REDUCING THE TAX BURDEN

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

JUNE 16 AND 23, 1999

Serial 106–24

Printed for the use of the Committee on Ways and Means

REDUCING THE TAX BURDEN -:- 2000

REDUCING THE TAX BURDEN

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

JUNE 16 AND 23, 1999

Serial 106–24

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

60–332 CC WASHINGTON : 2000

COMMITTEE ON WAYS AND MEANS

BILL ARCHER, Texas, *Chairman*

PHILIP M. CRANE, Illinois
BILL THOMAS, California
E. CLAY SHAW, JR., Florida
NANCY L. JOHNSON, Connecticut
AMO HOUGHTON, New York
WALLY HERGER, California
JIM MCCRERY, Louisiana
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
JENNIFER DUNN, Washington
MAC COLLINS, Georgia
ROB PORTMAN, Ohio
PHILIP S. ENGLISH, Pennsylvania
WES WATKINS, Oklahoma
J.D. HAYWORTH, Arizona
JERRY WELLER, Illinois
KENNY HULSHOF, Missouri
SCOTT MCINNIS, Colorado
RON LEWIS, Kentucky
MARK FOLEY, Florida

CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ROBERT T. MATSUI, California
WILLIAM J. COYNE, Pennsylvania
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM MCDERMOTT, Washington
GERALD D. KLECZKA, Wisconsin
JOHN LEWIS, Georgia
RICHARD E. NEAL, Massachusetts
MICHAEL R. MCNULTY, New York
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee
XAVIER BECERRA, California
KAREN L. THURMAN, Florida
LLOYD DOGGETT, Texas

A.L. SINGLETON, *Chief of Staff*
JANICE MAYS, *Minority Chief Counsel*

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

CONTENTS

Page

ENHANCING RETIREMENT AND HEALTH SECURITY

JUNE 16, 1999

SUBMISSIONS FOR THE RECORD

PROVIDING TAX RELIEF TO STRENGTHEN THE FAMILY AND SUSTAIN A STRONG ECONOMY

JUNE 23, 1999

WITNESSES

SUBMISSIONS FOR THE RECORD

Page

ENHANCING RETIREMENT AND HEALTH SECURITY

WEDNESDAY, JUNE 16, 1999

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

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

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
June 2, 1999
No. FC–10

Archer Announces Hearing Series on Reducing the Tax Burden: I. Enhancing Retirement and Health Security

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing series on proposals to reduce the tax burden on individuals and businesses. It will begin with tax proposals to enhance retirement and health security, including strengthening retirement plans, improving availability and affordability of health care, and increasing personal savings by reducing the tax burden on savings. The hearing will begin on Wednesday, June 16, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. The hearing is expected to continue on additional days, which will be the subject of supplementary advisories.

Oral testimony at this hearing will be from both invited and public witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

The budget resolution adopted by the House of Representatives and the Senate on April 15, 1999 (H. Con. Res. 68), directs the Committee on Ways and Means to report a tax relief package by July 16, 1999. Although the budget resolution does not provide for any net tax relief in fiscal year 2000, the tax relief reconciliation bill is to include up to $142 billion in tax reduction during fiscal years 2000 through 2004 and $778 billion during fiscal years 2000 through 2009.

Along with Social Security, employer-sponsored retirement plans and personal savings are often viewed as the traditional "three legged stool" of retirement security. However, about 50 million Americans, or nearly 50 percent of the private sector workforce, are not covered by an employer-sponsored retirement plan—a rate that has remained stagnant over the last 25 years. Only about 20 percent of the 40 million Americans employed in businesses with 100 or fewer employees are participating in a retirement plan. Meanwhile, the personal savings rate has fallen to a record low of minus 0.7 percent, continuing a long-term trend. At the same time, health security is a continuing concern to Americans, with the number of people lacking health insurance growing to more than 43 million.

In announcing the hearing, Chairman Archer said: "We have already set aside the Social Security surplus, about $1.8 trillion, to save and strengthen Social Security and Medicare, and I am committed to working with the President and Democrats to find long-term solutions. At the same time, we have an obligation to American taxpayers to provide tax relief, because taxes are still too high. It is entirely appropriate that we begin this process by looking at ways to enhance Americans' retirement and health security."

FOCUS OF THE HEARING:

The focus of the first hearing day will be retirement and health security, including strengthening retirement plans, improving availability and affordability of health care, and increasing personal savings by reducing the tax burden on savings. Proposals to be reviewed include pension reforms, health care incentives, long-term care incentives, estate and gift tax relief, and savings incentives.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Pete Davila at (202) 225–1721 no later than the close of business, Wednesday June 9, 1999. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee on staff at (202) 225–1721.

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

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

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, of their prepared statement for review by Members prior to the hearing. Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than June 14, 1999. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, June 30, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments

by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

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

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

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. The Committee will come to order.

The Chair invites guests and staff to take seats so that the Members can listen to each other.

Good morning to everybody. The Committee today begins hearing a series on reducing the tax burden on American families, individuals, and businesses.

The Congressional Budget Office confirms that the tax burden on our society today is currently at a record peacetime high at 21 percent of GDP. President Clinton, on the other hand, claims the average American is paying lower taxes than at any time since 1976, which may be why he included over $170 billion in new tax hikes in his budget. But most Americans feel that they pay more taxes today than they have in the past and not less, which is why Republicans are committed to cutting taxes so people can keep more of what they earn.

Likewise, I know several of my Democratic friends have sponsored bills to cut taxes this year, and I look forward to working with anyone who has a plausible idea for tax relief for the American people.

Cutting taxes should not be a partisan issue, just as saving Social Security and Medicare need not and are not partisan issues. In that light, these hearings will explore areas where there is bipartisan interest in providing tax relief. Today's subjects, health and retirement security, including a look at pensions and the death tax, clearly qualify in that category.

Next week, we will focus on family tax relief, including reducing the marriage penalty and helping families and students pay for the high cost of education, two more areas that have attracted bipartisan support. We will also look at ways to boost savings and investments so that more Americans can enjoy and participate in our strong economy.

This morning, I am releasing two new studies by the American Council for Capital Formation that show how the current Tax Code discourages savings and punishes families with the confiscatory death tax.

On the death tax, the research shows that of 24 major industrial countries, only Japan's top tax rate of 70 percent, is higher than the 55-percent rate in the United States. Fifty-five percent is way too high, and some estates actually pay a marginal rate of 60 percent. No American, no matter their income, should be forced to pay the government up to 55 percent of their savings when they die, a tax that is triggered by one event, not an economic transaction, one event, the death of the person who has saved. And that is why we should significantly reduce, if not eliminate, the death tax; and I ask my Democratic colleagues to work with me to do that.

The second study is equally disturbing because it underscores the one problem that Federal Reserve Chairman Alan Greenspan and most economists agree is a major cloud on our economic horizon and that is our negative personal savings rate. Net private savings in this country today are at an all-time low for the entire history of our country. As we have learned through our Social Security debate, retirement is a three-legged stool of personal savings, pensions, and Social Security. We know that Social Security is facing serious problems. What makes that problem even more serious is the other legs of that stool, personal savings and pensions, are weak and are being weakened further by the Tax Code.

Today I ask that we look at ways to make retirement security more secure through lower taxes on savings, lower taxes on investments, and lower taxes on financial assets on which people depend. Taxes are too high, Americans are paying too much, and too often our Tax Code punishes Americans who are trying to do the right thing for themselves and their families. That is wrong, and we should commit ourselves to working together to fix that this year.

I truly believe that we can save and strengthen Social Security this year and Medicare and give Americans the tax relief they deserve, and I look forward to having the Committee work together to try to accomplish exactly that.

[The following was subsequently received:]

An International Comparison of Death Tax Rates

June 1999

ACCF Center for Policy Research Special Reports are published periodically to serve as a catalyst for debate on current economic policy issues. Contact the ACCF Center for Policy Research for permission to reprint the Center's Special Reports.

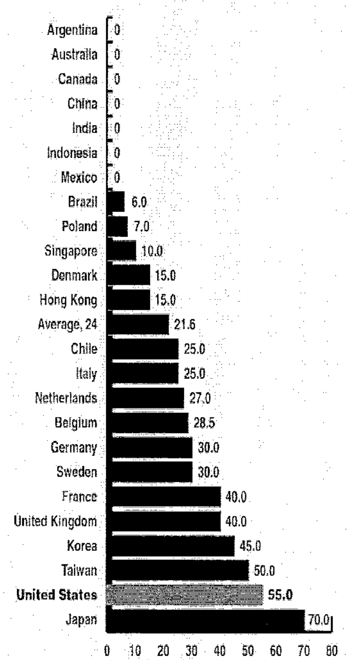
The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, trade, and environmental policies. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2302; telephone: 202/293-5811; fax: 202/785-8165; e-mail: info@accf.org; Web site: www.accf.org.

Introduction

Many countries tax estates (or inheritances) more lightly than does United States, according to a new survey of 24 industrialized and developing countries sponsored by the American Council for Capital Formation Center for Policy Research and compiled by Arthur Andersen LLP (see Figure 1).

The U.S federal tax code imposes a gift tax on lifetime transfers and an estate tax on transfers at death. The Tax Reform Act of 1976 included a unified system so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime. A unified credit effectively exempts a total of $650,000 in 1999 from the estate and gift tax; the Taxpayer Relief Act of 1997 increases the exemption gradually to $1 million by 2006. For estates and gifts over $650,000, the marginal tax rate ranges from 37 to 55 percent; in certain instances involving the generation-skipping transfer tax, the combined marginal tax rate on transfers by gift or at death can reach nearly 80 percent.

Figure 1	International Comparison of Top Marginal Death Tax Rates



International Survey Results

The top U.S. federal marginal "death tax" rate is higher than that of all other countries surveyed except for Japan (see Figure 1). Death tax rates imposed on estates inherited by spouses and children average only 21.6 percent for the 24 countries in the study compared to 55 percent in the United States (see comparison table, col. 2). (Tax rates are often higher on assets inherited by more distant relatives or by non-relatives.) Seven countries, including Argentina, Australia, Canada, China, India, Indonesia, and Mexico, have no death or inheritance taxes. The average tax rate in the 17 countries with a death tax is only 30.5 percent, which is slightly more than one-half of the U.S. top federal estate tax rate.

Not only are U.S. death tax rates higher than those in most of the industrialized and developing world, but the value of the estate where the top tax rate applies is lower. The average value of the estate where the top tax rate applies is over $4 million, compared to only $3 million in the United States (see comparison table, col. 3).

Conclusions

The survey, which shows that the U.S. death tax rate is higher than almost all of the 24 countries surveyed, lends support to the conclusions of many academic scholars and policy experts that the estate tax should be repealed or reduced because it adds to the already heavy U.S. tax burden on saving and investment and, by raising the costs of capital, impedes investment. In particular, the estate tax makes it harder for family businesses, including farms, to survive the deaths of their founders. Reform or repeal of the death tax could also help increase the low U.S. saving rate (see comparison table, col. 4).

DEATH TAX COMPARISON TABLE (*indicates note)

Country	(1) Death/Inheritance Tax	(2) Top Marginal Rate for Spouses or Children	(3) Value of Estate Triggering Top Marginal Rate	(4) Gross Domestic Saving as a Percent of GDP, 1997
Argentina	No*	--	--	18.0
Australia	No	--	--	21.0
Belgium	Yes	28.5*	$413,000*	22.0
Brazil	Yes	4% tax on real estate; 6% on other assets.	$237,000	19.0
Canada	No	--	--	21.0
Chile	Yes	25%	$764,000	25.0
China	No	--	--	43.0
Denmark	Yes	0 for surviving spouse; 15% on estates over $29,000.	$29,000	24.0
France	Yes	40%	$1,898,000	20.0
Germany	Yes	30%	$28,414,000	22.0
Hong Kong	Yes	15%	$1,355,000	N/A
India	No	--	--	20.0
Indonesia	No	--	--	31.0
Italy	Yes	25%	$1,727,000	22.0
Japan	Yes	70%	$15,268,000	30.0
Korea	Yes	45%	$3,570,000	34.0
Mexico	No	--	--	26.0
Netherlands	Yes	27%	$832,000	26.0

Poland	Yes	7%	$5,000	18.0
Singapore	Yes	10%	$7,176,000	51.0
Sweden	Yes	30%	$75,000	21.0
Taiwan	Yes	50%	$2,981,000	N/A
United Kingdom	Yes	0 for surviving spouse; 40% on estates over $383,000.	$383,000	15.0
United States	**Yes**	**0 for surviving spouse; 55% on estates over $3,000,000**	**$3,000,000**	**16.0**
Average	71% have a death tax	21.6% (all 24 countries)* 30.5% (17 countries w/ death tax)	$2,839,000 (all 24 countries) $4,007,000 (17 countries w/ death tax)	25.0 (average)

NOTES
General
Foreign currency conversions were made with 1998 weighted average exchange rate from the *Federal Reserve Bulletin,* March, 1999, published by the Federal Reserve Board of Governors.

Col. 1
Argentina imposes a court filing fee ranging from 2-3% based on fair market value; the fee is paid by the beneficiaries.

Col. 2
Belgium: average for Flemish and Walloon regions.

The calculated average uses the rate applied to children when the spouse tax rate is 0.

Col. 3
Belgium: average for Flemish and Walloon regions.

Col. 4
Source: World Bank, *World Development Indicators 1999* (Washington, D.C.: World Bank, 1999).

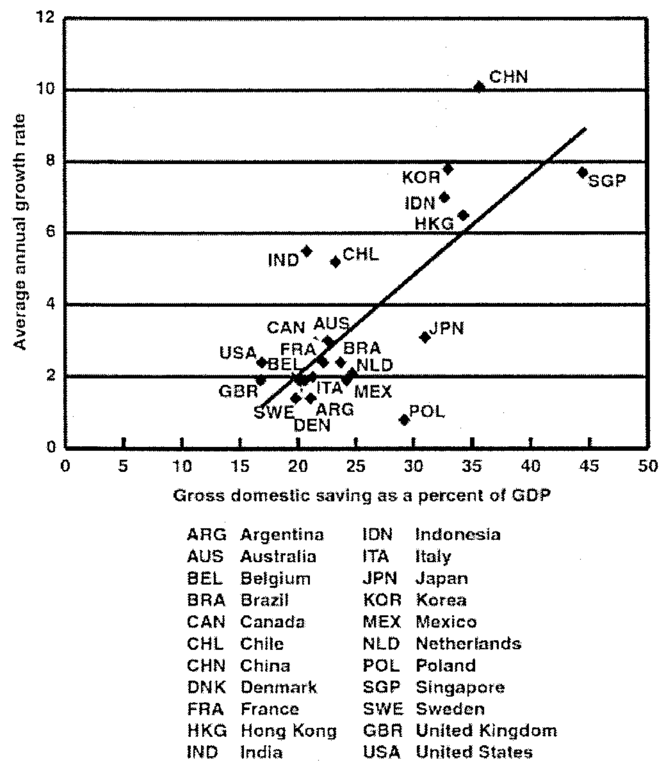
UPDATE: AN INTERNATIONAL COMPARISON OF INCENTIVES FOR RETIREMENT SAVING AND INSURANCE

ACCF Center for Policy Research Special Reports are published periodically to serve as a catalyst for debate on current economic policy issues. Contact the ACCF Center for Policy Research for permission to reprint the Center's Special Reports

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, trade, and environmental policies. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006–2302; telephone: 202/293–5811; fax: 202/785–8165; e-mail: info@accf.org; Web site: http://www.accf.org.

