, the statute adopt a flexible approach that takes into account the difficulties taxpayers encounter in obtaining accurate data as of the time the return is filed and in producing that data for the IRS.

"excess interest expense," *i.e.*, its net interest expense exceeds 50 percent of its adjusted taxable income plus the excess limitation carry forward.

Section 2207 of the President's proposal would provide that any loan from an unrelated lender that is guaranteed by a related party would be treated as related party debt for purposes of the earnings stripping rule. Except as provided by regulations, a guarantee would be defined to include any arrangement under which a person directly or indirectly assures the payment of another's obligation. The proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993, without regard to when the underlying loan agreement was executed. Moreover, for taxable years commencing after December 31, 1993, the Administration has announced its intention to apply the earnings stripping rules to any indebtedness issued on or before July 10, 1989 (or issued after that date pursuant to a binding written contract in effect on such date).

2. *TEI Position.* TEI submits that the interest disallowance rule should apply only where the transaction presents a possibility of earnings being "stripped." Hence, section 163(j) only applies to interest that is not subject to U.S. income tax on the payee/recipient. If, for example, a domestic corporation pays interest to its foreign parent that is subject to the 30-percent withholding tax, section 163(j) is inapplicable. In such a case, no earnings have been "stripped" from the United States without taxation and the domestic subsidiary's interest expense is properly deductible.

Similarly, where a U.S. subsidiary of a foreign parent corporation borrows from a U.S. bank (or other taxable third-party lender) and pays interest on the loan to the U.S. lender, there is no earnings stripping, regardless of whether such loans are guaranteed (or otherwise supported) by the borrower's foreign parent. All of the interest paid to the U.S. lender is fully subject to U.S. income tax. TEI submits that section 163(j) should not be expanded to deny an interest deduction to the U.S. subsidiary in such circumstances.

In addition, the President's proposal would discriminate against U.S. companies that are foreign owned vis-á-vis their U.S. competitors that are domestically owned. In either situation, indebtedness owed to U.S. lenders may be guaranteed by the corporate parent. Denying an interest deduction to a foreign-owned company might not only violate the anti-discrimination clauses of treaties with many countries, but would also represent bad tax policy.

When the earnings stripping provision was enacted in 1989, Congress expressed concern that the use of loan guarantees not be used to circumvent the application of the rule. It recognized, however, that loan guarantees were often given in the ordinary course of business:

> Some have argued that the House report's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings. The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course.[16]

This rationale remains valid today. Loan guarantees that are given in the ordinary course of business should not be viewed as a tax-avoidance device.

Finally, TEI objects to the retroactive nature of the provision. The proposed expansion of the earnings stripping provision would apparently apply to transactions that were entered into before December 31, 1993. It would also apply the earnings stripping rules to any indebtedness issued on or before July 10, 1989. Such retroactive application of the proposal is inequitable, unwarranted and, in our view, totally unprecedented. The proposed effective date is especially improper in light of the conscious decision made in 1989 to make section 163(j) generally prospective.

TEI therefore opposes broadening the earnings stripping provision.

CONCLUSION

Tax Executives Institute appreciates this opportunity to present our views on the international provisions of President Clinton's Proposals for Public Investment and Deficit Reduction. If you have any questions, please do not hesitate to call me at (408) 765–1202 or Timothy J. McCormally of the Institute's professional staff at (202) 638–5601.

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[16] H.R. Rep. No. 101–386, 101st Cong., 1st Sess. 566 (1989).

STATEMENT OF UNILEVER UNITED STATES, INC.

Good Morning. My name is Richard A. Goldstein. I am President and Chief Executive Officer of Unilever United States, the U.S. subsidiary of Unilever, an Anglo-Dutch multinational. Unilever's shares are traded on the New York stock exchange, and Unilever United States is headquartered in New York City.

Unilever has been doing business in the United States since 1895. Our major operating companies in the United States include Lever Brothers, Thomas J. Lipton, Chesebrough-Pond's, Van den Bergh Foods, Elizabeth Arden, Calvin Klein cosmetics, and National Starch and Chemical Company. We employ approximately 24,500 people in more than 115 plants and facilities in 27 states—including New York and many of the states represented by members of the Committee. We have $9 billion invested in U.S. assets and in 1993, we expect to manufacture almost $10 billion of products in the U.S., a significant portion of which will be exported. Some of our brand names with which you may be familiar are: Good Humor ice cream; Lever 2000 and Dove soap; Wisk, Surf and Sunlight cleaning products; Lipton tea and soups; Wish-Bone salad dressings; Country Crock and Promise margarines; Close-up and Aim toothpastes; Vaseline and Q-tip products; Elizabeth Arden cosmetics, and Calvin Klein fragrances.

Unilever is committed to being a part of a growing U.S. economy and remaining a responsible corporate citizen—which includes paying our fair share of federal, state and local taxes. I am testifying on behalf of Unilever, and also as Chairman of the Organization for International Investment sometimes referred to as "OFII." OFII members consist of more than fifty U.S. businesses whose parent companies are headquartered in countries outside the U.S., including the United States' most important trading partners. OFII members include some of the largest foreign investors in the United States, employing a significant portion of the almost 5 million Americans who work for U.S. foreign-owned companies. A list of the OFII members is attached.

My purpose in being here is to oppose legislation which will unfairly limit the ability of my company and others like us to continue to compete in the U.S. where we have already invested so heavily for so many years. I refer to the so-called "enhanced earnings stripping" provision in the President's tax proposals.

BACKGROUND

The new proposal would "enhance" the current law regarding earnings stripping now contained in IRC section 163(j)). This statute was passed in 1989 over the strong objection of the Treasury Department and our foreign trading partners, all of whom objected because it discriminates against U.S. foreign-owned companies. The existing statute limits interest deductions to companies which have a debt to equity ratio of more than 1.5 to 1 computed on a tax basis and whose net interest payments to a related tax-exempt entity", e.g. any foreign related company, exceed 50% of adjusted taxable income. The existing legislation is, in effect, a "thin capitalization" rule which limits interest deductions only for foreign-owned companies.

The current statute applies only to debt issued after July 10, 1989, and leaves the issue of when guarantees by a foreign parent will be considered loans to be resolved in regulations. Although proposed regulations have been issued under section 163(j), the treatment of guarantees has been specifically reserved. Thus, there is no guidance to the application of the current earnings stripping rules to guarantees except as provided in the legislative history.