Experts predict that today's federal budget surpluses are likely to be a relatively short-lived phenomenon. The long-term prosperity of the United States remains threatened by the prospect of looming budget deficits arising from the need to fund the retirement of the baby boom generation in the next century. In addition, the U.S. saving rate continues to compare unfavorably with that of other nations, as well as with our own past experience; U.S. net domestic saving available for investment has averaged only 4.8 percent since 1991 compared to 9.3 percent over the 1960–1980 period. Though the U.S. economy is currently performing better than the economies of most other developed nations, in the long run low U.S. saving and investment rates will inevitably result in a growth rate short of this country's true potential. A country's saving rate is strongly correlated with its rate of economic growth, as shown in Figure 1.

Figure 1	**Correlation Between Saving Rates and Growth: An International Comparison (1980-1885)**



Note: For Singapore, the average saving rate uses data from 1980-1992; for the United Kingdom, 1980-1991; and for the United States, 1980-1993.

Source: World Bank, World Development Indicators CD-ROM, 1997.

The ACCF Center for Policy Research presents this special report in order to stimulate debate on tax policy reforms that could encourage additional private saving and social security restructuring as well as the purchase of various types of mutual fund and insurance products to assist baby boomers as they retire in the twenty-first century.

This report is an analysis of a recent Center-sponsored survey of the tax treatment of retirement savings, insurance products, social security, and mutual funds in twenty-four major industrial and developing countries, including most of the United States' major trading partners. The survey, compiled for the Center by Arthur Andersen LLP, shows that the United States lags behind its competitors in that it offers fewer and less generous tax-favored saving and insurance products than many other countries. For example:

• Life insurance premiums are deductible in 42 percent of the surveyed countries but not for U.S. taxpayers; for many individuals life insurance is a form of saving;

• Thirty-three percent of the sampled countries allow deductions for contributions to mutual funds while the United States does not;

• More than half of the countries allow a mutual fund investment pool to retain earnings without current tax, a provision which increases the funds' assets; the United States does not;

• Thirty percent of the countries with a social security system allow an individual to choose increased benefits by increasing their contributions during their working years; and

• Canada provides a generally available deduction of up to $9,500 (indexed) yearly for contributions to a private retirement account, compared to a maximum deductible Individual Retirement Account contribution of $2,000 for qualified taxpayers in the United States;

The Center's study demonstrates that many countries have gone further than the United States to encourage their citizens to save and provide for their own retirement and insurance needs.

*RETIREMENT SAVINGS (*INDICATES NOTE)*

Country	Gross domestic saving as a percent of GDP, 1997	Tax-favored retirement accounts?	Deductible contributions?	Annual limit on deduction?	Changes in portfolio composition taxable?
Argentina	18.0	No*	N/A	N/A	N/A
Australia	21.0	Yes	No*	No	No
Belgium	22.0	Yes	Yes	Yes,* not indexed	Generally yes; rate: 56.7%
Brazil	19.0	Yes	Yes	No	No
Canada	21.0	Yes	Yes	Yes, approximately US $9,439 indexed.	No
Chile	25.0	Yes	Yes	Yes, approximately US $20,200 indexed.	N/A
China	43.0	No	N/A	N/A	N/A
Denmark	24.0	Yes	Yes	Generally no*	Generally yes;* rate: 58%
France	20.0	No	N/A	N/A	No
Germany	22.0	Yes	Yes	Yes, approximately US $2,178 not indexed.	N/A
Hong Kong.	N/A	No	N/A	N/A	N/A
India	20.0	Yes	Yes	Yes, 20% of contribution, max. approx. US $306 indexed.	No
Indonesia	31.0	Yes	Yes	Yes*	Yes, rate: 30% or 20% treaty rate
Italy	22.0	Yes	Yes	Yes, 2% of wages, max. approx. US $306 indexed.	No
Japan	30.0	No	N/A	N/A	N/A
Korea	34.0	No	N/A	N/A	N/A
Mexico	26.0	Yes	Yes	Yes, approx. US $420 per year indexed.	No
Netherlands.	26.0	Yes	Yes	Yes,* indexed	Generally yes
Poland	18.0	No	N/A	N/A	N/A
Singapore	51.0	Yes	Yes	Yes, approximately US $8,559* not indexed.	No

*RETIREMENT SAVINGS (*INDICATES NOTE)—CONTINUED*

Country	Gross domestic saving as a percent of GDP, 1997	Tax-favored retirement accounts?	Deductible contributions?	Annual limit on deduction?	Changes in portfolio composition taxable?
Sweden	21.0	Yes	Yes	Yes, approximately US $2,300 indexed.	Generally no
Taiwan	N/A	No	N/A	N/A	N/A
United Kingdom.	15.0	Yes	Yes	Yes*	No
United States.	16.0	Yes	Yes	Yes*	No
Summary	25% (average)	67% of countries answered yes.	63% of countries answered yes.	54% of countries answered yes.	17% of countries answered yes

*INSURANCE (*INDICATES NOTE)*

Country	Deductible national health insurance premiums?		Deductible private long-term health insurance premiums?	Deductible private life insurance premiums?	Annual increase in life insurance surrender value taxable each year?	Deductible payments to mutual funds for retirement purposes?	Tax treatment of insurance annuity reserves:	
	For individuals?	For employers?					Investment income on reserves taxable?	Individual taxed on receipt of annuity payments?
Argentina.	Yes	Yes	Yes subject to limits.	Yes subject to limits.	No	No	Yes, rate: 33%.	Yes, rate: 33%
Australia.	No	N/A	No*	No	No	No	Yes, rate: 36%.	Yes, rate: 33.5%
Belgium	Yes	Yes	Yes	Yes*	No	Yes*	Yes, rate: 40.2%.	Yes, rate: 56.7%
Brazil	Yes	Yes	No	No	No	Yes*	Yes, rate: 43%.	Yes, rate: 27.5%
Canada	No	Yes	No	No	Yes	No	Yes, rate: 29.1%.	Yes, rate: 31.3%
Chile	Yes	Yes	No	No	No	Yes*	Yes, rate: 15%.	No
China	No	Yes	No	No	No	N/A	Yes, rate: 33%.	No
Denmark.	N/A	N/A	No	No	No	No	Yes, rate: 34%.	No
France	Yes	Yes	No	No	No	Yes, if retirement plan is compulsory.	Yes, rate: 41.7%.	Yes, rate: 58.1%

*INSURANCE (*INDICATES NOTE)—CONTINUED*

Country	Deductible national health insurance premiums?		Deductible private long-term health insurance premiums?	Deductible private life insurance premiums?	Annual increase in life insurance surrender value taxable each year?	Deductible payments to mutual funds for retirement purposes?	Tax treatment of insurance annuity reserves:	
	For individuals?	For employers?					Investment income on reserves taxable?	Individual taxed on receipt of annuity payments?
Germany.	Yes, subject to limits.	Yes	Yes, subject to limits.	Yes, subject to limits.	No	Yes, under certain conditions.	Yes, rate: 45%.	Generally yes,* rate: 55.9%
Hong Kong.	N/A	N/A	No	No	No	No	Yes, rate: 16%.	No
India	N/A	N/A	Yes, up to approximately US $255 per year.	Yes*	No	No	Yes, rate: 30%.	
Indonesia.	No	No	No	No	Yes	No	Yes, rate: 30%.	No
Italy	Yes	Yes	No	Yes*	No	Yes*	Yes, rate: 37%.	Yes, rate: 46%
Japan	Yes	Yes	Yes, up to approximately US $383 per year.	Yes, up to approximately US $383 per year.	N/A	No	No	Yes, rate: 50%
Korea	Yes	Yes	No	Yes	No	No	N/A	N/A
Mexico	No	Yes	No	No	No	No	N/A	N/A
Netherlands.	Yes subject to. limits*	Yes	Yes subject to. limits*	Yes subject to. limits	No	Yes, depending on fund type*.	N/A	N/A
Poland	N/A	Yes	No	No	No	No	Yes, rate: 36%.	Yes, rate: 40%
Singapore.	Yes*	Yes	No	Yes subject to limits.	No	Yes subject to limits.	Yes, rate: 26%.	Yes, rate: 28%
Sweden	Yes	Yes	No	No	No	No	Yes, rate: 28%.	Yes, rate: 57%
Taiwan	Yes	Yes	Yes*	Yes	No	No	Yes, rate: 25%.	Yes, rate: 40%
United Kingdom.	No	Yes	No	No	No	No	Generally no.	Generally yes
United States.	N/A	N/A	Yes subject to limits.	No	No	No	Yes*	Yes, rate: 39.6%

*INSURANCE (*INDICATES NOTE)—CONTINUED*

Country	Deductible national health insurance premiums?		Deductible private long-term health insurance premiums?	Deductible private life insurance premiums?	Annual increase in life insurance surrender value taxable each year?	Deductible payments to mutual funds for retirement purposes?	Tax treatment of insurance annuity reserves:	
	For individuals?	For employers?					Investment income on reserves taxable?	Individual taxed on receipt of annuity payments?
Overall number of countries answering "yes".	54% of countries answered yes.	75% of countries answered yes.	33% of countries answered yes.	42% of countries answered yes.	8% of countries answered yes.	33% of countries answered yes.	75% of countries answered yes.	67% of countries answered yes

*SOCIAL SECURITY TAXES (*INDICATES NOTE)*

Country	Possibility for individual to choose increased benefits by increasing contributions?
Argentina	Yes
Australia	No social security taxes
Belgium	No
Brazil	No
Canada	No
Chile	Yes
China	No
Denmark	No
France	No
Germany	Yes under certain conditions
Hong Kong	No social security taxes
India	No social security taxes
Indonesia	Yes
Italy	Yes
Japan	No
Korea	No
Mexico	Yes
Netherlands	No
Poland	No
Singapore	No social security taxes
Sweden	No
Taiwan	No
United Kingdom	No
United States	No
Overall number of countries answering "yes"	30% of countries answered yes

*MUTUAL FUNDS (*INDICATES NOTE)*

Country	Can an investment pool retain earnings without current tax?		Preferential capital gains treatment for disposition of interest in investment pool?
	Ordinary gain	Capital gain	
Argentina	Yes if qualifying fund	Yes if qualifying fund	No
Australia	Yes	Yes	Yes
Belgium	Yes	Yes	Yes
Brazil	Yes	Yes	No
Canada	No	No	Yes
Chile	Yes for individuals	Yes	No
China	N/A	N/A	N/A
Denmark	No	No	No
France	No	No	Yes

*MUTUAL FUNDS (*INDICATES NOTE)—CONTINUED*

Country	Can an investment pool retain earnings without current tax?		Preferential capital gains treatment for disposition of interest in investment pool?
	Ordinary gain	Capital gain	
Germany	No	Generally no	No
Hong Kong	Yes	Yes	N/A
India	Yes	Yes	Yes
Indonesia	No	Yes	No
Italy	Yes	Yes	Yes, rate: 12.5%
Japan	No	No	Yes
Korea	N/A	N/A	N/A
Mexico	Yes	Yes	No
Netherlands	Yes depending on type of fund*.	Yes depending on type of fund*.	Generally Yes
Poland	Yes	Yes	Yes
Singapore	Generally Yes	Generally Yes	Yes
Sweden	N/A	N/A	N/A
Taiwan	Yes	Yes	Yes
United Kingdom	No	Yes	Yes if qualifying fund ("PEP")
United States	No	No	Yes
Overall number of countries answering "Yes".	54% of countries answered Yes.	63% of countries answered yes.	54% of countries answered yes

**NOTES ON RETIREMENT SAVINGS*

Argentina	Col. 1: Contributions to certain approved private pension funds may be deductible.
Australia	Col. 2: Superannuation accounts must be contributed to by an individual's employer, currently at a minimum rate of 6 percent of salary. Amounts contributed on behalf of an employee are not taxable to the employee.
Belgium	Col. 3: Limits vary depending on the type of fund to which contributions are made.
Denmark	Col. 3: The maximum deductible annual contribution to a capital pension scheme is DKr 33,100 (US $4,833). Contributions to other pensions can be deducted without limit. Col. 4: A payout from a capital pension (which is a lump sum payment) is subject to tax at 40 percent.
Indonesia	Col. 3: The deductible annual contribution is limited to 5.7 percent of regular income for the government-sponsored program (i.e., Jamsostek) or 20 percent for a Ministry of Finance-approved private pension program.
Netherlands	Col. 3: The deductible amount depends upon the amount of salary, the duration of employment, and the type of pension plan.
Singapore	Col. 3: The annual deduction limit of S$14,400 (US $8,559) applies to contributions on ordinary wages. Contributions on additional wages not accruing on a monthly basis (e.g., bonuses, incentive payments) are subject to separate capping rules.
U. Kingdom	Col. 3: The limit on deductibility of the contribution varies depending upon the type of plan and age of the individual. The minimum limit is 15 percent of earnings up to maximum earnings of uu87,500 (US $144,445). The limit is indexed for inflation at the discretion of the government.
United States	Col. 3: The limitation on deductibility of the contribution varies depending upon the type of plan (e.g., for contributions to an individual retirement account the annual limit is US $2,000), the individual's amount of earned income, the individual's overall income level, and the individual's age.

**NOTES ON INSURANCE*

Australia	Col. 2: For families with taxable income less than A$70,000, a tax rebate of up to A$450 is allowed to encourage participation in private health insurance.
Belgium	Cols. 3,5: Belgium provides a tax credit (computed by reference to various items) when premiums are paid on life insurance or contributions are made to a collective pension savings account.
Brazil	Col. 5: Payments to domestic pension funds are deductible.
Chile	Col. 5: Only payments to the mandatory retirement system are deductible.
France	Col. 6: The taxable portion of an annuity payment decreases based on the age of the recipient.
Germany	Col. 6: Payments received by an individual would not be taxable if the prerequisites for a tax-exempt life insurance policy are fulfilled.
India	Col. 3: The individual is entitled to a tax rebate of up to 20 percent of life insurance premium paid, subject to the overall limit of Rs 12,000 (US $306) along with other items (e.g., contribution to a retirement fund).
Italy	Col. 3: Up to a maximum of Lit. 2,500,000 (US $1,414), life insurance premiums paid can give rise to a nonrefundable tax credit of 19 percent of the premium paid.
	Col. 5: For employees, same limits as for life insurance premiums. For professionals, the maximum deductible contribution to a retirement fund is 6 percent of income, not exceeding Lit. 5,000,000 (US $2,828).
Netherlands	Cols. 1,2: An individual can deduct public or private health insurance premiums only as an extraordinary expense and only above a certain percentage of the individual's income.
	Col. 5: See "Mutual Funds" notes section for comments on mutual funds in the Netherlands.
Singapore	Col. 1: Singapore does not have national health insurance per se, but does have insurance plans established under the approved pension scheme (Central Provident Fund) instituted by the government.
Taiwan	Col. 2: The deductible insurance premium is NT$24,000 (US $735) per person if the individual itemizes.
United States	Col. 6: Income earned on reserves is taxable, however, a deduction is permitted to the extent the earnings are credited to the account of the annuity contract.

**NOTES ON MUTUAL FUNDS*

Netherlands	Col. 1: The tax treatment of mutual funds in the Netherlands varies significantly depending on the type of fund. One of the most important issues is the question of whether the fund is a legal entity or only a cooperation of a group of individuals. In the latter case the fund will be considered transparent, in other words, for tax purposes no fund exists and each individual will be considered participating in person for his share in the fund capital. In that case capital gains are nontaxable; ordinary income is taxable at progressive rates.
	If the fund is a legal entity, a distinction must be made between foreign funds and Dutch funds. Foreign funds are subject to a special Dutch tax treatment (taxability of a fictitious income); the taxability of Dutch funds depends upon whether the fund is a special qualifying fund. For a qualifying fund, capital gains are tax free; ordinary income is subject to tax at progressive rates.

And now I am pleased to recognize my colleague, Charlie Rangel, for a statement on behalf of the Minority. And, without objection, each Member may insert written statements in the record at this point.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

I support the direction in which you are going and taking the Committee on behalf of the Congress, and I assume your criticism of the President was just by habit, rather than by intent, since you are pushing so desperately hard to create a bipartisan atmosphere, and that can't be done by just knocking the President in terms of advocating tax increases. I think it is very important and certainly politically expedient to concentrate on tax cuts, and it is going to be hard for you to get rid of me in terms of supporting tax cuts.

Next year, I think we will be supporting even more dramatic tax cuts. This is especially so if the Majority is convinced that the President is going to veto anything that is done in an irresponsible way.

Having said that, I think we all had agreed, however, that before we move in the direction of reducing revenue that we would dedicate ourselves to the resolution of the problems that we face with Social Security and Medicare. I know we have language that says this money has been put in a lockbox, but I think it is abundantly clear that the Majority party has the key to the lockbox to use for whatever funds they have the votes to use it for.

So I think we would all feel much more comfortable if we made more progress in a bipartisan way, of course, in resolving Social Security and Medicare before we entertain reducing taxes. This is especially so since a large part of your private sector investment under the Archer-Shaw plan requires general revenues—and bills we are discussing now, of course, would reduce general revenues.

But whatever we do look at, I do hope that the Social Security system and the USA account proposal will be included in our studies. We should also take into consideration the number of individuals who have no health insurance at all. I hope we will be able to take a look at the President's proposal for tax-exempt bonds so that we will be able to rebuild our schools and create an atmosphere where kids can get a decent education in the public school level.

In any event, I look forward to the meetings that we are going to have in executive session; and I hope, as you have invited the private sector to participate, I am confident that you also will invite the administration to participate. These are going to be some very sensitive days and weeks and months as we both try hard to create a bipartisan atmosphere.

I agree with you. I know it is doable, that we could come up with a bipartisan solution to the Social Security problem that our Nation faces. I know that you and the President of the United States, both of whom will not be here for the new Congress, would want a part of your legacy that this was done, and I would hope that this Congress would be a part of that history.

I just want the record to be made abundantly clear that before this Committee moves forward in any public way, that we expect that we will have the support of the leadership on both sides of the aisle in the House; and even though it is difficult to get any commitment from the House, it would seem to me that at least communication should be made with them as we move forward.

In order to be successful, Chairman Archer, I think we all have to be reading from the same page and attempting to move forward together in a bipartisan way to resolve a problem that Democrats don't have and Republicans don't have but our Nation and the kids and the people that will be depending on the system will have. I want you to know that you can depend on my support in that area, and I thank you for giving me this opportunity to express the views of the Minority.

[The opening statements follow:]

Statement of Hon. Charles B. Rangel a Representative in Congress from the State of New York

I think it's very important, and certainly politically expedient, to concentrate on tax cuts. And, it's going to be hard for you to get rid of me when it comes to supporting tax cuts. Next year, I think we'll be supporting even more dramatic tax cuts. This is especially so if the Majority understands that the President is going to veto anything that's done in an irresponsible way.

Having said that, I thought we all agreed that before we move in the direction of reducing revenue, we would dedicate ourselves to the resolution of the problems we face with Social Security and Medicare. I know we have language that says this money has been put in a "lockbox," but I think it's abundantly clear that the Majority Party has the key to the lockbox and can use the money for what ever purpose they have the votes to use it for.

I think we all would feel much more comfortable if we made major progress, in a bipartisan way of course, in resolving Social Security and Medicare before we entertain using any of the surpluses to reduce taxes. This is especially so since a large part of the private sector investment provision under the Archer-Shaw plan requires general revenue financing, and the tax bills we are discussing now involve the reduction of general revenues.

I hope that the effect on saving the Social Security system and the President's USA Accounts proposal will be considered. I hope we will take into consideration the number of individuals who have no health insurance at all. I also hope we will be able to take a look at the President's proposal for tax credits for school modernization bonds, which I sponsored, so that we can re-build our schools and create an atmosphere where our kids can get a decent education in the public schools.

In any event, I look forward to the bipartisan private meetings that we are going to have. Since you (Chairman Archer) have invited the private sector to participate, I'm confident that you will also invite the administration to participate. These are going to be some very sensitive days and weeks and months ahead as we both try hard to create a bipartisan atmosphere. I agree with you, Mr. Chairman—I know it's doable for us to come up with a bipartisan solution to the Social Security problem that our nation faces. I know that you and the President of the United States, both of whom will not be here for the new Congress, would want this accomplishment to be part of your legacy. And I would hope that this Congress would be a part of that history.

I just want to make it abundantly clear that, before this Committee moves forward in any public way, we expect that we will have the support of the leadership on both sides of the aisle in the House. And, even though it is difficult to get any commitment from the other House, it would seem to me that at least communication should be made with the senators as we move forward. If we are to be successful, Chairman Archer, I think we all have to be reading from the same page and attempting to move forward together in a bipartisan way to resolve a problem, that Democrats don't have, and that Republicans don't have, but that our nation and future generations have.

Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for calling this hearing to learn more about how we can reduce the tax burden facing Americans—which is at the highest level in history!

As we learned yesterday in our Health Subcommittee, the tax burden for healthcare services disproportionately hits those most in need to tax relief to help them afford health coverage. While low-income Americans have access to government sponsored healthcare and those with higher incomes tend to have healthcare coverage through their employers, hard working, lower-income and middle-income Americans, especially the self-employed and those working for small businesses, have limited access to seemingly unaffordable coverage.

A more equitable tax code which provided tax relief for individuals who purchase healthcare coverage would not only help address the number of uninsured Americans, it would also address the issues of portability and greater consumer choice in the marketplace. Stimulating competition within the health care industry is greatly needed to improve the entire health care delivery system.

As I mentioned yesterday, I am proud of this Committee's attention to this issue through the passage of Medical Savings Accounts (MSAs). I strongly support the Chairman's bill to remove the unnecessary restrictions surrounding these truly patient-oriented plans soon for many of their colleagues who still remain priced out of the health insurance market.

In outlining my tax priorities for this year, in addition to health care tax relief, I also listed my strong support for comprehensive pension reform legislation introduced by Reps. Portman and Cardin. Tax relief to help Americans save for their retirement is critical and necessary to improve our nation's abysmal savings rate.

I look forward to learning more from our witnesses about the factors that contribute to the number of uninsured in America today, as well as ways to significantly reduce those numbers.

Statement of Hon. Richard E. Neal, a Representative in Congress from the State of Massachusetts

Mr. Chairman, as the sponsor of H.R. 1213, the Employee Pension Portability and Accountability Act of 1999, I want to commend the Administration for its proposals to improve the chances for every American to have a secure retirement of which an adequate level of retirement income is a crucial factor. The proposals are aimed at making it easier for employers to offer pension plans, and for employees to retain their pension benefits when switching jobs. Proposals to encourage small businesses to establish pension plans, and to encourage more individuals to utilize retirement accounts are included, as well as numerous simplification initiatives.

As we all know, it is assumed that every worker will have retirement income from three different sources—social security, private pensions, and personal savings. This so-called three-legged stool does not exist for many workers, either because they work for employers who do not offer a pension plan, or the benefits offered are inadequate, or because some employees earn too little to save for their retirement on their own. While the 106th Congress is expected to address the problems of the social security system, it is imperative that this Congress expand and improve the private pension system as well.

Many workers, like federal workers in FERS, are eligible to save for their retirement through social security, a defined benefit plan, a defined contribution plan, and hopefully through personal savings. In general, employers in the private sector, however, have moved away from offering defined benefit plans, much to the detriment of overall retirement savings. Since 1985, the number of defined benefit plans has fallen from 114,000 to 45,000 last year. The number of defined contribution plans, conversely, has tripled over the last twenty years. While defined contribution plans have the advantage of being highly portable, and are an important source of savings, it is also important to remember that defined contribution plans were intended to supplement, rather than be a primary source of, retirement income.

In addition, we cannot ignore the fact that women and minorities face special challenges in obtaining adequate retirement savings. For women, this is directly related to employment patterns. Women are more likely to move in and out of the workforce to take care of children or parents, work in sectors of the economy that have low pension coverage rates, and earn only 72 percent of what men earn. Fifty-two percent of working women do not have pension coverage, and 75 percent of women who work part-time lack coverage. For minorities, lack of pension coverage and a lower pension benefit level is often related to low wages. While 52 percent of white retirees receive an employment-based pension at age 55, only 32 percent of Hispanic Americans and 40 percent of African Americans receive such pensions.

While these problems cannot be solved overnight, it is necessary for us to make improvements in the pension system whenever there is an opportunity. Some argue that the best way to help low and moderate income workers is to provide an incentive for the highest income to have more of a personal investment in the pension plan they control. Others would argue, perhaps somewhat unfairly, that this is simply a new version of trickle down economics. It certainly raises the question as to why some proponents of changes in pension law rest so much of their case on their assertion that the Chief Executive Officers of America's corporations are so indifferent to the future of their loyal employees and their families that they need an extra $50,000 of pension income themselves in order to consider better benefits for everyone else.

Speaking for myself, I would give it to them if I thought those low and moderate income Americans who have little or no employer pension benefits because they barely survive from paycheck to paycheck, would also benefit. That case has not been made. I would be more comfortable if proposals were being brought to me by the pension community that would require an increase in benefits for the low and moderate income worker in conjunction with increasing benefits for the highest paid, but that has not occurred.

There are, however, many proposals in the major pension bills that can be supported by all parties, especially but not solely in the area of portability. I look forward to working with you, Mr. Chairman, and with the other members of the Committee on these proposals.

Chairman ARCHER. Our first panel today is represented by our colleagues—six of our colleagues, and we are pleased to have your input to start off this hearing on enhancing retirement and health security.

Mrs. Johnson, would you lead off?

STATEMENT OF HON. NANCY L. JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CONNECTICUT

Mrs. JOHNSON of Connecticut. Thank you very much, Mr. Chairman. I appreciate your holding this hearing on enhancing retirement security and health security for all Americans.

First of all, I think this Committee is uniquely positioned to offer the American people a package of reforms that will radically enhance retirement security, Social Security reform, Medicare reform, and pension reform so that more than 50 percent of our people can have access to pensions, and long-term care insurance reform which would radically change retirement for Americans in the future. I hope we will get to that four-part agenda.

In starting, I want to talk about health security for all of us. Every year, or at least in 1998, the Federal Government contributed $111 billion toward tax benefits for people to purchase health insurance. Most of that went to the employers who purchased health insurance for their employees.

The employee-provided health insurance system has a unique strength. It allows the pooling of insurance costs to lower the cost of insurance for the sicker and older individuals in our society. In other words, the value of employer-based health insurance is much greater than the wage that the single employee could receive in the absence of the benefit. It also means that the current tax subsidy is more meaningful and worthwhile for those who are in poor health or older.

So the employer system is working extremely well for those covered by it, which is about two-thirds of Americans who are under 65, but we must do more to make sure that all Americans have access to affordable health insurance. Employers find that covered employees use fewer sick days, worker morale is higher, and worker loyalty is higher.

It is good business to provide good health benefits to your employees. So why doesn't everybody? Well, of course, because it is expensive. That is why. And only 28 percent of employers with less than 25 workers offer health insurance because it is not only expensive in premiums but the overhead is high.

A recent survey by Hay Huggins showed that small firms with fewer than 10 employees carry 35 percent administrative costs for health insurance plans, really completely unaffordable.

There is one thing we can do that we must do now, I hope we will do this year, and that is to make the Tax Code fair, to treat those who don't get insurance through their employers with equity, to allow them the same tax benefit that people who receive their health insurance through their employers receive today.

My bill is unique in the history of bills that I have proposed in this area and I think in terms of bills on the table because it tries to match the benefit that the individual uninsured person who is buying his own health insurance on the open market gets with the benefit an employee gets in an employer-provided plan. So it is far richer.

It just doesn't look at the tax consequences of wage replacement, which is only a very small part of the benefit. It looks at the real benefit that a person working for an employer who provides health insurance gets and that is health coverage at an affordable deductible. So it is very much richer.

It seeks to provide 60 percent of the cost of health insurance, up to $1,200 for the individual and $2,400 for couples and families. It would be available for people who purchase COBRA as well. It is focused on a credit for the lower earners and a deduction for higher earners.

It is essential to structure any health benefit in that way, any tax incentive in that way, because so many without health insurance are in the 15-percent bracket where a deduction is essentially a very small incentive to purchase. A credit really does give them the money to purchase.

And in my bill we are still working on how to allow them to take that credit on a monthly basis so there will be the real power to purchase, doing it through income withholding to lower the amount of taxes that they pay during the year.

My bill would create a check off line on the W–2 form to remind people that the option is available, and the benefit this option would offer them through withholding over the year would allow a great majority of those who are uninsured to buy insurance.

Until we provide tax equity for the uninsured, we cannot reduce the pool of the uninsured in a way that will allow us to get at the ultimate problem which is some amount of subsidy.

My time has expired so I will just allude briefly to the long-term care provisions in my bill.

We are looking at the cost of Social Security. We are looking at the cost of Medicare. We are not looking at the costs of long-term care which are going to literally explode when the baby-boom generation retires. Already HCFA, the Health Care Financing Administration, is spending $40 billion on long-term care and expects to spend $148 billion by the year 2007, which is before the baby boomers start reaching the age when they will use long-term care. So I commend the bill that Karen Thurman and I have introduced on long-term care to your attention.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Hon. Nancy L. Johnson, a Representative in Congress from the State of Connecticut

Thank you for calling this hearing today, Mr. Chairman, and giving me the opportunity to testify on two issues that I care deeply about: health and retirement security. While our tax code provides significant benefits in these areas. We must improve these benefits if we are to reduce the number of uninsured Americans and meet the challenges that we face as the number of elderly Americans doubles.

In 1998, the federal government contributed an estimated $111 billion toward tax benefits aimed at the purchase of health insurance. The vast majority of these tax breaks went to those who held employer-sponsored health insurance. Only $4.3 billion was in the form of tax deductions taken by individuals for out-of-pocket health spending. That leaves $106.7 billion devoted to workers who received health insurance through their employers—$70.9 billion through the federal income tax and $28.2 billion and $7.8 billion in Social Security and Medicare taxes, respectively. This employer-based tax break equals approximately $1000 for the average family with coverage.

This favorable tax treatment of employer-based health insurance has resulted in the coverage of nearly two-thirds of adults under the age of 65. Through group purchasing, it spreads the risk of insuring people with varying health needs, making insurance costs lower for those who are sicker or older. This makes the value of employer-based health insurance much greater than the wages that any single employee could receive in the absence of the benefit. It also means that the current tax subsidy is more meaningful and worthwhile for those with poor health.

Health benefits are consistently ranked as the most important employee benefit among workers. In a competitive labor market, the promise of health benefits not only makes workers more likely to take a job but also more likely to stay at a job. In addition, employers offering benefits have found that their workers are more productive, through decreased number of sick days, improved worker morale, and increased loyalty.

One of the major faults of the employment-based health insurance system is that many small employers cannot afford to offer health insurance to their workers. Only 28% of employers with less than 25 workers offer health insurance, compared with over 66% of employers with 500 or more employees. The largest reason for small employers not offering health insurance is the higher costs they face. Their small size means they cannot spread the risk associated with a few unhealthy employees. They also face higher administrative costs. A 1998 Hay Huggins coverage survey found that overhead costs for firms with few than 10 employees exceeded 35%, compared with about 12% for firms over 500.

If we are going to address the problem of uninsured Americans, we must help more small employers afford to offer health insurance coverage. People working for small businesses account for 16% of the under–65 population, but 28% of the uninsured. And small businesses provide one of the fastest growing employment opportunities.