The legislative history of section 163(j) contains a detailed discussion of problems presented by loan guarantees and specifically states that "in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings, the conferees intend to clarify that the provision is not to be interpreted generally to subject third party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course." See Conference Report of Omnibus Budget and Reconciliation Act of 1989, (H.R. Rep. No. 386, 101st Cong., 1st Sess., at 567(1989).

While specifically exempting loan guarantees given "in the ordinary course" from the operation of the earnings stripping rules, the Conference Report also states that there are circumstances in which loan guarantees should be covered by the rules and clearly envisions that the Treasury Department would issue regulations setting forth those circumstances. One very important admonition to the Treasury Department is made with regard to the effective date of such regulations: "The conferees expect that *any such regulations would not apply to debt outstanding prior to the notice of the rule* if and to the extent that the regulations depart from positions the Service and the Treasury might properly take under analogous principles of present law that would recharacterize guaranteed debt as equity." *Ibid* (emphasis added.)

DESCRIPTION OF THE PROPOSAL

The new proposal would "enhance" the current statute by changing it in two fundamental ways: (1) the original "grandfather" exemption for debt issued prior to July 11, 1989 would be eliminated so that the restrictions on interest deductions in section 163(j) would apply to Ball interest paid or accrued for tax years beginning after December 31, 1993; and (2) all loans guaranteed by a related party would be considered related party debt subject to the earnings stripping rules, similarly effective for interest paid or accrued in tax years beginning after December 31, 1993.

OBJECTIONS TO THE PROPOSAL

- *Punishes nonabusive transactions*

This new proposal will disallow interest deductions in totally nonabusive situations in which, for example, a U.S. subsidiary borrows from a U.S. bank and obtains a guarantee from its foreign parent in order to lower its interest costs. Lenders, both domestic and foreign, normally expect parent company assurances that the subsidiary will pay its debts in order to grant the best interest rates. A lower interest rate means a smaller tax deduction, hence higher taxable income. There is no rationale for denying an interest deduction where the parent guarantee does no more than assure a better interest rate in the ordinary course of commercial lending.

The entire rationale for the earnings stripping rules rests upon the assumption that some U.S. subsidiaries are inflating their interest costs to their foreign parent, i.e. "stripping earnings" out of the U.S. by disguising dividend payments as interest and paying this interest to a "tax-exempt" entity—the foreign parent. There is no rationale for denying interest deductions in situations where the interest deductions are actually lower than they would have been without the parent guarantee and the interest payments are subject to tax in the U.S.

- *Violates our tax treaties ad exacerbates the discriminatory effect of the existing law*

All U.S. tax treaties contain a general nondiscrimination article which states that foreign investors will not be subjected to tax laws which are "more burdensome than the taxation and connected requirements to which other similar enterprises" are subjected. Most treaties also follow the U.S. Model Income Tax Treaty provision that interest paid by a foreign person is "deductible under the same conditions" that would apply to citizens.

The current earnings stripping statute runs afoul of these articles because it disallows interest deductions for U.S. foreign-owned companies where similarly situated U.S.-owned companies face no disallowance. The new proposal exacerbates the discriminatory effect of current law since it will apply solely on the basis of foreign ownership even where lenders are domestic and there is no tax base erosion from inflated or non-taxed interest payments to foreign persons.

- *Effective date is retroactive, totally unfair ad imposes an unprecedented burden on existing debt*

The original earnings stripping legislation was made to apply only to loans that were made after the date of House Ways and Means Committee action, July 10, 1989. This enabled affected companies to try to arrange their affairs to comply with the law to avoid imposition of its penalties. The new proposal eliminates the original "grandfather" for existing debt and applies the new restrictions on guarantees to *all interest paid or accrued* after December 31, 1993.

The current proposal violates one of the most fundamental principles of effective tax policy by imposing a tax penalty on debt that is already committed under long term contracts, including public offerings. It will be very costly for some of these companies to try to buy back such debt at a premium in order to avoid a tax penalty. There is nothing to warrant such harsh treatment of companies that acted in good faith reliance upon the law in effect at the time they entered into these obligations.

Whatever decision is made with regard to the treatment of loan guarantees, whether in new legislation or regulations, it should apply only to debt issued after the effective date, and not to *interest paid* or accrued after the effective date. The legislative history of the existing statute makes clear that this was the original intent, but fundamental fairness also requires that any new rules be prospective in application.

- *Treats companies from treaty countries more harshly than those from nontreaty countries*

The original earnings stripping statute treats companies from treaty countries more harshly than those from non-treaty countries, and this new proposal will make

that discrimination worse. Under the current earnings stripping rules companies with parents in non-treaty countries are not subject to the earnings stripping rules because any interest which they pay to their foreign parent is subject to a 30 percent withholding tax, and thus the interest is not paid to a "related tax-exempt entity."

Under the new proposal, this anomaly becomes even more significant since whenever a U.S. subsidiary borrows from a U.S. third party with a guarantee from its parent company, and the parent company is located in a *non*-treaty country (i.e., subject to the 30 percent withholding tax on direct interest payments), the new legislation will not be applicable and neither will the 30 percent withholding tax.

- *Invites retaliation or mirror legislation*

As in all legislation which discriminates against U.S. foreign-owned companies, there is always the risk of retaliation or, at a minimum, mirror legislation applicable to the subsidiaries of U.S. companies operating abroad. Since the U.S. is still a net exporter of investment capital, it is important that the U.S. government not enact legislation which could provide justification for treaty partners similarly to ignore their treaty obligations and to discriminate against U.S. companies operating in foreign jurisdictions. The discrimination of the existing legislation is expanded in the new proposal, thus making retaliation or mirror legislation more likely.

- *Discourages foreign investment in the U.S. just when we should be encouraging it*

The rapid growth in foreign investment in the U.S. during the 1980s has come to a dramatic halt in the 1990s. In 1992 there was actually a *net disinvestment* of $3.9 billion in the U.S. by foreign companies. This new proposal which discriminates against foreign investment will certainly not help reverse this trend and, thus, is especially ill-conceived under the circumstances. The U.S. should be sending precisely the opposite message to those seeking to invest capital and create jobs in the U.S.