The challenge in our voluntary health insurance system is to provide equal benefits for people who do not have access to employer-sponsored coverage. It is important to preserve the current employer-based system because many people prefer getting coverage through their job and employer coverage has been very successful in covering two-thirds of the workforce. As the nature of employment changes, moving to small businesses and temporary and contract work, it is necessary that we also allow an individually based tax benefit for those who are not offered employer-based coverage.

This is not only a matter of equity in the tax code but also a means of addressing the problem of uninsured Americans by making health insurance more affordable. Increasing tax benefits to individuals would by no means solve the uninsured problem, but it would help those who can afford to purchase health insurance on their own. If we can isolate this category of the uninsured, we will have a better idea of how to approach the remaining uninsured, those who need significant assistance purchasing health insurance or who lack access to health insurance because of their health status. There are many reasons that people do not purchase health insurance, so we need a multi-faceted approach to solve the problem.

I am advocating a combination of tax credits and deductions for people who purchase their own health insurance. According to a Congressional Research analysis of the March 1997 Current Population Survey, 52% of the uninsured fall in the 15% tax bracket. For the majority of the uninsured, a deduction would provide only a 15% discount on the cost of their health insurance. A credit, on the other hand, would provide the same benefit to all taxpayers. And studies have shown that a significant credit is required to encourage people to begin purchasing health insurance.

Kenneth Thorpe demonstrated in a 1999 study that a tax credit of $400 would encourage 18% of single uninsured workers with incomes at 150% of the federal poverty level to participate in a health plan. A credit worth double that amount ($800) would raise the participation rate among this group to 22%.

My tax credit proposal, found in H.R. 2020, would offer taxpayers a credit worth 60% of the cost of their health insurance, up to $1200 for individuals and $2400 for couples and families. It would be dedicated to those people who do not have access to an employer-sponsored health plan and have incomes below $40,000 for individuals and $70,000 for couples and families.

My credit would be available for people who purchase individual or COBRA health insurance coverage. Therefore, it would have the benefit of increasing the number of people who purchase COBRA coverage and lower the costs to businesses of providing this coverage. COBRA coverage is costly to businesses because the people who tend to buy it are sicker people who most need the coverage. Making it more affordable, as my tax credit would, has the potential to add more healthy people to the pool of people purchasing COBRA.

Making individual health insurance more affordable would also help stimulate the individual health insurance market. Currently, only 7–9% of individuals purchase coverage on the individual market. My tax credit would create more demand for individual insurance and help stimulate the market to come up with new products. In addition, we may want to consider other health insurance reforms to create broader pooling for individual health policies to make them more affordable and accessible for people with health care needs.

Finally, we should develop a tax credit system that makes the credits available to people during the year, rather than at the end of the tax year. Making the money accessible at the time of purchase would help ensure that people can afford the coverage. The option that I am examining would allow people to increase their income tax withholding to lower the amount of taxes that they pay during the year. It would create a check-off line on the W–2 form to remind people that the option is available. The benefit of this option is that people can change their withholding form at any time during the year, so they could change the withhold when their insured status changes.

My legislation also would create a tax deduction for individuals who pay at least 50% of the cost of their health insurance. The deduction would be available for individuals whose income is too high to qualify for the health credit or who are purchasing group coverage and paying at least 50% of the cost. The deduction would enable small employers to offer health insurance and take advantage of lower costs through pooling, even if they could not contribute a significant portion of the cost, knowing that their employees could take a deduction for the portion of the cost that they contribute.

The potential benefit for credits and deductions decreasing the number of uninsured is significant. The General Accounting Office evaluated a proposal to provide a 30% tax credit and found that nearly 40 million non-elderly individuals would have been eligible in 1996. The GAO study shows that this approach would provide significant assistance to the uninsured—31.9 million of the eligible individuals were uninsured and would have received a tax credit. The Congressional Research Service roughly estimated in a 1997 memo that “allowing taxpayers to deduct the full cost of health insurance would increase coverage by about 9% for those with a 15% marginal tax rate (about 1.4 million adults) and 17% for those with a 28% marginal tax rate (about 345,000 adults).” According to CRS, a 100% deduction would reduce the number of uninsured by 1.75 million. Combining a deduction with a credit would, therefore, reach a significant number of the uninsured.

I also want to talk about the issue of long-term care and the legislation that I have introduced. Long-term care promises to be the most significant health issue of the next century as the Baby Boom generation begins to retire and the number of our elderly doubles. Medicare and Social Security are two of the three government sponsored-programs that are critical to the elderly. The other federal program significantly impacted by the increasing number of elderly is the Medicaid program through its coverage of nursing home care.

In 1997, Medicaid paid nearly 50% of nursing home care—at a cost of $40 billion. Nursing home care averages $50,000 per year or $136 per day. The Health Care Financing Administration estimates nursing home costs will be $148.3 billion by 2007. If Medicaid continues to pay for a significant amount of long-term care, this will nearly double Medicaid nursing home costs over the next seven years. And this is before the full impact of the Baby Boom retirement. Today’s 77 million baby boomers start turning 85 in 2030. If past trends continue, 20% of those over age 85 will need nursing home care.

How do we deal with these staggering costs? We need to encourage people to prepare for the largest threat to their retirement security. If we encourage more people to plan ahead, we can ensure that we target precious Medicaid dollars to those who are truly in need. We began this process in 1996 by passing provisions to give greater tax benefits to long-term care insurance. But many individuals cannot take advantage of these provisions because they do not have health expenses that exceed 7.5% of their adjusted gross income.

Congresswoman Karen Thurman and I have introduced the Long-Term Care and Retirement Security Act of 1999, H.R. 2102, to create individual tax incentives for people to meet their long-term care needs. Our legislation would create an above-the-line tax deduction for people who purchase qualified long-term care insurance policies, as defined by the Health Insurance Portability and Accountability Act of 1996. In effect, people would be able to deduct the cost of their long-term care insurance policy from their taxable income, eliminating the need to meet the 7.5% floor and the requirement to itemize.

H.R. 2102 would also create a $1000 tax credit for caregiving and long-term care services. Family caregivers provide a tremendous amount of long-term care services. Their role goes far beyond comforting a family member struggling with a chronic illness. National studies have demonstrated that caregivers provide services estimated to value over $190 billion annually. Without the assistance of caregivers, more people would require institutional care and the public cost of long-term care services would increase significantly.

The other critical problem in the area of long-term care is that people are not aware of the need to plan ahead. Seventy-nine percent of older baby boomers surveyed believe that long-term care is the greatest risk to their standard of living. Despite this concern, people are misinformed about the necessity of planning ahead. Several national surveys have shown that the majority of people believe that Medicare covers long-term care, but it does not. And people are unaware that Medicaid qualification requires that they become impoverished.

H.R. 2102 would address this dire lack of information by creating an educational campaign within the Social Security Administration targeted toward individuals and employers. The legislation would instruct the Social Security Administration to provide information to people over 50 as part of their existing annual mailing of earnings statements. It would make individuals aware of the shortcomings of Medicare and the requirement that a person impoverish themself to qualify for Medicaid. In addition, it would illustrate the tax benefits associated with purchasing long-term care insurance.

Finally, H.R. 2102 would remove the restrictions placed on states in 1993 and encourage more of them to create long-term care partnership programs. My legislation would allow people who purchase partnership plans to pass along to their children in their estates assets equal to 75% of the value of their partnership plan. State long-term care partnership programs are important because they make long-term care insurance affordable for low and middle-income people. By encouraging more people to purchase partnership plans, we ensure that people will have some private coverage of their long-term care expenses before qualifying for Medicaid. Connecticut was the first state to form an long-term care partnership, and our experience has been that one-third of the people who purchase the policies say that they would have disposed of their assets to qualify for Medicaid in the absence of a partnership program. As a result, the availability of partnership programs helps ensure that people use private long-term care insurance before applying for the Medicaid program. Most importantly, partnerships are a means to help us avoid some of the Medicaid financing of long-term care expenses, the fastest growing aspect of Medicaid spending.

We need to help Americans protect themselves and their hard-earned retirement savings from the catastrophic costs of long-term care. The Long-Term Care and Retirement Security Act of 1999 would strengthen current law in this area.

Chairman ARCHER. Thank you, Mrs. Johnson.

Our next witness is another Member of the Committee, the gentleman from California, Mr. Stark.

Mr. Stark, we will be pleased to hear your testimony.

STATEMENT OF HON. FORTNEY PETE STARK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. STARK. Thank you, Mr. Chairman.

I was interested to hear Mrs. Johnson's testimony. This is an attempt at bipartisanship. Most of what I am about to present to the Committee is a result of several months of labor with Republican leadership to attempt to come to an agreement that would bring some health care benefits to all Americans in a bipartisan manner. We were unable to reach complete closure, but I will tell you where we agreed and disagreed as I finish.

The biggest problem facing America today is the one in six citizens with no health insurance, as we learned yesterday. My first choice to solve this problem would still be an expansion of Medicare to everyone, and my second choice would be Congressman McDermott's single-payer system, but those efforts are not likely to succeed in a conservative or closely divided Congress.

I have just introduced legislation to try another approach, basically the Republican approach, a refundable tax credit which I believe could be made to work and which is similar to a number of bills already introduced by various Republicans and by Congressman McDermott.

Unfortunately, almost all the current tax bills don't work. The tax deductions for uninsured workers do nothing for the great number of uninsured in the zero to 15 percent brackets. Other bills provide a pitiful amount of money that wouldn't buy a decent policy. The biggest problem with the tax credit bills is that they waste money by providing basically no wholesale market. They force people into the retail market where they are subject to the whims of the insurance companies who take 20 or 30 percent off the top, as Mrs. Johnson said, and they refuse to insure the sick and raise rates on older people, so the credit eventually becomes inadequate.

Tax credits to buy insurance without insurance reform are a waste, and that is exactly where the leadership—your leadership, Mr. Chairman, and I could not come to an agreement. We both agreed that there has to be some standard on the insurance product so you are not letting people throw their tax credit away on something that won't work or provide a windfall to the insurance industry. We couldn't find that solution yet.

But those failures could be addressed. The Health Insurance for Americans Act that I have introduced provides a refundable tax credit of $1,200 per adult, $600 per child, an aggregate of $3,600 per family, which is exactly what we get in subsidy for our Federal Employee Health Benefit. We get about $3,600 for a family plan, and we have to kick in about $1,200 out of our paycheck. This would buy that equivalent of insurance.

The credit is available to everyone who is not participating in a subsidized health plan or eligible for Medicare. The credit could only be used to buy qualified health insurance, which is defined to be private insurance sold through a new Office of Health Insurance in the same general manner that the Federal employees buy guaranteed-issue, community-rated FEHBP health insurance through the OPM.

A refundable tax credit sounds like an easy idea, but there are some serious problems, and I address those in my written statement. There are two I would like to discuss.

First, how do you limit the credit to those who are uninsured and avoid employers substituting the credit for their current coverage? If you limit the size of the credit, most people will want to continue their current coverage. Still, there is no question that this credit is likely to erode gradually the employer-based system. Is that bad?

It is, frankly, probably good that this system would gradually erode if there is something to replace it. My bill provides that replacement. To the extent that workers today have better health care through their employer, their employer can continue to provide increased pay for the purchase of supplemental health benefits so that both the workers and the employers come out ahead.

The evidence shows us that employers are cutting back on benefits every day anyway, and this would be a replacement for those who lose it.

The bill I am introducing does not force an overnight revolution, but the current system is dying, and this provides a transition.

There is one monstrous question left: How to pay for it. I haven't addressed this issue in my bill but am willing to offer a number of options, and I might say the Republican leadership was willing to leave this unaddressed in the bill we had worked on cooperatively.

I would like to see the temporary budget surpluses used to start the program, but you need a permanent source of financing. The fairest way to finance it would be a tax on the businesses which do not provide an equivalent amount of insurance to their workers. Since many small businesses couldn't afford it, we would have to subsidize them.

Another approach would be that the next minimum wage increase would be dedicated to the payment of health insurance premiums by those firms who don't offer insurance. In other words, a buck an hour is $2,000 a year. That would cover most of the cost of employees if the company doesn't have health insurance. So the companies who do offer health insurance would have a lower minimum wage or there would be a dollar minimum. That could pay for it.

Other sources would be a provider insurance surtax since those groups would benefit and no longer have to subsidize the uninsured. And, finally, a small national sales tax dedicated to health care could work if the public, in fact, was convinced that this would insure them.

I have said that the earlier tax deduction and tax credit proposals have serious structural problems. The biggest problem is not seeing how they will pay for themselves. Until we are ready to agree on how to pay for them, the plans that are offered signify nothing. It is time for us to join the rest of the world, Mr. Chairman, and insure all of our residents; and this is an attempt to find a bipartisan common ground that will do that.

Thank you.

[The prepared statement follows:]

Statement of Hon. Fortney Pete Stark, a Representative in Congress from the State of California

Mr. Chairman, Colleagues:

The biggest social problem facing America today is that one in six of our fellow citizens have no health insurance and are all too often unable to afford health care.

About 44 million Americans have no health insurance. Despite the unprecedented good economic times, the number of uninsured is rising about 100,000 a month. It is unimaginable what will happen when the economy slows and turns down. One health research group, the National Coalition on Health Care, has estimated that with rising health insurance costs and an economic downturn, the number of uninsured in the year 2009 would be about 61.4 million.

The level of un-insurance among some groups is even higher. For example, in California it is estimated that nearly 40% of the Hispanic community is uninsured.

An article by Robert Kuttner in the January 14, 1999 *New England Journal of Medicine* entitled "The American Health Care System," describes the problem well:

> "The most prominent feature of American health insurance coverage is its slow erosion, even as the government seeks to plug the gaps in coverage through such new programs as Medicare+Choice, the Health Insurance Portability and Accountability Act (HIPAA), expansions of state Medicaid programs, and the $24 billion Children's Health Insurance Program of 1997. Despite these efforts, the proportion of Americans without insurance increased from 14.2% in 1995 to 15.3% in 1996 and to 16.1% in 1997, when 43.4 million people were uninsured. Not as well appreciated is the fact that the number of people who are under-insured, and thus must either pay out of pocket or forgo medical care, is growing even faster."

Does it matter whether people have health insurance? Of course it does. No health insurance all too often means important health care foregone, with a minor sickness turning into a major, expensive illness, or a warning sign ignored until it is fatal. Lack of insurance is a major cause of personal bankruptcy. It has forced us to develop a crazy, Rube Goldberg system of cross-subsidies to keep the 'safety net' hospital providers afloat.

Mr. Chairman, what is wrong with us? No other modern, industrialized nation fails to insure all its people. I don't believe we are incompetent, but our failure to provide basic health insurance to all our citizens is a national disgrace.

Personally, my first choice to solve this problem would be an expansion of Medicare to everyone. My second choice would be Rep. McDermott's single payer type program, which is modeled on Canada's success in insuring all its people for about 30% less than we spend to insure only 84% of our citizens.

But these efforts are not likely to succeed in a conservative Congress or in a closely-divided Congress.

Therefore, I have just introduced legislation to try another approach—a refundable tax credit approach—which I believe can be made to work and which is similar to a number of bills recently introduced by various Republican members and by Rep. McDermott.

Unfortunately, almost all tax bills simply do not work.

Some tax bills throw money at people who already have health insurance (e.g., 100% tax deductions for health insurance for small employers). Others try to solve the problem of lack of insurance by increasing the deduction for uninsured workers. The fact is, uninsured workers are overwhelming lower income workers, and they either pay no tax—so have nothing to deduct—or they are in the 15% bracket, so the deduction does little to help them with the heart of the problem: health insurance is expensive. I would like to enter in the Record a study by the GAO which documents, by income category, who the uninsured are and why tax deductions do little or nothing to help them.

Other bills provide a pitiful amount of money that wouldn't buy a a decent policy. For example, Rep. Shadegg proposes a $500 credit, leaving an impossible amount to be financed by the average, working, low-income family.

The biggest problem with all these tax credit bills is that if they do provide enough money (such as Rep. Norwood's refundable credit of $3600 a family—HR 1136), they waste it by providing no 'pool' or 'wholesale' market and forcing people into the retail market where insurance companies take 20 to 30% off the top, refuse to insure the sick, and raise rates on older people so that for people who really need insurance, the credit is woefully inadequate. I would like to include in the Record examples of what health insurance policies cost in the Washington, DC area for different types of individuals.[1] You will note that the sicker and older you are, the less likely a credit will be of any help.

To repeat, tax credits to buy insurance, without insurance reform, are a waste, will only help the easy-to-insure, and provide a windfall to the insurance industry.

These failures can be addressed. I think my proposal solves many of these problems. The idea of a tax credit approach to ending the national disgrace of un-insurance is a new one, however, and we desperately need a series of detailed, thoughtful hearings to design a program that will provide real help and not waste scarce resources on middlemen.

The Health Insurance for Americans Act I have introduced

—provides in 2001 and thereafter a refundable tax credit of $1200 per adult, $600 per child, and $3600 total per family. These amounts are adjusted for inflation at the same rate that the Federal government's plan for its employees (FEHBP) increases.

—the credit is available to everyone who is *not* participating in a subsidized health plan or eligible for Medicare.

—the credit may only be used to buy "qualified" health insurance, which is defined to be private insurance sold through a new HHS Office of Health Insurance (OHI) in the same general manner that Federal employees "buy" health insurance through the Office of Personnel Management.

—any insurer who wants to sell to Federal workers through FEHBP must also offer to sell one or more policies through OHI. OHI will hold an annual open enrollment period (similar to FEHBP's fall open enrollment) and insurers must sell a policy similar to that which they offer to Federal workers (but may also offer a zero premium policy), for which there is no-pre-existing condition exclusion or waiting period, for which the premium and quality may be negotiated between the carrier and OHI, and which must be community-rated (i.e., it won't rise in price as individuals age).

Mr. Chairman, a refundable tax credit sounds like an easy idea, but as in all things in America's $1.1 trillion health care system, there are some serious problems that have to be addressed.

The major problems with a refundable credit are 1) how to get the money to the uninsured in advance, so that the uninsured, who tend to be lower income, can buy a policy without waiting for a refundable credit?

2) how to make sure that the credit is spent on health insurance and there is no tax fraud?

I solve both of these problems through credit advances to insurers administered through OHI.

3) how to limit the credit to those who are uninsured, and avoid encouraging employers and those buying private insurance on their own from substituting the credit for their current coverage?

By limiting the size of the credit, most people who have insurance through the workplace or are participating in public programs will want to continue with their current coverage. The credit is adequate to ensure a good health insurance plan, but most workers and employers will want to continue with the current system. New Employee Benefit Research Institute data shows that the great majority of insured Americans like their employer-based system and want to continue it.

Having said this, there is no question that this credit is likely to erode gradually the employer-based system. It is hard to see employers wanting to offer new employees a health plan, when they can use this new public plan. Indeed, it is likely that an employer will say,

> "I will pay you more in salary if you will go use the tax credit program, you can use some of the extra salary to buy a better policy, or a supplemental policy, and we will both come out ahead."

But is this bad? The employer-based health insurance system is an historical accident of wage controls during World War II where in lieu of higher wages, people were able to get health insurance as a fringe benefit. This system is collapsing. No one today would ever design from scratch such a system where your family's health care depended on where you worked. It is, frankly, probably good that this system would gradually erode—if there is something to replace it. The Health Insurance for Americans Act provides that replacement. To the extent that workers have better health care through their employer, the employer can continue to provide increased pay for the purchase of "supplemental" or "wrap-around" health benefits and can

---

[1] Excellent documentation of this point is also included in a Kaiser Family Foundation study by Chollet & Kirk, March, 1998, entitled, "Understanding Individual Health Insurance Markets: Structure, Practices, and Products in Ten States."

even help arrange such additional policies for their workers-and both workers and employers come out ahead.

The bill I am introducing does not force an over-night revolution in the employer-provided system. But the current system is dying, and my bill provides a transition to a new system in which employees will have individual choice of a wide range of insurers (instead of today's reality, where most employees are offered one plan and only one plan).

Some Members are discussing ending the tax preferences for employer-provided health care, either by ending the deduction to employers or adding the value of the policy to the income of the workers. That would be a revolution. It would very quickly end the employer-provided system. And I don't think Americans like revolutions on something as important as their family's healthcare.

To repeat, the employer-based health care system is dying. The next recession will push it over the edge. It would be wise to build this refundable tax credit system now, so that people have someplace to go as the system deteriorates. But the public opinion polling is very strong: don't legislate the overnight termination of the current system.

4) another key question is how to make the credit effective by allowing the individual to buy "wholesale" or at group rates, rather than "retail" or individual rates?

5) how to make sure that individuals who most need health insurance—those who have been sick—are able to use the credit to obtain affordable insurance?

6) how to minimize the problem created when the healthiest individuals take their credit and buy policies which are "good" for them (e.g., Medical Savings Accounts), but "bad" for society because they leave the sicker in a smaller, more expensive insurance pool (that is, how do we keep the insurance pool as large as possible and avoid segmentation and an 'insurance death' spiral)?

Again, the OHI/FEHBP idea largely solves these 3 problems, by giving individuals a forum where they can comparison shop for a variety of plans that meet the standards of the OHI and achieve efficiencies of scale and reduced overhead.

These questions are the single biggest problem facing the refundable credit proposal. Even if we are able to 'pool' the individuals, will insurers offer an affordable policy to a group which they may fear will have a disproportionate number of very sick individuals? I think that fear is unfounded. Most uninsured are young and healthy, but we do not know for sure how the private insurers will respond.

We may need to develop a national risk pool 'outlet' to take the expensive risks and subsidize them in a separate pool, so that the cost of premiums for most of the people using OHI is affordable. Another alternative, and probably the one that makes the most sense for society, is to mandate that individuals participate in the OHI pool (if they don't have similar levels of insurance elsewhere). Only by getting everyone to participate can we ensure a decent price by spreading the risk. The danger that young, healthy individuals will ignore (forego) the tax credit program may be serious enough that it will cause insurers to price the OHI policies too high, thus starting an insurance "death spiral" as healthier people refuse to participate and rates start rising to cover the costs of the shrinking pool of sicker-than-average individuals.[2]

As I said earlier, previous tax credit proposals fail to deal with these key questions and problems. But all the bills have helped focus us on this national crisis. Through hearings and studies, I hope we can find ways to ensure that these technical—but very important questions—are addressed.

There is one key, monstrous question left: how to pay for the refundable credit so we may end the national disgrace of 44 million uninsured?

I have not addressed this issue in my bill, but am willing to offer a number of options. I would like to see the temporary budget surpluses used to start this program—but those surpluses are temporary and we need a permanent financing source.

The problem of the uninsured is largely due to the fact that many businesses refuse or are unable to provide health insurance to their workers. The fairest way to finance this program would be a tax on businesses which do not provide an equiv-

---

[2] These are extremely important technical questions. As the July 1999 EBRI Issue Brief will say,

Issues such as adverse selection, "crowd-out" of private insurance by public insurance, or substitution of individual coverage for group coverage are inherent to the current voluntary employment-based health insurance system, and will not be resolved by incremental changes made to improve this system. For example, young and healthy individuals are more likely than older unhealthy individuals to opt out of the employment-based system under certain circumstances. As long as the purpose of insurance continues to be the spreading of risk across higher-risk and lower-risk individuals, attempts to augment or replace the employment-based health insurance system may have unintended side effects that do not benefit the majority of the U.S. population.

alent amount of insurance to their workers. Such a tax, of course, would slow the tendency of this program to encourage businesses to drop coverage. Since many small businesses could not afford the tax, we will need to subsidize them.

Another approach would be to apply the next minimum wage increase to the payment of health insurance premiums by those firms which do not offer insurance. A 50 cent per hour minimum wage increase dedicated to health insurance would pay most of an individual's premium.

Other financing sources could be a provider and insurer surtax, since these groups will no longer need to subsidize the uninsured and will be receiving tens of billions in additional income.

Finally, to end the national disgrace of un-insurance, a small national sales or VAT tax would be in order. If we worked together, we could explain and justify a 'national health tax' to ensure every American decent private health insurance regardless of their work status.

Again, Mr. Chairman, I have said that the earlier tax deduction and tax credit proposals have serious structural problems. The biggest problem they have is not saying how they will pay for themselves. Until Members talk about financing, all of these plans are sound and fury, signifying nothing.

These tax credit bills are obviously expensive, but so is the cost of 1 in 6 Americans being uninsured. In deaths, increased disability and morbidity, and more expensive use of emergency rooms, American society pays for the uninsured. If we could end the national disgrace of un-insurance, we would save billions in improved productivity, reduced provider costs, bad debt, personal bankruptcy, and disproportionate share hospital payments.

Mr Chairman, it is time for America to join the rest of the civilized world and provide health insurance for all its citizens.

Chairman ARCHER. Thank you, Mr. Stark.

Our next witness is Rob Portman.

Mr. Portman, we would be happy to hear your testimony.

STATEMENT OF HON. ROB PORTMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. PORTMAN. Thank you, Mr. Chairman. It is a delight to be here.

Since this is a hearing in part about retirement security, I would like to start by commending you and Chairman Shaw for the fine work you have done on the Social Security front and the sound proposal that you have given this Committee to strengthen the Social Security system.

But as you are well aware, Mr. Chairman, I also strongly believe that this panel should complement that by moving this year to significantly increase the availability of retirement security for all Americans by strengthening our private employer-based pension system. I think it is a great opportunity for us, as Mrs. Johnson mentioned earlier.

This is a critical issue for all Americans, particularly the 76 million baby boomers approaching retirement age. That is why over the past 2 years we have been working hard on putting together a comprehensive set of changes to improve our pension system from top to bottom. My partner in this has been my colleague, Ben Cardin, who will address the Committee in a moment, but we have also worked with many other Members of this Committee—Mrs. Johnson, Mr. Weller, Ms. Dunn, Mr. Tanner, and others, even some from our other distinguished Committees like Mr. Pomeroy, who is also here today to talk about retirement security.

We have done it in a comprehensive way because we believe that is the way to build on the pension expansion and simplification measures that this Committee has taken the lead on in the past, including the SIMPLE, Savings Incentive Match Plan for Employees, plan for small businesses.

I am delighted to say, Mr. Chairman, as of today it is a bipartisan group of about 26 Ways and Means Members who have cosponsored H.R. 1102, over 90 members in total, an influential group, Mr. Chairman; and I ask my colleagues if they would take a look at a few charts regarding retirement security that will outline the problem that I think Ben is going to have an opportunity to go into in some more detail on some of our provisions.

The first simply makes the point that the retirement stool, which is the so-called three-legged stool, is very much supported by employer-based pensions already. Employer-based pensions are along with Social Security and private savings, absolutely essential to the retirement security of our constituents. This includes, of course, not just the traditional defined benefit plans, but when we talk about pensions, we are talking about all retirement plans that are employer-sponsored, including 401(k)s, 457, 403(b)s, and other arrangements.

The second chart shows that although it is a very important part of our retirement system in this country, we have a crisis in pensions. Only half of American workers are covered. It means about 60 million Americans have no pensions whatsoever. That chart is interesting because it shows that since 1983 we have made virtually no progress. It has been flat. Forty-eight percent of workers were covered in 1983. That chart says, in 1993, about 50 percent. Unfortunately, that is about the number it is today. It has remained flat despite the need for more retirement security as a backstop to Social Security.

It is even worse than that when you look at what small businesses offer in terms of retirement security to their workers. That chart will show you, at the bottom end toward the left, that those small companies, that is, companies with 25 or fewer employees where, frankly, most of the new employment is occurring, are growing the fastest in terms of adding new workers, yet only 19 percent offer anything, even a SIMPLE plan, a SEP, self-employed plan, or a 401(k). It is even worse than the fact that only half of American workers are covered. Those in small businesses have very little chance of having a pension at all.

The next chart gets, Mr. Chairman, to the point that you made early on, which is that our personal savings rate in this country is at a dangerously low level. You talked about this in the context of tax reform in the past, that we ought to focus on our tax reform proposal this year on trying to increase that.

Foreigners, frankly, are propping up a lot of our savings today, and there is a concern that some of that capital may leave this country at some point. And for capital formation, for investment, for the economic future of this country, we have got to increase our savings rate. This chart simply makes obvious the fact that we are back down to the rates we had during the Great Depression.

The next chart shows that with regard to distribution of pension benefits, most pension recipients are middle-income Americans. A pension, in fact, makes the difference between retirement subsistence, mere subsistence, and retirement security for millions of Americans.

I wish you could see that chart better, but the bottom line is the folks who are currently receiving benefits are primarily in the middle-income category. In fact, if you look at the right side of that chart, over 75 percent of workers participating in pension plans make less than $50,000 a year.

With regard to folks who are participating in pensions, again this is something that is focused on middle-income Americans; 77 percent of current pension participants are either middle- or low-income workers. The Portman-Cardin plan, again Ben is going to go into more detail on that, basically says, let's make it less costly and burdensome for employers to establish these new pension plans. The government ought to be in the business of encouraging pensions, not discouraging them.

We also ought to modernize the pension laws to address the needs of the 21st century work force, and this is where Earl Pomeroy has played a big role in helping us with regard to portability.

The bottom line, Mr. Chairman, is that we strongly believe that we ought to preserve our public Social Security system. I want to work with you toward that end, but we need to do more. Imagine the impact we could have—this panel could have—by expanding on the private side so that every American worker would have access to a 401(k) or some kind of a pension plan. It is a tremendous opportunity, and I urge us to seize it this year.

[The prepared statement follows:]

Statement of Hon. Rob Portman, a Representative in Congress from the State of Ohio

Thank you, Mr. Chairman, for allowing me to testify here today. I would like to take this opportunity to commend you and Chairman Shaw publicly for your leadership on increasing retirement security by strengthening our public Social Security system.

In addition to taking steps to save Social Security, I feel strongly that this panel should take steps this year to significantly increase the availability of secure retirement savings generally—primarily by strengthening our private, employer-based pension system.

This is a critical issue for *all* Americans—not just for current retirees or those 76 million Baby Boomers who are nearing retirement age—but also for those young people whose ability to enjoy a comfortable retirement in the future will depend on the policy approaches we adopt today.

That's why my Ways and Means colleague from Maryland, Mr. Cardin, and I have been working on comprehensive reforms to our pension system over the past two years. This year, we have introduced H.R. 1102—the Comprehensive Retirement Security and Pension Reform Act. It builds on the pension expansion and simplification measures this committee has taken the lead on in the past—including provisions in the Small Business Jobs Protection Act of 1996 that took steps to expand retirement plan options for small businesses by establishing the SIMPLE plan. And it incorporates pension reform proposals that have been put forward by a number of Members of this panel.

H.R. 1102 will increase retirement security for millions of Americans by strengthening that "third leg" of retirement security—our pension system—including traditional *defined benefit* plans as well as *defined contribution* plans like 401(k), 403(b) and 457 arrangements. And it will help those Americans who need it most—in fact, 77% of current pension participants are middle and lower income workers.

H.R. 1102 is designed to reverse some disturbing trends in our pension system.

• Right now, only *half* of all workers have a pension plan. That means about 60 million Americans don't have access to one of the key components to a comfortable retirement.

• And, far fewer than half of employees who work for *small* businesses have access to a pension plan. Today, only 19% of small businesses with less than 25 employees offer any kind of pension plan. Why? Over the years, the pension laws have become so complicated and so costly to set up and administer that many small businesses simply can't afford to offer them.