- *Will not raise significant revenue because interest deductions will increase*

The relatively small projected revenue increase of, on average, $33 million to $175 million per year, depending upon whether one uses the Joint Committee on Taxation or the Treasury Department estimates, does not justify the substantial adverse tax and trade policy ramifications of this proposal. To the extent that U.S. foreign-owned companies respond to the new legislation by borrowing without a parent guarantee at a higher interest cost, their U.S. interest deductions will increase and thereby lower their U.S. tax liabilities. In addition, the removal of foreign parent guarantees will have the collateral effect of weakening loan portfolios of U.S. banks and other investors holding debt of these companies.

In conclusion, let me point out that U.S. foreign-owned companies doing business in America, such as Unilever United States, neither receive nor seek special tax treatment. We simply ask for the same treatment as other U.S. companies. The new earning stripping proposal expands the discrimination of the existing statute, and *does it retroactively*. We urge you to delete this proposal from the final version of any tax bill which you consider.

Thank you for the opportunity to testify.

Statement of Hon. Dr. Rudi V. Webster, Ambassador of Barbados to the United States of America

I. EXECUTIVE SUMMARY

Barbados is deeply concerned about the proposal of the Clinton Administration and Senator Pryor to reduce or repeal section 936 tax provisions.

If enacted, this legislation will have a negative and detrimental impact on the CBI/936 program and on the economic stability and growth of Caribbean countries. Barbados believes that 936 funds are an important catalyst and resource for investment and economic development in the region.

Barbados believes that a change or loss of 936 funding could impact adversely on the economic and social gains of the past five years. A reversal of this trend would result in an unstable economic and political climate which could threaten democracy and human rights in the region. Such an environment could make countries more vulnerable to drug trafficking, money laundering, illegal immigration and organized crime.

In addition to these adverse effects on the Caribbean this proposal could result in a weakening of tax cooperation just when the U.S. Government needs to improve its infrastructure for international tax compliance and raising revenue.

II. THE 936 CARIBBEAN DEVELOPMENT PROGRAM—BENEFITS TO PUERTO RICO AND THE CARIBBEAN

The 936 Caribbean Development Program has produced significant achievements. As of December 31, 1992, 117 projects had been promoted in 13 Caribbean countries, creating more than 29,000 direct jobs and an investment of more than $1 billion.

By mid-March 1993, $684.6 million worth of investments were funded by the same source in nine countries covering 46 projects and creating 13,000 jobs. By year end 1993, total disbursement could reach $1.5 billion.

Many of the infrastructure projects financed by 936 funds will provide for expanded communications, transportation, and other trade and investment linkages between the United States and the Caribbean. Already these linkages have resulted in a trade balance between Puerto Rico and the Caribbean, in excess of $1.7 billion. Trade between Puerto Rico and the Caribbean increased by 58% during the last five years.

The qualified possession source investment income (QPSII) and the 100% credit on interest earnings have been a powerful incentive to deposit funds in Puerto Rico and to invest in Caribbean Basin Countries. A withdrawal of this treatment will result in a significant reduction in manufacturing activity in Puerto Rico.

A decrease in U.S. foreign assistance to the region during the last five years was partially compensated by the 936 technical assistance and collaboration program. Changes to the 936 legislation would therefore seriously affect the future of technical assistance in CBI countries.

III. THE 936 CARIBBEAN DEVELOPMENT PROGRAM—BENEFITS TO THE U.S. ECONOMY

The Sixth Annual Report on the Impact of the Caribbean Basin Economic Recovery Act on U.S. Industries and Consumers, shows that in 1990, for the fifth consecutive year, the U.S. had a trade surplus with Caribbean Basin countries of $2.1 billion. The Caribbean Basin was the 11th largest export market for the U.S. and grew 5.6% in 1990 compared with 1989.

The U.S. Department of Commerce estimates that each $1 billion in U.S. exports creates 20,000 U.S. jobs. Hence, the $9.7 billion in U.S. exports to the region in 1990 supported almost 200,000 U.S. jobs. In addition, it is estimated that for every dollar earned in the Caribbean Basin, 60 cents is used towards buying U.S. products. On average, over 45% of all CBI imports are sourced from the U.S., which is the highest in the Latin American region.

IV. ADVERSE CONSEQUENCES OF THE REDUCTION OF SEC. 936 TO THE U.S.

Reduced financing and development in the Caribbean Basin will cause adverse economic impact in the U.S., including a reduction in exports and a loss of jobs. The following are some of the areas that will be negatively affected:

A. Decreased Tax Cooperation

Ironically, although the proposed changes to Sec. 936 will raise revenue, significant long-term injury may result in the ability of the U.S. to raise revenue because the loss of Sec. 936 benefits is likely to result in some governments cancelling TIEAs, and in their reluctance to conclude tax and other related enforcement treaties with the U.S.

The new Administration has pledged to raise revenue in part from tougher international tax compliance. Yet the Sec. 936 proposal risks jeopardizing the ability of the U.S. Government to raise revenue in the Caribbean region which many U.S. persons utilize for tax and business planning purposes. Indeed, the TIEA program was designed to combat evasion and avoidance of U.S. tax by U.S. taxpayers.

In February 1986, testimony indicated that the lack of success of the TIEA program was due to insufficient incentive, and at that time only 5 of the 29 eligible CBS countries had signed TIEAs. However, when the TIEA program was linked to 936 financing benefits, the number rose to 12. The removal of these benefits will make the cumulative incentives for signing future TIEA agreements less attractive.

B. Diminished Ability to Conclude Treaties

The reduction of 936 benefits may be regarded as a violation of U.S. tax treaty obligations. In 1981, the U.S. Government terminated all the U.K. tax treaties that had been extended with the Caribbean. Barbados and the U.S. then concluded a treaty in 1984 along with a TIEA. After a lengthy ratification process in which both Treasury and the Joint Committee on Taxation made written studies of the 1984 income tax treaty between the U.S. and Barbados, the U.S. Congress within one year of the signing enacted legislation overriding the exemption of federal excise

tax. In December 1992, a protocol to the existing treaty was signed, partly to compensate for the override. In the last session of Congress, Sec. 302 of HR 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992, proposed to override the protocol.

C. Erosion of Criminal and Enforcement Cooperation

Criminal and enforcement cooperation between the U.S. and the Caribbean is at a critical juncture. The U.S. has concluded Mutual Legal Assistance in Criminal Matters Treaties with some countries, such as the Bahamas, the Cayman Islands, Jamaica, and Panama. The U.S. has begun to conclude modern extradition treaties with Caribbean and Latin American countries. In addition, cooperation has included investigation and prosecution of commodities futures, securities crimes, money laundering, and a host of other matters.