• And, not enough workers have pension coverage at the same time that overall savings is dangerously low. In fact, the personal savings rate in this country—the amount of money people save for retirement and other needs—is at its lowest rate since 1933. For economists who are looking beyond our immediate apparent economic prosperity as a country, this is the most troubling statistic out there.

Simply put, the Portman-Cardin legislation lets workers save more for retirement. We make it easier for employers to establish new pension plans or improve existing ones. And, we modernize pension laws to address the needs of a changing, 21st Century workforce.

Let me highlight a few of the key provisions.

Increased Contribution Limits: Over the last 20 years, Congress has lowered the annual dollar limits on contributions workers can make and benefits they can accrue. These restrictions have been an obstacle to adequate private pension savings. Portman-Cardin substantially increases the limits for alltypes of plans and repeals the current 25% of compensation limit on contributions to defined contribution plans—our proposal generally restores these limits to 1982 levels.

Catch-up Contributions: Portman-Cardin increases the limits on all employee contributions to all plans by an additional $5,000 for workers 50 and older so that they can "catch-up" for years when they weren't employed, didn't contribute to their plan or otherwise weren't able to save. We know from research that many Baby Boomers who are *now* approaching retirement age have not saved adequately for their retirement. In particular, this catch-up provision will benefit women who have returned to the workforce after taking time away to raise families.

Increased Portability: We're told that the average worker in the next century will hold nine jobs by the age of 32, and workers typically do not stay in any job for more than five years until age 40. Portman-Cardin reflects the needs of an increasingly mobile workforce. HR 1102 includes "portability" provisions to allow workers who are changing jobs to roll over retirement savings between 401(k)s, 403(b)s and 457s.

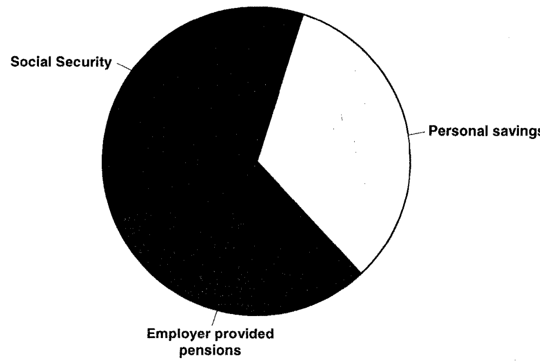
Faster Vesting: Under current law, many employees do not become fully vested in a pension plan until they have been with an employer for 5 years. Portman-Cardin would lower the vesting requirement for matching contributions to 3 years.

Cutting Pension Red Tape: he increasing complexity of the laws governing pensions—both in the private sector and in the non-profit and government sectors—has discouraged the growth of pension plans. In fact, for many small businesses in particular, the costs and liabilities associated with pension plans have made it too expensive for many companies to offer plans. Larger companies, state and local governments and non-profits have too often been discouraged from improving existing plans because the rules are so complicated and costly. Portman-Cardin takes steps to cut the unnecessary red tape that has put a stranglehold on our pension system.

We now have more than 90 bipartisan cosponsors and more than 60 endorsing organizations from across the ideological spectrum—from the U.S. Chamber of Commerce and the NFIB to labor organizations like AFSCME and the Building and Construction Trades Department of the AFL–CIO.

I commend Chairman Archer and this entire panel for taking a leadership role on preserving our public Social Security system. But imagine the impact we would have on our national savings rate and overall retirement security if we could give every American worker access to a 401(k) or another kind of pension plan. This is a tremendous opportunity that I urge this panel to seize this year.

Pensions Are an Important Component of Retirement Security



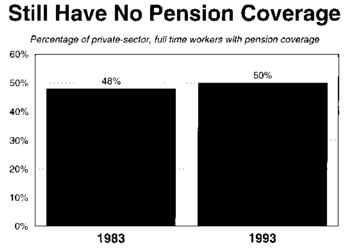
Social Security, employer-provided pensions, and personal savings provide a "three-legged stool" of savings to support American workers in their retirement years.

Source: Social Security Administration

The Portman-Cardin Plan

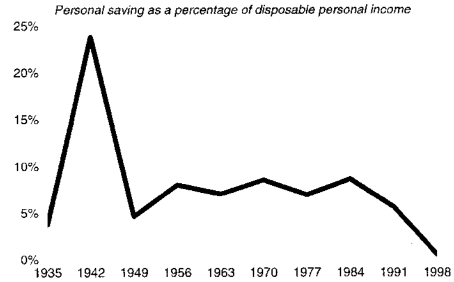
- ✓ Increases retirement security by allowing workers to save more
- ✓ Gives small businesses relief to expand retirement plan opportunities
- ✓ Addresses the needs of an increasingly mobile workforce
- ✓ Makes pensions more secure
- ✓ Cuts pension red tape and simplifies rules

Half of American Workers Still Have No Pension Coverage



U.S. Personal Savings Rates are at the Lowest Level Since the Great Depression

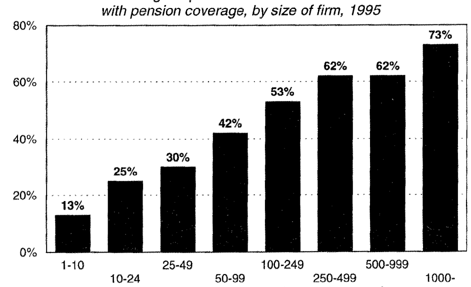
Personal saving as a percentage of disposable personal income



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

Small Business Employees Least Likely to Have Pensions

Percentage of private-sector full-time workers with pension coverage, by size of firm, 1995



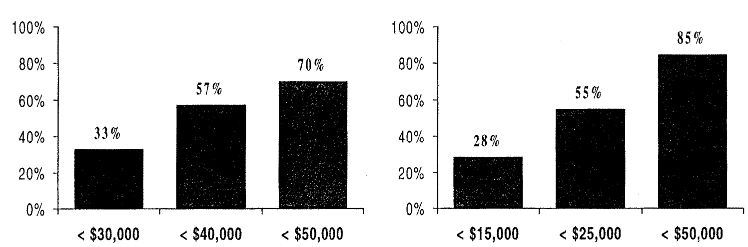
Source: U.S. Department of Labor

Most Pension Recipients are Middle Income

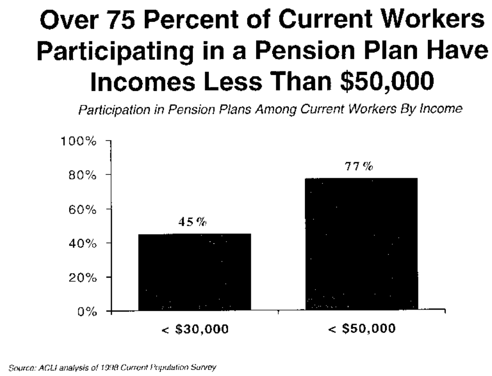
Pension Recipients By Income

Married Couples

Widows / Widowers



Source: ACLI analysis of 1998 Current Population Survey.



Chairman ARCHER. Thank you, Mr. Portman.

Mr. Cardin, since your name was mentioned, we would be happy to receive your testimony.

STATEMENT OF HON. BENJAMIN L. CARDIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. CARDIN. Thank you, Mr. Chairman.

Let me ask unanimous consent that my full statement be included in the record.

Chairman ARCHER. Without objection.

Mr. CARDIN. Thank you for this opportunity and for holding these hearings. I think they are extremely important, as your opening statement pointed out.

I want to thank Mr. Portman for the work he has done on the bill that we have filed.

The debate over retirement security is desperately needed in this country. As you have pointed out, our savings ratios as a nation are deplorable. Economic trends look good. Budget deficits are over. We have got surpluses in the future. Unemployment rates are low. Interest rates are low. But the savings rates of this Nation as we compare ourselves to any of the nations that we like to compare ourselves to is too low. We need to do something about it.

As important as Social Security is—and I do hope that we, like you, address the problems of Social Security this year. This is the year we should do it. But Social Security alone will not be enough. Social Security was never intended to be the sole income source for retired Americans. We must supplement that with modern, private pension plans.

That is why Rob Portman and I introduced H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act. It is rebuilding our Nation's private pension system.

We use the term "rebuilding" because we go back and correct some of the mistakes that we have made over the last 2 decades in pension changes that we have made that have reduced the opportunity of Americans to put money away and have made it more complicated.

We have listened to the concerns from Americans across our entire country, and we have included provisions to strengthen and expand saving opportunities for Americans who work for small businesses, large businesses, State and local government, and nonprofit organizations.

First, we increase the limits on retirement savings to allow Americans to put more away. We do that for defined contribution plans, defined benefit plans and qualified compensation. We make it easier for young people to establish retirement plans. We take the model that Mr. Thomas and Senator Roth used for IRAs and use that for 401(k)s and 403(b) plans. We increase the opportunity of Americans to put their plans together through portability, recognizing the realities of the current labor market by allowing portability between 401(k)s, 403(b)s, and 457 plans.

As Mr. Portman pointed out, we simplify dramatically our pension laws for both large companies and small companies. We remove many of the restrictions on the multiemployer plans that discriminate against workers for large companies and unionized members, and we also deal with small businesses by eliminating some and reforming many of the tests, including the top-heavy rules are reformed. We think that will go a long way to make pension plans more available to the American public.

Mr. Chairman, there are many provisions in the Portman-Cardin legislation. We have tried to listen to all of the different interest groups and respond in a reasonable way, but we have tried to avoid any of the major controversial areas so that we could work in a bipartisan way to get legislation enacted this year. And we would urge the Committee in whatever vehicle moves through this Congress on the Tax Code that we help Americans take care of their needs when they retire and include the provisions that are in the Portman-Cardin legislation.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Hon. Benjamin L. Cardin, a Representative in Congress from the State of Maryland

Mr. Chairman, I am pleased to appear this morning to testify before the most distinguished committee of the United States Congress.

Let me start by commending you for holding this hearing and to examine new proposals to strengthen our nation's private pension and retirement savings system. I am especially pleased to be here with such a distinguished panel of witnesses, including my good friend and partner in the enterprise of pension reform, our colleague Rob Portman.

The debate over retirement security has attained new significance in the past few years. As the "baby boom" generation approaches retirement, the need to help this generation and future generations of Americans live comfortably in retirement has gained greater prominence as a legislative priority.

One indication of this need, of course, has been the on-going national debate over the future of the Social Security system. We must all make every effort to make sure that Social Security, the most successful social program in our nation's history, will continue to be there for current and future retirees. I am committed to working with you, Mr. Chairman, and with every member of this committee, and with the President, to achieve this vital goal.

As important as Social Security is, however, it is not enough. Social Security was never intended by itself to provide an adequate standard of living for retired Americans, and it cannot fill that role now.

That is why Rob Portman and I have introduced H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act. This legislation takes the next step, in a process that began with pension reforms enacted over the past three years, in rebuilding our nation's private pension system.

I use the term "rebuilding" because in many respects, H.R. 1102 simply restores the pension law to what it was a decade or two ago. For over a decade, beginning in the early 1980's, our federal pension policies suffered from a severe disconnect between rhetoric and action. While we acknowledged the economic advantages of private retirement savings, and exhorted Americans to save more, we frequently passed legislation that imposed obstacles to the achievement of those goals.

The distressing results are before us in the most recent savings statistics. Across the spectrum, the domestic economic news is encouraging. Unemployment is low, inflation is low, productivity is high, family income is up, economic growth is strong. Yet private savings has continued to drop, and now stands at the lowest rate since before the creation of Social Security.

H.R. 1102 says we can do better. The bill proposes a number of changes that will expand employer-sponsored retirement savings opportunities for millions of American workers. In developing the bill, we have listened to the concerns from Americans across our entire country, from every sector of the economy. We have included provisions to strengthen and expand savings opportunities for Americans who work for small businesses, large businesses, state and local governments, and non-profit organizations. We have listened to the concerns of public school teachers, plan administrators for Fortune 100 companies, women and men who own small businesses, and representatives of organized labor. We have included specific reforms that benefit Americans who participate in multi-employer pension plans. We have included proposals that will strengthen defined contribution plans and defined benefit plans, as well as IRAs, 401(k) plans, 403(b) arrangements, or 457 plans.

In short, Mr. Chairman, the message of H.R. 1102 is we want Americans to save more, and we are determined to help provide incentives that will allow and encourage them to do so.

Let me mention a few of the major initiatives included in the bill. Perhaps the heart of the bill is the proposed increases in the limits on retirement savings. Over the past eighteen years, we have ratcheted down the benefits and contributions permitted under qualified retirement plans. These changes have contributed to a decline in the number of employers sponsoring plans, and reduced opportunities for workers to save. We propose turning the clock back to restore the limits—on defined contributions, defined benefits, and qualified compensation—that have been in effect in past years.

We would also increase the opportunity for workers to take their retirement savings with them when they change jobs. The law imposes too many restrictions that prevent workers from moving their savings from one type of retirement plan to another. We would break down the barriers between 401(k), 403(b), and 457 plans, allow workers to roll over their funds when they move from one job to another.

Despite the success we have had over the past few years, working on a bipartisan basis, with the support of the Clinton Administration, in enacting pension simplification reforms, the current law is still too complex. It still imposes too many restrictions on multi-employer plans, penalizing workers, and especially union members, who participate in these plans. H.R. 1102 will make the law work better for these multi-employer plans.

Current law still imposes too many restrictions on small businesses. Less than twenty percent of Americans who work for small businesses have the opportunity to save in an employer-sponsored retirement plan. H.R. 1102 removes many burdensome restrictions on small businesses, including reform, but not repeal, of the "top heavy" rules.

Mr. Chairman, there is no single answer to the retirement savings crisis in our country. In presenting the Portman-Cardin proposal to the House, however, we have worked to formulate a plan that will take federal pension law in a new direction. We want to back up our pro-savings rhetoric with pro-savings legislation.

I appreciate the opportunity to testify before this committee today. Two-thirds of the members of our committee, with strong bipartisan representation, has cosponsored this bill. I look forward to working with all the members of this committee to rebuild our nation's private savings system.

Chairman ARCHER. Thank you, Mr. Cardin.

Our next witness is William Jefferson.

We would be pleased to hear your testimony.

STATEMENT OF HON. WILLIAM J. JEFFERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. JEFFERSON. Thank you, Mr. Chairman.

Mr. Chairman and Mr. Rangel and Members of the Committee, I am pleased to have the opportunity to testify regarding the Small Savers Act. I want to thank Lindsey Graham and Mr. Wexler for cointroducing this bill with me.

I thank the Chairman for holding this hearing on tax proposals to enhance retirement and health security through, among other things, increasing personal savings by reducing the tax burden on savings.

Retirement security is an important issue to all of us. It is important to all Americans, and it is important that we have something that we can do this year on this subject.

By encouraging personal savings, the Small Savers Act represents sound economic and social tax and fiscal policy. The Small Savers Act represents sound economic and social policy because it would result in increased savings and investments by millions of Americans.

Most economists agree that the best way to ensure retirement security for future generations is to maintain continued and sustained growth of the economy. However, this growth is threatened by the low and approaching negative personal savings rates in our country. It is alarming that over one-third of Americans have no personal savings at all, and most who do have less than $3,000. This is not much to retire on.

The Small Savers Act provides four modest tax incentives that will induce low- and middle-income Americans to save and invest more and reverse this alarming trend.

First, the Small Savers Act raises the 15 percent tax bracket by $10,000 for joint filers, $5,000 for single filers phased in over 5 years. As a result, more low- and middle-income tax payers, actually more than 7 million, will be pushed into the lower 15 percent tax bracket and therefore pay a lower tax bill. With more money in their pockets, these families will have more money available to put toward savings.

Second, the bill allows taxpayers filing jointly to deduct up to $500 of interest and dividend income. Single filers will be able to deduct half that amount.