The U.S. Government would like and indeed needs to expand its formal anti-money laundering enforcement agreements and other forms of cooperation. Maintaining the spirit of its existing treaty commitments will enable the U.S. to enhance enforcement cooperation with Caribbean governments.

The significant reduction of 936 benefits and unraveling of the TIEA network would strike a blow to regional enforcement cooperation at a time when the region should be strengthening cooperation against organized crime, narcotics trafficking, money laundering, and other criminal conduct.

PREPARED STATEMENT OF SAMUEL Y. SESSIONS

Chairman Moynihan and Members of the Committee:

I am pleased to have this opportunity to present testimony today concerning the President's proposals on the possessions tax credit, earnings stripping, and the revenue provisions affecting international businesses. These proposals are designed to ensure that all businesses bear their fair share of the tax burden and to eliminate tax incentives that favor operation abroad rather than operation in the United States.

TREATMENT OF ROYALTIES IN COMPUTING FOREIGN TAX CREDIT AND ALLOCATION OF RESEARCH EXPENSE

Current Law

U.S. persons are taxable on their worldwide income, including income from foreign sources. To avoid double taxation, a foreign tax credit is allowed for income taxes paid to a foreign country. The foreign tax credit is limited, however, to the taxpayer's U.S. tax liability with respect to net foreign source income. A taxpayer will have "excess foreign tax credits" if foreign taxes paid on foreign source income exceed its U.S. tax on that income. A taxpayer will have "excess limitation" and will owe "residual U.S. tax" if foreign taxes paid on foreign source income are less than its U.S. tax on that income.

The foreign tax credit limitation is calculated separately for certain categories of foreign source income. The separate categories include various types of income that are typically subject to either low or high rates of foreign tax or that are easily located in a low-tax jurisdiction. Most active business income is subject to a residual or "general" foreign tax credit limitation. The separate categories prevent "cross-crediting" of foreign taxes paid at rates higher than the U.S. rate on items of income in one category against residual U.S. tax payable on items of income in another category that are taxed at low foreign rates. "Cross-crediting" is generally permissible, however, with respect to items of high-taxed and low-taxed income in the same category.

Foreign source royalties derived by licensing intangible property for use overseas are generally included within the existing separate category for passive income. There are, however, two significant exceptions under which foreign source royalties may be included in the general limitation category. First, royalties derived in the active conduct of a trade or business and received from an unrelated person are treated as general limitation income. Second, any royalty received or accrued from a controlled foreign corporation (CFC) in which the taxpayer is a U.S. shareholder is treated as income in the general limitation category or in a separate category to the extent that it is properly allocable to income of the payor corporation in such category. Under this "lookthrough" rule, for example, royalties paid to a U.S. parent corporation by a CFC that earns only general limitation income may be treated by the U.S. parent as general limitation income.

To compute the foreign tax credit limitation for each category, it is necessary to determine the taxable amount of foreign source income in that category. Expenses incurred by the taxpayer must therefore be allocated to U.S. source income or a category of foreign source income. Allocation of an expense to foreign source income reduces the foreign tax credit limitation for the relevant category, while allocation of an expense to U.S. source income does not affect the foreign tax credit limitation. For this reason, U.S. taxpayers generally prefer to have expenses allocated to U.S. source income.

Treasury Regulations issued in 1977 provide detailed rules for the allocation of deductible research and experimental expenditures ("research expenses"). Under this regulation, research expenses are generally allocated on a product category basis, and a taxpayer may choose either a sales method or a gross income method. Under the sales method, 30 percent of the research expense is generally allocated directly to U.S. source income, and the remainder is apportioned among U.S. and foreign source income based on the taxpayer's relative proportions of U.S. and foreign sales receipts in the relevant product category. Under the gross income method, all research expense is apportioned between U.S. and foreign source income based on the taxpayer's relative proportions of U.S. and foreign gross income in the product category. No exclusive apportionment to U.S. source income is permitted.

Since 1981, the 1977 Treasury Regulation has been subject to a series of temporary statutory modifications. The most recent temporary rule, which expired midway through the first taxable year beginning after August 1, 1991, permitted taxpayers to allocate 64 percent of the expense of U.S. research directly to U.S. source income. Similarly, 64 percent of the expense of foreign research was allocated directly to foreign source income. The remaining research expense was apportioned, at the election of the taxpayer, on the basis of either sales receipts or gross income.

In June, 1992, the IRS announced that the Treasury Department and the IRS had undertaken a review of the 1977 Treasury Regulation and that, pending this review, taxpayers are not required to apply the regulation during an 18-month transition period. Instead, research expenses incurred during this transition period may be allocated and apportioned in accordance with a transition method based on the statutory "64 percent" rule described above.

Reasons for Change

Foreign source royalties generated by licensing intangible property for use abroad are generally deductible against foreign income and thus subject to no net basis foreign tax. In addition, royalties are generally subject to low rates of foreign withholding tax, or exempt from withholding tax altogether, under an income tax treaty. In the absence of "cross-crediting" opportunities, foreign source royalties would generally be subject to residual U.S. tax.

Foreign source royalties that are included in the general limitation category, however, can be sheltered from residual U.S. tax through "cross-crediting" of excess foreign taxes paid on other business income in the general category.

This opportunity for "cross-crediting" can create a tax preference for income derived through licensing intangible property for use overseas -- as compared to income derived from the use or license of intangible property in the United States. This tax preference may constitute an incentive for the use of intangible property in foreign rather than domestic manufacturing activities.

In addition, opportunities for elimination of residual U.S. tax on foreign royalties may result in an unacceptable erosion of the U.S. tax base. For example, a taxpayer may develop intangible property through research activities undertaken in the United States. When research expense deductions (and credits) are claimed on a current basis, as permitted under existing law, these expenses cannot be apportioned to income later generated by that intangible. Under existing law, moreover, these expenses are often allocated substantially to U.S. source income earned in the year of deduction. As a result, foreign source royalty income generated by intangible property often is not reduced by an appropriate amount of related expense. These rules, in combination with the foreign tax credit rules, increase the potential for erosion of the U.S. tax base. Foreign source royalty income is sheltered from U.S. tax through "cross-crediting," while related expense deductions (and credits) reduce tax on other, often U.S. source, income.