Third, the bill will allow taxpayers to exempt up to $5,000 of long-term gain from taxation. These two provisions will reduce the tax bias against savings. Under present law, $100 saved is taxed greater than $100 consumed because the earnings on the $100 saved are also subject to tax.

Finally, the bill allows taxpayers to increase annual contributions on traditional IRAs from $2,000 to $3,000 and begins index inflation in 2009. Since IRA contributions have the attractive feature of being tax deferred, increasing the contribution limits will encourage additional savings that can be used to help individuals maintain their standard of living during retirement.

The Small Savers Act represents good tax policy because it addresses one of the major problems with our current tax system, complexity. For most Americans, filling out Federal income tax forms has long been a daunting task. Now this task has become increasingly more overwhelming with increased complexity of the Code. In addition to the complicated form 1040, many Americans must fill out numerous additional forms in order to determine their tax liability. Americans spend millions of dollars unnecessarily not on paying their tax liability but on paying tax preparation fees.

If the Small Savers Act is enacted, millions of taxpayers will no longer have to pay tax on their interest, dividend or capital gains income. Thus, more taxpayers will be able to file their taxes using the simpler form 1040 EZ and will no longer have to use the complicated form 1040 D or form 1040 schedule A to itemize their interest, dividends and capital gains income. Taxpayers will save millions of dollars in tax preparation fees, money that can be used for further savings.

The Small Savers Act is also good fiscal policy because it does not require using any of the Social Security surplus. The Small Savers Act is expensive, to be sure. It costs $134 billion through fiscal year 2004, and $345 billion over 10 years. But this figure is less than half of projected $787 billion in non-Social Security surplus over 10 years. The remaining non-Social Security surplus can be prudently invested if the Congress should so desire in education, in defense, and any other way, perhaps even to pay down the debt.

Mr. Chairman, the Small Savers Act should in no way be viewed as a panacea for the savings crisis facing our country or a threat to retirement security. However, this bill is a bipartisan compromise from which to start, and I can't emphasize it enough that it is something which I think is doable this year.

I commend the Chairman for also including legislation to reform our private pension system in this hearing and having bipartisan meetings to discuss areas of common ground toward the plan to save Social Security. I will continue to work with the Chairman, with the other Members of the Committee, my colleagues in the House, and with the administration to fashion legislation to address all areas of improving retirement security.

Thank you again, Mr. Chairman, for the opportunity to testify.

[The prepared statement follows:]

Statement of Hon. William J. Jefferson, a Representative in Congress from the State of Louisiana

Mr. Chairman and members of the Committee, I am pleased to have the opportunity to testify regarding "The Small Savers Act."

I thank the Chairman for holding this hearing on tax proposals to enhance retirement and health security, through among other things, increasing personal savings by reducing the tax burden on savings. Retirement security is an important issue to me. It is an important issue for my constituents in Louisiana and it is an important issue for all Americans.

By encouraging personal savings, the Small Savers Act represents sound economic, social, tax, and fiscal policy. The Small Savers Act represents sound economic and social policy because it will result in increased savings and investments by millions of Americans. Most economists agree that the best way to ensure retirement security for future generations is to maintain continued and sustained growth of the economy. However, this growth is threatened by the low-and approaching negative-personal savings rates in this country. It is alarming that over one-third of Americans have no personal savings at all.

The Small Savers Act provides four modest tax incentives that will induce low and middle-class Americans to save and invest more and reverse this alarming trend.

First, the bill raises the 15% tax bracket by $10,000 for joint filers; $5000 for single filers phased in over 5 years. As a result, more low and middle income taxpayers—actually more than 7 million more—will be pushed in the lower 15% tax bracket and pay a lower tax bill. With more money in their pockets, these families will have more money available to put towards savings.

Second, the bill allows taxpayers filing jointly to deduct up to $500 of interest and dividend income. Single filers will be able to deduct half that amount.

Third, the bill will allow taxpayers to exempt up to $5000 of long-term gain from taxation. These two provisions will reduce the tax bias against savings. Under present law $100 saved is taxed greater than $100 consumed because the earnings on the $100 saved are also subject to tax.

Finally, the bill allows taxpayers to increase annual contributions on traditional IRA from $2000 to $3000 and begins indexing for inflation in 2009. Since IRA contributions have the attractive feature of being tax deductible, increasing the contribution limits will encourage additional savings that can be used to help individuals maintain their standard of living during retirement.

The Small Savers Act represents good tax policy because it addresses one of the major problems with our current tax system—complexity. For most Americans, filling out federal income tax forms has long been a daunting task. Now, this task has become increasingly more overwhelming with the increased complexity of the Tax Code. In addition to the complicated Form 1040, many Americans must fill out numerous additional forms in order to determine their tax liability. Americans spend millions of dollars unnecessarily; not on paying their tax liability, but on paying tax preparation fees.

If the Small Savers Act is enacted, millions of taxpayers will no longer have to pay tax on their interest, dividend or capital gains income. Thus, more taxpayers will be able to file their taxes using the simpler Form 1040 EZ and will no longer have to use the complicated Form 1040 D or Form 1040 Schedule A to itemize their interest, dividend and capital gains income. Tax payers will save millions in tax preparation fees. Money that can be used for further savings.

The Small Savers Act is also good fiscal policy because it does not require using any of the Social Security surplus. The Small Savers Act is estimated to cost $134.7 billion through FY 2004 ($345.7 billion through FY 2009). This figure is less than half of the projected $787 billion in non Social Security surplus over 10 years. The remaining non Social Security surplus can still be used to fund important spending initiatives such as education and defense or to pay down the debt.

Mr. Chairman, The Small Savers Act should in no way be viewed as a panacea for the Savings crisis facing our country or the threat to retirement security. However, this bill is a bipartisan compromise from which to start. I commend the Chairman for also including legislation to reform our private pension system in this hearing and having bipartisan meetings to discuss areas of common ground towards a plan to save Social Security. I will continue to work with the Chairman, my colleagues in the House and with the Administration to fashion legislation to address all areas of improving retirement security.

Thank you Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Jefferson.

Our last witness is Earl Pomeroy.

We are delighted to have you before the Committee and thank you for your work that you have done on retirement issues. We would be pleased to hear your testimony.

STATEMENT OF HON. EARL POMEROY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. POMEROY. Thank you, Mr. Chairman. It is indeed a great delight to be in the Ways and Means Committee, even for a brief time.

I don't think there is an issue before us more important than retirement savings. I commend you for holding this hearing.

In my testimony I want to advance four points for your consideration.

First, retirement savings is a national priority.

Second, tax cuts in this area should begin by increasing the immediate financial incentive for retirement savings efforts by families and individuals of middle and modest income means.

Third, tax cuts should be shaped to increase the prospects employers will offer and continue pension coverage for their work force.

Fourth, a tax bill should include provisions that include the portability of workers' retirement savings.

First, the national priority. Our population is aging. Our savings rates declining. These are ominous trends, and they require our attention if we are to avoid the prospect of growing numbers of Americans without adequate personal resources to meet their needs in retirement years.

Wonderful breakthroughs in medicine and health care have increased the number of years we can hope to live, and that not only makes our problem worse—consider the following facts:

The number of retirees will double as baby boomers move into retirement age. The national savings rate is at its lowest point in some 60 years. Seventy percent of those with 401(k) plans have balances below $30,000 and nearly half below $10,000.

The conclusion I draw from all of this is that stepping up retirement savings is a true national imperative. Like the line from that old muffler ad, it is a "pay now or pay later" situation. Either we take steps to help families accumulate retirement savings so they can meet their needs with their own resources or we pay later through publicly funded programs providing the support people require.

I believe tax cuts in this area represent excellent tax policy and return a long-term dividend of reducing demand on public programs down the road.

Retirement savings for middle and modest income families: We have achieved a great deal through retirement savings in the workplace but, as Mr. Portman mentioned, so many don't have that retirement savings opportunity. In North Dakota, four out of 10 workers have retirement savings at work.

Congress needs to enhance incentives for vehicles like individual retirement accounts. Now, last Congress we took steps in this area, strengthening IRA incentives in several areas, none, however, for households in the category $50,000 and below.

It is not surprising that these are the very families that have the most difficulty saving for retirement. Discretionary dollars gets stretched thin just covering basic living expenses ranging from school clothes to car repairs. They need a more meaningful retirement savings incentive.

I propose increasing the incentive by establishing a 50 percent tax credit for IRA contributions of $2,000 or less each year for families earning $50,000 or below. An individual is $25,000 and below.

The President has proposed USA, universal savings accounts, that is an even more ambitious effort to get savings comprehensively established. This IRA tax credit proposal is another way of approaching the same issue. I believe you could market an IRA tax credit to families like an employer match in a 401(k) setting. There hasn't been an incentive for retirement savings more effective in my opinion than that employer match on the 401(k). Let's apply the same dynamic to the IRA through this tax credit.

Support for pension plans should be stepped up, too. Of all the employer-based retirement savings, it is the pension plan that offers the most predictable stream of income in retirement, but what we are seeing is a dramatic decrease in the number of pension plans out there. The number of workers covered has diminished over the last 10 years, even though the work force has grown substantially, and the number of employers offering plans has absolutely just collapsed.

Congress and the administration—several administrations bear much of the responsibility. We have made it too complex, too costly; and we need to address that. In 1996, we advanced regulatory relief for retirement plans, but that was defined contribution plans through the SIMPLE legislation.

Congresswoman Johnson and I have introduced a bill known as SAFE, Secure Assets for Employees, which does basically the same type of regulatory relief for defined benefit plans.

Now, new incentives to save, cost money, and the amount of money you will have available for your tax bill, Mr. Chairman, will determine what you can do. But removing disincentives to save don't cost much money.

And this would be my final point, portability. We have over the years through happenstance in the Tax Code made it very difficult for someone to move their retirement savings as they move through the work force. Take, for example, someone who works for a private for-profit. They would have a 401(k) defined contribution plan. If they went to work for a nonprofit, they would have a defined contribution 403(b) plan. If they later went to work for State government, they would have a defined contribution 457 plan. All defined contribution plans but none of them convertible one to another.

When a person has a bunch of little retirement accounts, we know what happens. They have them disbursed. When they have them disbursed, we know what happens. They spend it. In fact, more than 60 percent of the time the money is not fully reinvested in retirement savings. So by making it impossible for someone to keep their retirement funds in one account we encourage disbursement and therefore spending.

Let's stop that. We introduced a bill called RAP, the Retirement Account Portability bill, that would allow for this type of rollover. I think there is no public policy served by frustrating someone's ability to collect their retirement accounts in one place. There is very little cost to the Treasury in addressing this legislation; and whatever you do with the tax bill, Mr. Chairman, I would hope the portability issue is included.

Thank you for listening to me.

[The prepared statement follows:]

Statement of Hon. Earl Pomeroy, a Representative in Congress from the State of North Dakota

Mr. Chairman, members of the Committee, thank you for the opportunity to appear before you this morning. The topic we discuss today—how to encourage greater savings for retirement—is one of critical importance to the economic health of our people and our nation. No tax cut proposal this Committee will consider is more important than those that assist America's families in saving for their retirement, and I commend you for holding this hearing today.

In my testimony I will advance four points for your consideration:

1) Retirement savings is an urgent national priority;

2) Tax cuts in this area should begin by increasing the immediate financial incentive for individual retirement savings efforts by families and individuals earning modest incomes;

3) Tax cuts should increase the prospects employers will offer and continue pension coverage for their workforce;

4) A tax bill should include provisions that improve the portability of workers' retirement savings as they change employers in the course of their careers.

RETIREMENT SAVINGS AS A NATIONAL PRIORITY

Our population is aging and our savings rate is declining. These are ominous trends that require our attention if we are to avoid the prospect of growing numbers of Americans without adequate personal resources to meet their needs in retirement years. Wonderful breakthroughs in medicine and health care have increased the number of years we can hope to live, but that serves to make the problem of inadequate retirement savings even worse.

The following collection of facts serve to make the point:

- The number of retirees will double as baby boomers move into retirement age.
- The proportion of active workers per retiree will move from three to one today to two to one by 2030.
- The national savings rate ran about eight percent from World War II to 1980, dropped to four percent thereafter and languishes today at or slightly below one percent. (Some contend this data, drawn from the Commerce Dept., does not capture all of the resources families have available—like home equity. In any event, however, our rate of savings is declining when it needs to be increasing.)
- 70 percent of those with 401(k) plans have balances below $30,000 and nearly half (48 percent) are below $10,000.
- The fastest growing segment of our population are Americans 85 years and older.

The conclusions I draw from all of this is that stepping up retirement savings rates is a true national imperative. Like the line from the old muffler ad, our choice is a "pay now or pay later" proposition. Either we take steps now to help families accumulate retirement savings so they can meet their needs with their own resources or we pay later with publicly funded programs providing the support people require.

Mr. Chairman and committee members, you will consider many areas worthy of tax relief. I strongly believe that tax cuts which help families save for retirement is excellent tax policy which returns the long term dividend of reducing the demand on public programs down the road.

RETIREMENT SAVINGS FOR MIDDLE AND MODEST INCOME FAMILIES

Perhaps the most successful retirement savings are achieved through workplace retirement plans, but only half of those in the workforce today have this savings opportunity. In rural states the problem is even more severe. In North Dakota, for example, only four workers out of ten have workplace retirement savings programs.

Congress needs to continue to enhance the incentive for private retirement savings through vehicles like Individual Retirement Accounts (IRAs). Last Congress strengthen IRA incentives in several ways, most notably the creation of the Roth IRA. It did not, however, increase or strengthen the IRA incentive for households that find it most difficult to save, those earning $50,000 annually or less.

It is not surprising that the more modest the income the more difficult it is to set money aside for retirement. Discretionary dollars get stretched thin just covering basic living expenses ranging from school clothes to car repairs. Modest income families need a more meaningful savings incentive.

I propose increasing the incentive by establishing a 50 percent tax credit for IRA contributions of $2,000 or less each year for families earning $50,000 and individuals earning $25,000 annually.

This proposal is contained in H.R. 226, the Family Retirement Saving Act. It would be my expectation that the credit opportunity could be marketed similar to the employer match incentive in place in many, many employment based retirement plans across the country. I believe the employer match has proven itself to be the single most effective savings incentive we have going. Let's try to apply this dynamic to the Individual Retirement Account for our middle and modest income families.

Remember, the new IRA incentives last Congress went to those earning between $50,000 and $150,000 annually. It's time we direct additional help in this area to those who need it most, households at $50,000 and below.

SUPPORT FOR PENSION PLANS

Of all employer based retirement savings programs, none provide a more dependable stream of income in retirement than the traditional defined benefit pension plans. Over the last 20 years, however, the number of employees covered under pensions has declined even while the workforce has significantly expanded. In addition, the number of employers offering defined benefit plans has collapsed.

Congress and the past several Administrations bear much of the responsibility for this disturbing trend by reducing incentives for employers while increasing the complexity and cost administering a plan to employers. The problem has been particularly acute for small employers.

In 1996 Congress passed regulatory relief for small employers offering defined contribution plans. This legislation, known by its acronym SIMPLE, has proven successful in the marketplace. Now it's time to advance a similar small employer initiative for defined benefit plans.

This week Congresswoman Nancy Johnson and I introduced H.R. 2190, which is substantially identical to our SAFE proposal from the last Congress. This bill would significantly increase the appeal to employers of offering a defined benefit plan and would greatly simplify the administrative burden by reducing complexity and cost of compliance.

I am also pleased to cosponsor the important legislation proposed by Committee members Rob Portman and Ben Cardin. The Portman-Cardin bill represents a comprehensive, significant effort to further stimulate employer based retirement savings plans.

MAKING RETIREMENT SAVINGS PORTABLE

Mr. Chairman, it costs money to create new incentives for retirement savings regardless of whether we expand IRAs or address employer based plans. I recognize the size of the tax relief legislation will dictate what, if anything, we can accomplish in this area.