Finally, the "lookthrough" rule that attributes royalties received from CFCs to the various limitation categories based on the underlying income of the CFC does not have its intended result when "cross-crediting" opportunities exist. This rule was intended to encourage the repatriation of foreign earnings through deductible (for foreign tax purposes) royalty payments, thereby reducing foreign tax liability and increasing the residual U.S. tax collected. When taxpayers may eliminate the resulting U.S. tax through "cross-crediting," however, the fisc realizes no benefit from the reduction in foreign tax liability.

The numerous statutory modifications to the rules governing allocation of research expense have resulted in uncertainty and complexity and have impeded the efforts of U.S. taxpayers to plan research and development activities. The Administration believes that permanent allocation and apportionment rules will facilitate planning and promote compliance. In addition, the Administration hopes to encourage the conduct of research activities in the United States by ensuring that the expenses associated with such activities do not reduce the foreign tax credit limitation.

The Administration's Proposal

The Administration's proposal would treat all foreign source royalties attributable to the licensing of intangible property as income within the existing separate foreign tax credit limitation category for passive income. To prevent avoidance of this rule, the proposal would provide the same treatment for any payment made in consideration of a sale or other disposition of intangible property, to the extent such payment is contingent on the productivity, use, or disposition of the property. The existing separate category for passive income prevents "cross-crediting" of excess foreign taxes paid on business income against residual U.S. tax on passive income (which is typically low-taxed). Inclusion of all foreign source royalties within this category will similarly prevent taxpayers from sheltering foreign royalty income from residual U.S. tax through "cross-crediting."

The proposal would permit taxpayers to group all royalties together for purposes of applying the so-called "high-tax kickout" from the passive category. Under the high-tax kickout, income that would otherwise be included in the passive category may be treated as general limitation income if it is subject to an effective foreign tax rate equal to the maximum U.S. rate. The grouping rule will permit taxpayers to "cross-credit" excess foreign taxes paid on royalties earned in a high-tax country against residual U.S. tax on other royalties earned in low-tax countries.

The proposal will also provide a favorable rule for the allocation of research expense. Under the proposal, 100 percent of the taxpayer's expense attributable to research activities conducted in the United States may be allocated to U.S. source income. This rule will encourage the conduct of research and development in the United States by ensuring that the expenses of U.S. research do not reduce the foreign tax credit limitation. The expense of foreign research activities will be apportioned among U.S. and foreign source income on the basis of the taxpayer's relative proportions of U.S. and foreign gross sales receipts. We believe that this apportionment rule best reflects the relationship of foreign research expense to U.S. and foreign source income.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1993.

FOGEI/FORI and SHIPPING WORKING CAPITAL

Current law

For most industries, foreign source income earned on temporary investments of working capital is categorized as passive income for foreign tax credit limitation purposes. Segregating this income, which is typically subject to low foreign tax, in the passive basket reduces taxpayers' ability to "cross-credit" higher foreign taxes paid on other foreign source income. If taxpayers were allowed to mix high- and low-taxed foreign income, they would have an incentive to invest working capital abroad where it would be subject to little or no foreign tax.

Under a vestige of prior law, the oil and gas and shipping industries enjoy an exception to this treatment of working capital, which enables them to cross-credit. As a result, they have an incentive to invest working capital abroad to generate low-taxed, foreign source income to absorb higher foreign taxes paid on other foreign income.

In addition to the general foreign tax credit limitation, a special limitation, which pre-dates the baskets established by the 1986 Act, prevents the cross-crediting of particularly high foreign taxes on foreign oil and gas extraction income ("FOGEI"). A similar provision applies to foreign oil related income ("FORI"). Under current law, income from the temporary investment of working capital related to oil and gas activities is treated as FOGEI or FORI even though it is not itself subject to the same high foreign rates. Allowing lower taxed income on foreign investments of working capital to be averaged with the higher taxed extraction income reduces the effectiveness of the FOGEI and FORI limitations.

Reasons for Change

No industry besides oil and gas and shipping currently enjoys special treatment of working capital. This preferential treatment is difficult to support. As long as the typically low foreign taxes associated with passive income from working capital are

permitted to be averaged with higher foreign taxes associated with active foreign income, taxpayers will have an incentive to locate their passive investments abroad rather than in the U.S. This incentive under current law is even more pronounced in the context of oil and gas because of the opportunity to inflate the special credit limitation with foreign working capital income.

The Administration's Proposal and its Effects

The Administration's proposal would eliminate the preferential treatment currently accorded the oil and gas and shipping industries by categorizing as passive all dividend and interest income that would be in the passive basket if earned by any other industry. These rules would apply for general foreign tax credit purposes and for purposes of the special FOGEI/FORI limitation of Code Section 907. Thus, residual U.S. tax payable on foreign dividends and interest, whether or not the income is attributable to temporary investments of working capital, would not be offset by higher foreign taxes paid on other types of foreign source income. Elimination of opportunities for "cross-crediting" should reduce the incentive that taxpayers in the oil and gas and shipping industries now have to maximize the amount of earnings characterized as "working capital" and invested abroad. The proposal would apply to income earned in taxable years beginning after December 31, 1992.

REQUIRE CURRENT TAXATION OF CERTAIN EARNINGS OF CONTROLLED FOREIGN CORPORATIONS

Current Law

The United States generally taxes U.S. persons currently on their worldwide income. However, U.S. shareholders of a foreign corporation generally are not taxed currently by the United States on foreign income earned by the corporation. Rather, U.S. tax on such income generally is deferred until the income is repatriated.

The Code provides several exceptions to this general tax deferral regime for foreign income earned by U.S. shareholders through a foreign corporation, including the subpart F rules applicable to controlled foreign corporations and the passive foreign investment company rules.

Under the subpart F rules, a U.S. person owning 10 percent or more (a "10 percent U.S. shareholder") of a "controlled foreign corporation" ("CFC") is required to include in income currently its pro rata share of the "subpart F income" of the CFC. A CFC generally is defined as a foreign corporation more than 50 percent owned by 10 percent U.S. shareholders. Subpart F income generally includes passive income, as well as certain types of active income considered to be particularly mobile. However, it does not include most types of active business income.

The passive foreign investment company ("PFIC") rules are designed to eliminate the benefit of deferral of U.S. tax on a U.S. shareholder's pro rata share of the PFIC's total undistributed earnings. These provisions apply regardless of the U.S. shareholder's percentage ownership. A corporation (whether or not a CFC) is a PFIC if (1) 75 percent or more of its gross income for the taxable year is passive income, or (2) 50 percent or more of its assets produce, or are held for the production of, passive income. For this purpose, passive income generally does not include active banking or insurance income.

A U.S. shareholder of a PFIC may elect to include currently in income its pro rata share of the PFIC's total earnings. If this election is not made in a timely manner, the U.S. shareholder is subject to an interest charge when it receives certain distributions of PFIC earnings or disposes of PFIC stock.

Reasons for Change

Under current law, U.S. shareholders of CFCs may defer U.S. tax on the CFC's earnings that are not subpart F income, until the earnings are repatriated or a PFIC inclusion is triggered. Many CFCs are able to defer tax indefinitely on accumulated income by managing their passive income and assets so as to avoid exceeding the PFIC thresholds.

The Administration believes that the broad deferral provisions of present law create a significant tax incentive to hold earnings in passive investments offshore, instead of repatriating or reinvesting them in an active business. This incentive is difficult to justify on competitiveness or other policy grounds.

The Administration's Proposal

The proposal would curtail deferral for certain earnings invested in passive assets abroad. It would require 10 percent U.S. shareholders of certain CFCs to include in income currently their respective pro rata shares of a specified portion of the CFC's current and accumulated earnings.

The proposal would apply to any CFC (including a CFC that is a PFIC) holding passive assets representing more than 25 percent of the value of its total assets.

The portion of current and accumulated earnings subject to inclusion would be the lesser of (1) total current and accumulated earnings and profits, or (2) the amount by which the value of the CFC's passive assets exceeds 25 percent of the value of its total assets. Earnings subject to inclusion would be adjusted to account for amounts previously taxed.

For purposes of this proposal, passive assets generally would be defined as under the rules that now apply in determining whether a foreign corporation is a PFIC.

The proposal generally would be effective for taxable years of CFCs beginning after September 30, 1993 and for taxable years of their U.S. shareholders ending with or within such taxable years. Under a phase-in rule, however, the amount subject to current inclusion in a taxable year would be limited to the U.S. shareholders' respective pro rata shares of the applicable percentage of the total earnings of the CFC subject to inclusion for the year under the proposal. The applicable percentage would be 20 percent for the taxable year beginning during the 12 months immediately following September 30, 1993, 25 percent for the taxable year beginning during the 12 months immediately following September 30, 1994, 35 percent for the taxable year beginning during the 12 months immediately following September 30, 1995, 50 percent for the taxable year beginning during the 12 months immediately following September 30, 1996, and 100 percent for taxable years beginning after September 30, 1997.

IMPROVED ENFORCEMENT OF SECTION 482

Current Law

Section 6662(a) imposes a penalty in the amount of 20 percent of any underpayment of tax attributable to certain section 482 allocations that constitute substantial valuation understatements. For this purpose, a substantial valuation understatement arises if (1) the transfer price for any property or services (or for the use of property) claimed on a return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the arm's length price, or (2) the net section 482 adjustment exceeds $10 million. The penalty is increased to 40 percent in the case of a gross valuation misstatement, which arises if (1) the

transfer price for any property or services (or for the use of property) claimed on a return is 400 percent or more (or 25 percent or less) of the amount determined under section 482 to be the arm's length price, or (2) the net section 482 adjustment exceeds $20 million.

Section 482 adjustments are excluded in determining the $10 million or $20 million net section 482 adjustment thresholds if the taxpayer acted in good faith and had reasonable cause for establishing the particular transfer price. The statute does not elaborate on what constitutes "good faith" or "reasonable cause."

Reasons for Change

Largely because there is no statutory or regulatory elaboration of the reasonable cause and good faith exception, the IRS has not attempted to apply the substantial or gross valuation misstatement penalties to section 482 adjustments. A statutory definition of the exception would provide the Service with guidance necessary to enforce the penalties more effectively. More effective penalties in turn would enhance compliance with the arm's length standard.

Many multinationals currently appear to ignore the arm's length standard when determining their transfer prices. Moreover, taxpayers under audit typically feel no obligation to provide the examiner with data demonstrating that their prices satisfied the arm's length standard. As a result, the examiner most often bears the burden of demonstrating that a particular intercompany price was not established on an arm's length basis. The examiner thus normally must obtain comparable uncontrolled transactions data and apply a transfer pricing methodology to the data. Requiring taxpayers to prove use of a reasonable transfer pricing methodology would further enhance 482 compliance by reducing the burden on examiners and encouraging the taxpayer to develop supporting data prior to an audit.

Finally, the current threshold of $10 million for imposition of the 20 percent penalty may not create an adequate inducement for all taxpayers to comply with the arm's length standard. For many taxpayers, a $10 million section 482 adjustment would be extremely large in relation to the volume of intercompany transactions. Lowering the $10 million threshold and adding an additional threshold based on a percentage of a taxpayer's gross receipts would broaden the incentives for all taxpayers to comply with section 482 and to provide documentation of their attempted compliance to examiners.

Administration's Proposal

Section 6662(e) would be amended to provide that a net section 482 transfer pricing adjustment would not result in a substantial or gross valuation misstatement penalty if the taxpayer provided documentation demonstrating the application of one or more reasonable transfer pricing methodologies to the taxpayer's controlled transactions. Although it need not have been prepared at the time that the relevant intercompany transactions were completed, the documentation must have been prepared before the taxpayer's tax return for the taxable year was filed.

A reasonable transfer pricing methodology is defined as any method provided under the section 482 regulations (other than so-called "other" methods) for determining an arm's length result with respect to the type of transaction under review (e.g., transfer of tangible property) if the method is applied in a reasonable manner. The application of a method will not be reasonable unless the taxpayer observes and documents any procedural or other requirements imposed by the regulations with respect to the

particular method. For example, if adjustments required under a particular method are not made, the taxpayer's application of the method would not be reasonable.

Methods other than those specifically prescribed in the section 482 regulations may be reasonable if the taxpayer can establish that, at the time of the controlled transactions, the specifically prescribed methods would not have been likely to lead to an arm's length result but the method actually applied would have been. If, prior to filing its tax return, the taxpayer becomes aware that, more likely than not, the chosen method did not lead to an arm's length result, then application of that method is no longer reasonable.

In some cases it only will be possible to apply a transfer pricing methodology based on data from a preceding taxable year or years. Sole reliance on such data is acceptable (solely for purposes of section 6662(e)) unless more current reliable data becomes available prior to filing the tax return for the relevant year.

The thresholds for imposition of the substantial or gross valuation misstatement penalties would be modified. A net section 482 transfer pricing adjustment would potentially be subject to the 20 percent penalty if it exceeded the lesser of $5 million (as compared to the current $10 million) or 10 percent of the taxpayer's gross receipts. The 40 percent penalty would potentially be triggered if the net section 482 transfer pricing adjustment exceeded the lesser of $20 million or 20 percent of the taxpayer's gross receipts. The Administration's legislative proposal would be effective for taxable years beginning after December 31, 1993.

The Administration further proposes to initiate an enforcement initiative targeted at transfer pricing abuses. This initiative entails the addition of 235 full-time employees for the 1994 fiscal year at a cost of $30.6 million. It includes additional international examiners, improved coordination of transfer pricing issues within the IRS, improved training of examiners, and a greater emphasis on avoidance of lengthy and expensive litigation through Advanced Pricing Agreements. It is expected that, in conjunction with the legislative proposal, this initiative will result in a substantial improvement in compliance.

DENIAL OF PORTFOLIO INTEREST EXEMPTION FOR CONTINGENT INTEREST

Current Law

Under current law, a 30 percent tax generally is imposed on the gross amount of U.S. source interest, dividends, rents or other investment income paid to a nonresident alien or foreign corporation. The 30 percent tax, however, does not apply to "portfolio interest." Subject to certain exceptions (e.g., interest paid to a related person), the term portfolio interest includes any interest, provided that certain procedural requirements are satisfied.

Whether a financial instrument is treated as debt for federal income tax purposes, and therefore the income on the instrument qualifies for the portfolio interest exemption, depends on the facts of the particular case. Under existing case law, however, an instrument may qualify as debt even if the instrument provides the holder with significant equity participation rights.

For example, a domestic corporation that owns commercial real estate might issue a debt instrument to a foreign investor that pays a fixed amount of annual interest plus additional annual amounts equal to a percentage of the rental income derived by the corporation. Alternatively, the instrument might pay a contingent

amount at maturity equal to a percentage of any increase in the fair market value of the real property owned by the corporation over the term of the loan. Under current law, the contingent interest paid on such instruments would qualify for the portfolio interest exemption even though the income represents a significant equity participation in the underlying venture.

Reasons for Change

A significant erosion of the U.S. tax base results from applying the portfolio interest exemption to interest that represents a participation in the profits or other gain derived from a venture. If the foreign investor held a direct ownership interest in the venture, the income or gain realized by the investor typically would be subject to U.S. tax (e.g., as dividends, rent or gain taxable under the Foreign Investment in Real Property Tax Act (FIRPTA)). Indeed, in some cases (e.g., with respect to dividends), the debtor would not be able to claim a deduction for the amount paid.

Administration's Proposal

The portfolio interest exemption would be made inapplicable to certain types of contingent interest. In particular, subject to certain exceptions, the term "portfolio interest" would not include any amount of interest that is determined by reference to:

(i) any gross or net income or cash flow of the debtor or a related person,

(ii) any change in the value of property owned by the debtor or a related person, or

(iii) any dividends, partnership distributions or similar payments made by the debtor or a related person.

Interest generally would be subject to the provision only if the rate of interest is contingent. Thus, the provision would not apply if a debt instrument pays a fixed rate of interest but the timing (although not the amount) of repayment of principal is subject to contingencies.

The provision would be subject to certain express "safe harbors." Under these, the provision would not apply where --

(i) the amount of interest is determined by reference to the value of actively traded property, such as commodities or publicly traded stock -- other than an interest in real property subject to FIRPTA;

(ii) the amount of interest correlates with the income, cash flow, or value of property of the debtor or a related person merely because the debtor or related person enters into a hedging transaction to reduce the risk of interest rate or currency fluctuations with respect to such interest;

(iii) the interest is paid with respect to a regular interest in a REMIC, or another debt instrument described in section 1272(a)(6)(C) of the Code, and all or substantially all of the amount of such interest is determined by reference to any other amount of interest that is not contingent within the meaning of this provision (or by reference to the principal amount of indebtedness on which such other interest is paid); or

(iv) the interest is contingent solely by reason of the fact that it is paid with respect to nonrecourse or limited recourse indebtedness.

Denying the portfolio interest exemption in the circumstances covered by the proposal prevents the tax-favored treatment of debt paid to foreign persons from being utilized to transform taxable rents, dividends and other income into tax-exempt interest.

The provision would not override existing U.S. income tax treaties that reduce or eliminate the 30 percent withholding tax on interest paid to foreign persons.

AUTHORIZATION OF REGULATIONS CONCERNING CONDUIT ARRANGEMENTS

Current Law

Some taxpayers engage in various types of conduit arrangements for the purpose of achieving unwarranted tax benefits. For example, a transaction that, in substance, represents a direct loan between two parties might be formally structured as back-to-back loans involving a third party.

There is little guidance under current law concerning the circumstances under which a three-party financing arrangement will be recharacterized as a two-party transaction for federal income tax purposes on the grounds that the intermediary party is a mere conduit in the transaction. Few reported court cases address the issue.

The IRS has issued public and private rulings on point. However, taxpayers have questioned whether existing law provides adequate authority for the results reached in the rulings.

Reasons for Change

The uncertainty in the law has created incentives for taxpayers to engage in conduit arrangements for tax avoidance purposes.

Administration's Proposal

The Secretary would be authorized to issue regulations that set forth rules for recharacterizing any multiple-party financing arrangement as a transaction between any two (or more) of the parties, where such a recharacterization is appropriate to prevent avoidance of tax.

POSSESSIONS TAX CREDIT

Current Law

Section 936 of the Internal Revenue Code provides that U.S. corporations with active business operations in a U.S. possession generally may claim a credit that completely offsets the U.S. tax liability on the earnings from such operations. In addition, the earnings from these operations may be invested in certain financial instruments and earn interest income free of U.S. tax. Dividends paid by a section 936 corporation to a U.S. corporate shareholder that owns all the stock of the section 936 corporation also are effectively exempt from U.S. tax. (Such dividends do, however, constitute adjusted current earnings for purposes of the alternative minimum tax).

Reasons for Change

Section 936 of the Internal Revenue Code was enacted to promote jobs and investment in Puerto Rico and other possessions. Section 936 has in fact contributed to the development of the manufacturing and banking sectors in Puerto Rico. While the provision therefore has achieved some significant successes (in 1989 section 936 companies employed 105,000 workers, representing about 12 percent of the island's total employment), many have suggested that the provision could be modified to achieve most or all of these successes at a greatly reduced level of tax expenditures.

Many studies conducted over the past 15 years have indicated that a disproportionate share of the tax benefits attributable to section 936 is realized by intangible-intensive industries that create relatively little economic growth or activity. For instance, Treasury data indicates that while the average pharmaceutical worker in Puerto Rico earned $30,400 in total compensation in 1989, the tax expenditure for each such job was $66,081, or 217 percent of wages. Companies accounting for only 12.6 percent of section 936 employment received 63.5 percent of total section 936 benefits. Furthermore, at the end of 1989, section 936 corporations held only $3.6 billion in net plant and equipment in Puerto Rico. Data of this nature suggests that while section 936 has promoted economic growth in Puerto Rico, the growth is too small in relation to section 936 tax expenditures.

The reason for this disparity is that the section 936 credit is tied to the maximum amount of income that a company can earn in the possession, rather than the number of jobs and amount of investment attributable to the company's operations in the possession. As a result, the corporations that claim the largest tax benefits under section 936 often are the corporations that produce the most profitable products, rather than those corporations making the largest contribution to economic growth in Puerto Rico.

The Administration's Proposal

In general, the current rules under section 936 would be unchanged. Two limitations would, however, be placed on the benefits that otherwise could be claimed under section 936. First, the credit for active business operations would be limited to 60 percent of wages paid (as defined under the Federal Unemployment Tax Act (FUTA)). Wages would continue to be fully deductible. The combination of the credit and the deduction comes close to a 100 percent wage credit. The proposal would be phased in over three years. The amount of wages taken into account for each employee would be limited to the amount of wages subject to federal social security withholding. This base includes wages, vacation allowances, and payments in kind and is currently $57,600. This limit would be pro-rated (based upon the portion of the year that the employee worked) in the case of part-time and part-year workers.

Second, the tax exemption for income from qualified investments of possession source earnings would be limited to the income attributable to assets with a value equal to 80 percent of the firm's average annual tangible business investment within the possession. For this purpose, tangible business investment would include inventory and property, plant and equipment.

Effects of Proposal

Linking the credit directly to jobs and capital investment will create incentives for corporations to increase their employment and capital investment in the possessions. In addition, companies will be able to claim a credit with respect to income attributable to intangible assets only to the extent that such income is linked to Puerto Rican employees and capital investment.

The proposal is designed to minimize disruption to the Puerto Rican economy by disproportionately affecting those companies accounting for the smallest fraction of employment. Companies employing a large number of workers relative to their existing section 936 tax credits will be unaffected. For companies above the 60 percent wage credit threshold, the proposal provides a powerful incentive to increase employment. For every $100 of extra wages, they would obtain a $60 tax credit plus a full tax deduction for wages worth $36 (assuming the new corporate rate) -- close to a 100 percent wage credit.

The revisions to the Administration's proposal reflect an effort to respond to the priorities identified by the Governor. The revisions provide a specific tax benefit for passive investments of section 936 companies. Moreover, by tying this benefit to the level of investment in tangible assets, an indirect capital investment incentive is created.

ENHANCEMENT OF EARNINGS STRIPPING RULES

Current Law

Under present law, a thinly capitalized corporation may not claim a current deduction for excessive interest paid to a related party if the interest income is exempt from U.S. tax. These "earnings stripping" rules apply, for example, if a foreign parent corporation capitalizes a U.S. subsidiary with excessive amounts of debt and the interest payments on the debt are exempt from 30% withholding tax under a U.S. income tax treaty. The rules also apply if the related party is a domestic tax-exempt entity.

The earnings stripping rules apply to a corporation only if it has a debt-equity ratio in excess of 1.5 to 1 and the corporation's net interest expense exceeds 50% of its adjusted taxable income for the year. The amount of interest that is disallowed equals the lesser of the "excess interest expense" (i.e., the amount by which net interest exceeds the 50% of adjusted taxable income limitation) or the total "disqualified interest" (i.e., the total interest paid to related parties that is exempt from U.S. tax). Amounts disallowed may be carried over indefinitely and claimed in a later year to the extent that the taxpayer has excess limitation in that later year.

Pursuant to a "grandfather" provision in the enacting legislation, interest paid or accrued on any fixed-term debt instrument issued on or before July 10, 1989 (or issued pursuant to a binding contract in effect on such date) is not treated as disqualified interest for purposes of the earnings stripping rules.

Reasons for Change

The earnings stripping rules can be easily circumvented if the rules are not applied to a loan from an unrelated party that is guaranteed by a related party. Although the interest on guaranteed debt is paid to an unrelated lender, the debt serves as a close substitute for a direct related party loan because of the fungibility of money. For example, since one dollar is a perfect substitute for another, the use of guaranteed debt to finance a foreign-controlled U.S. corporation frees up other capital for other uses by the foreign parent. There is, thus, a close economic equivalence between (i) a loan from a bank to the U.S. subsidiary that is guaranteed by the foreign parent, and (ii) a loan from the bank to the foreign parent, followed by an on-lending by the parent to the U.S. subsidiary.

The Administration's Proposal

The earnings stripping rules would be amended to provided that the term "disqualified interest" includes any interest paid with respect to a loan from an unrelated lender that is subject to a disqualified guarantee and on which no gross basis tax is imposed. Subject to certain exceptions, a "disqualified guarantee" would mean any guarantee by a related foreign person or a related domestic tax-exempt entity. Except as provided in regulations, the term "guarantee" would mean any arrangement under which a person directly or indirectly assures, on an unconditional or contingent basis, the payment of another's obligation.

To the extent provided in regulations, the provision would not apply to guaranteed debt if the interest on the indebtedness would have been subject to net basis taxation had the interest been paid to the guarantor. The provision also would not apply if the debtor corporation owns a controlling (i.e., 80 percent) interest in the guarantor.

For purposes of the provision, interest would be considered subject to "gross basis" taxation if tax is imposed on the gross amount of interest income. Interest subject to withholding tax under section 871(a) or section 881(a) of the Code would satisfy this condition. Interest paid to a U.S. lender that is subject to net basis taxation under section 11 of the Code would not.

In addition, for taxable years commencing after December 31, 1993, the earnings stripping rules would apply to interest paid on any indebtedness issued on or before July 10, 1989 (or issued after such date pursuant to a binding written contract in effect on such date).

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