Regardless of whether we create new incentives to save (and I hope we do!) It does not cost much money to tackle disincentives to retirement savings that accumulated over the years.

One of the most significant barriers to savings is the lack of portability of retirement savings. In some instances these barriers are a happenstance creation of the tax code that serve no public purpose whatsoever.

Take for example the inability to move savings among three common forms of defined contribution plans: 401(k), 403(b), and 457.

If you begin your career working for state government you save under a 457 plan. Moving to a nonprofit may avail you of a 403(b) opportunity. In your next job perhaps you would have a private for profit 401(k) savings plan. Each plan is a defined contribution plan but rollovers from one to another are prohibited.

As a result, people often have their accounts dispersed and all too often these funds do not get fully reinvested. In fact, at least 60 percent of the time funds dispersed are not put back into retirement savings.

In order to address this problem, I have introduced H.R. 739, the Retirement Account Portability Act (the RAP Act), with Rep. Jim Kolbe. This bill unravels the regulatory complexity and ends the statutory barriers that prevent workers from moving their pensions with them from job to job.

This bill has industry and labor support, and has been endorsed by the Clinton Administration and is included in the bipartisan Portman-Cardin bill. Best of all, RAP has only negligible cost to the Treasury. Enacting RAP this year is an achievable goal that will greatly enhance workplace savings.

Mr. Chairman, I thank you for your leadership on this issue and look forward to working with you.

Chairman ARCHER. The Chair appreciates the testimony by each of you, all of which is very constructive, and now the Chair asks if any Members would like to inquire.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman.

I also want to compliment the Members. You are dealing with two areas that are absolutely critical, and you have suggested a number of very, what I would consider simple, commonsense changes, especially the idea of portability, especially the ability of setting up a structure which allows for retirement security. But I listened very carefully and I didn't hear any mention—I may have been negligent, but I don't think so—of long-term care proposals.

I tell my friend from North Dakota that Fram oil filters spent a lot of money on that ad, and they are sorry you referenced a muffler. The pay me now or pay me later ad is a good example. The pitch is a cheap oil filter change and—oil change and oil filter—or pay me for a replaced engine.

Today, given the point that all of you mentioned in terms of Americans living longer, the simplest fix for long-term care is the time value of money because of the more predictable need for that care in later life. So I would just urge you, as you are looking at the very positive suggested changes, if you are able to expand by definition or structurally include the ability to pay for long-term care from a fund created over time, health insurance today tends to be acute. Medicare in terms of health care needs for seniors is acute. We have some surrogates for long-term care today in Medicare, but they, unfortunately, are the fastest growing and most difficult to control price areas.

So, in that sense, I would hope that you think about long-term care as part of a comprehensive retirement security package.

Mr. Chairman, I tell you just as recently as yesterday the Health Subcommittee held a hearing on the uninsured. What we got out of it was basically that there is no single or simple solution.

Although 43 million Americans are uninsured, when you begin examining the various groups, you find some that make incomes of more than $50,000, and they choose not to participate in a program. What we have been told is that even if you put billions of dollars into a program, the percentage change, especially if it is a tax credit to try to buy down the cost of that insurance, produces only modest increases in the number of people who participate in the program.

Even in those areas that it is 100-percent paid for, for low-income, Medicaid and the S–CHIP, State Children's Health Insurance Program, from the Balanced Budget Act of 1997, 13.4 percent of those who are currently uninsured qualify for that program. So what we have to do is look at our attempts to provide assistance to people who do not now have health insurance. We showed it in a way that maximizes the number of people who receive it but that, too, shows we are not fooled by the belief that the solution to this problem is a simple one or that there is a single approach to the very complex picture of who is among the uninsured today.

But I want to underscore the ideas that you are presenting, especially to my friends Mr. Portman and Mr. Cardin, frankly, I think are just long overdue. No one looked at them. No one focused on them. No one pulled them together. You folks have. I give you plenty of credit for that.

Mrs. Johnson, I know, has been wrestling with this question, as has Mr. Stark on the health care provision. It is something I think that we need to work on, begin the process, but that it clearly is not subject to a single fix.

And with that, Mr. Chairman, if anyone wants to respond to anything I said, I would appreciate it. But, please, long-term care is an ongoing need. It will increase, and it ought to be simple, on the time value of money to look into some kind of pension structure.

Chairman ARCHER. You have 1 minute to respond.

Mrs. JOHNSON of Connecticut. If I may just briefly call your attention to the bill that Karen Thurman and I introduced that is focused on long-term care. I didn't have time to go into it in much detail.

It does have four provisions. It not only for the first time rewards holding of long-term care insurance over time so the deduction goes up for the number of years that you hold it for the first 5 years, but it also provides a recognition of the tremendous contribution that in-home care givers provide and eliminates this arbitrary limit on partnership, State partnerships, that help people, induce them to buy long-term care insurance, an arbitrary provision of Federal law.

Last, it has a very aggressive educational program so people will really understand that neither Medicare nor Medicaid provide long-term care except under extraordinary circumstances. So the educational provisions are about as important as anything else.

Mr. THOMAS. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you.

Let me first thank my colleagues for the work they have put into these very meaningful proposals that are before us.

Mrs. Johnson, do you believe that we can handle on this Committee Social Security, Medicare, and tax cuts this year?

Mrs. JOHNSON of Connecticut. I think we can certainly do Social Security reform. I think we can and should do Medicare reform. I think we can do pension reform. Those are three of the—and long-term care reform. So I think we can do retirement security reform, and I think the tax reform bill, the effort to cut taxes, will have to be paired with the development of surpluses that are over and above the Social Security surpluses.

But we do expect to move into years when we have a genuine surplus over and above Social Security revenues next year and the years thereafter, and I think it is appropriate for this Committee to set economic policy, particularly since we have heard how catastrophically low our savings rate is. I think it is actually imperative for this Committee to set some course for this Nation through long-term tax policy and not leave the Members thinking this is all going to be free dollars to spend on new programs. Our savings rate is catastrophic. There are big problems in our providing retirement security, long-term care security and those things. So I think almost all of the balls are in the court of this Committee in terms of using our resources as a nation into the future to provide a strong economy and retirement security.

Mr. RANGEL. And the tax cut would be based on projected surpluses after Social Security?

Mrs. JOHNSON of Connecticut. We have all agreed that we are not going to use Social Security revenues for anything other than Social Security. So that is a bipartisan agreement and we are going to stick to it.

Mr. RANGEL. And Medicare?

Mrs. JOHNSON of Connecticut. We did set aside 62 percent for Social Security and 15 percent for Medicare, so there is some ability to use that surplus to solve the immediate problems in Medicare, which I consider to be acute and also for long-term reform of Medicare.

Mr. RANGEL. If we did have a tax cut, what year do you think that it would become effective?

Mrs. JOHNSON of Connecticut. First of all, I would hope that part of it would become effective almost immediately. The research and development tax credits expire. The work opportunities tax credit, which is critical to the reemployment, to the employment of welfare recipients, expires.

Just like we have to budget every year, we have to pass some kind of tax legislation every year. As to bigger provisions, they will depend on the estimates as to when the surpluses exceed the Social Security tax revenues.

The other provisions in my personal, I am not speaking for anyone but myself, I think the extension of the R&D, the extension of the work opportunities tax credits demand the same attention as the appropriations proposals that we have on the floor because losing continuity or breaks in those—that tax law are very costly to both the people and the businesses that we count on to make our economy strong. I want to make sure that they go ahead immediately.

Mr. RANGEL. Do you agree that we ought to enact the revenue neutral extended tax bill to make certain that we don't have the extended included in the appropriations bill?

Mrs. JOHNSON of Connecticut. I think this Congress under both Republican and Democratic leadership have used a reconciliation very effectively to make sure that the key interests of the Nation are addressed across the board, whether they are in the tax area or the appropriations area. While it may be necessary to use that instrument to some extent this year, I think this Committee, under this Chairman, is going to pass tax legislation that will stake out in a sense the tax policy that will strengthen our economy over the long-term and address some of the problems that we have raised today about retirement security, pension reform and savings rates.

Mr. RANGEL. What size tax cuts do you think that we are talking about?

Mrs. JOHNSON of Connecticut. We have a large surplus predicted in the outyears, and I think it is our responsibility as the tax Committee to help the public understand that sound tax policy is critical to a strong economy and a secure society in the future. We are at the threshold of seeing our major retirement security plans collapse, not just Social Security but pensions, too.

Mr. RANGEL. What size——

Mrs. JOHNSON of Connecticut. I would say most of that surplus ought to be in that tax bill and not be available for new programs.

The new program demands should be met by making government far more efficient than it has been in the past.

Mr. RANGEL. What size tax cut do you think we are talking about?

Mrs. JOHNSON of Connecticut. I don't know what the surpluses will be, Mr. Rangel. I can't answer that.

Mr. RANGEL. You have no idea what we are looking for in the tax bill, though?

Mrs. JOHNSON of Connecticut. The projections are several hundred billion in 5 years, and many more hundred billions in 10 years.

Mr. RANGEL. Would 800 billion over 10 years sound like what——

Mrs. JOHNSON of Connecticut. That is what the estimators are saying. My goal is that we stake out the majority of that money and demonstrate to the people of America how we can strengthen the economy and secure us each individually in our lives and in our retirement, and I think that is the number one obligation of this Congress and far exceeds our obligation to spend that on programs in the future.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. Kleczka.

Mr. KLECZKA. A quick question to Mrs. Johnson, you just indicated that you think the Congress should, and I am paraphrasing, stake out the majority of that money for programs that this panel is talking about? For what type of tax cuts?

Mrs. JOHNSON of Connecticut. This is not a hearing on the tax bill and so there is no sense in my going into the details.

Mr. KLECZKA. Everything that has been discussed by this panel could be included in the tax bill.

Mrs. JOHNSON of Connecticut. That is why the Chairman is very wise to have a hearing on retirement security.

Mr. KLECZKA. I was hoping that you were saying that we should stake out a majority of that surplus for the things that we are talking about today. Otherwise what this Committee is doing is raising some false hopes with the public by having an all-day hearing on retirement security and health security. And I say if we were to pick up a small portion of all of your good ideas, 10 percent of Jefferson and 10 percent of Pomeroy and 2 percent of the Stark because of the cost, that would more than eat up the surplus and there would be no room for estate tax changes or capital gains tax elimination.

So I think we as a Congress have to make some priorities. Are these our priorities, the items discussed at this all-day hearing on things that are so important not only to the economy but to so many Americans? My answer to that is "Yes." We are all talking about all sorts of new savings instruments. USA accounts are proposed by the administration, the Chairman has a new Social Security account which has a mix of stocks and bonds. We are recreating the wheel here, my friends. We have the savings instruments in place today. Let's make them meaningful. Let's take our IRAs and boost them. Let us increase the 401K caps. Let us provide for portability and some type of interweaving of the current pension plans, like Mr. Pomeroy says.

One of the issues that I have been working on is health care for retirees. I had a GAO study done which indicated more and more employers are willy nilly canceling their retiree health care.

I had a situation in my district with Pabst Brewing Co. where the retirees woke up 1 day and found that the employer just canceled their health benefits. I am talking regular retirees and early retirees. I had a situation with a constituent, an early retiree who had a wife with MS at home. With the early retirement package offered to him at age 55 which included coverage for health care for his wife's condition, he thought that he could make it and go home and take care of his wife. The day that they canceled his benefits, he found out that his health insurance premium with a private insurance plan cost more per month than his entire retirement benefit.

So what we are talking about today is important, but my friends, it would take the entire surplus that is projected, not the Social Security surplus, to address a piece of those needs.

Mr. Portman, what is the CBO estimate of your pension bill and Mr. Cardin's pension bill, which I happen to be a supporter of?

Mr. PORTMAN. You sound like a Chairman talking about working on priorities. We don't have a Joint Tax Committee estimate yet for this year. We are promised one this week. We asked for it back in April.

Last year's bill, which is substantially similar to this year's bill, was roughly $9 billion exclusive of the minimum distribution proposal over a 5-year period. But remember, we are talking about a substantial surplus and a possibility of substantial tax relief bill. Over the next few days, we will have an estimate and it may be higher because we do get into the IRAs, raising the limit from $2,000 to $5,000 in IRAs. If you take that out, we hope to be close to where we were last year.

Mr. KLECZKA. If we are serious about the dialog that we are having today in the Committee, if we are even going to put a dent into these problems, problems facing regular Americans, it would take the entire surplus.

So as the Chairman talks about the estate tax and others talk around Capitol Hill about eliminating the capital gains tax, know that there is not going to be any room for that, plus the extenders, which is an expensive piece of pie.

Mr. Chairman, I thank you for your time. Let's not forget our retirees and their health care. I will be introducing legislation to help retirees age 55 through 64. You can offer them tax deductions for their health care premiums, but if they don't have the income to offset it, what is the sense? I will have a proposal in the next few weeks which would truly help retirees and hopefully you folks on the panel will cosponsor what I introduce.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman from Wisconsin has given the Committee a sneak preview of the real challenge that will be before the Committee, which is to accommodate the multiplicity of good ideas within the dollars that are available to us under the budget. Although we do not have the final estimate on the Portman-Cardin-Kleczka, and so forth, bill, simply raising the limit on IRAs from $2,000 to $5,000 a year cost $38 billion over 10 years. That number I do know.

In the end we are going to have to really examine priorities. I am always fascinated as chairman that I can't simply go out and cosponsor every bill for all of the good things that we want to see done in tax relief in the Tax Code. Members individually can do that. So when a good idea comes along, it is easy to jump on board, and then we have bills that have a hundred, 200 cosponsors. If each Member began to consider the revenue losses that in the aggregate occur as a result of all the bills that he or she has cosponsored, we would find that it is an impossibility to accomplish all of that.

So the gentleman from Wisconsin has put his finger on a very sensitive point that we have all got to consider because retirement security is exceedingly important, and that is not just the pension side, that is also the health side, which includes long-term care. But there are many, many other items that are important, too, in a tax bill. We have to sort through that.

Mr. Portman.

Mr. PORTMAN. If I can just make one comment which relates to what Mr. Kleczka and you have raised with regard to the revenue impact, we need to keep in mind what you have stated a number of times in reference to the guarantee accounts in your Social Security proposal, which is with regard to the pension side, this is going to increase our savings rate in this country, meaning there will be more money invested in the markets. There will be more capital formation and increased revenues from that. If the Joint Tax Committee had the ability to do a dynamic score, it would look quite different, and I just raise that because some tax proposals will result in higher savings and more general revenues coming in as a result of better economic conditions.

With regard to retirement security, I hope we look at it in that context and in the context of how cost effective it is. In the retirement area, as you know, you are leveraging a lot of private dollars and the nondiscrimination rules ensure that. It is an awfully good bargain for the Treasury and you will have a much more cost effective way of handling retirement needs by making some of these common-sense changes on the retirement side.

Chairman ARCHER. The issue before us today is a wonderful way to kick off our hearings, but we will be holding hearings on other aspects of tax relief as we go along.

I am particularly looking forward to how we tax foreign-source income and what that is doing to put barriers before our ability to compete in the world marketplace, which is going to be essential to our economy in the next century. If we don't win the battle of the global marketplace, we are not going to have the resources to do all of the things that we need to do in the next century. I hope every Member will try to attend that hearing.

I think Ms. Dunn wants to be recognized, and then Mr. Weller.

Ms. DUNN. Before this panel leaves, I want to call attention to one of the provisions in Mr. Portman's very excellent pension reform bill that shows how important education is to retirement. There is an area of tax treatment of employer provided advice to employees on retirement planning, and this is currently a benefit that employers provide to employees. They educate their employees on the importance of saving for retirement. Currently, this has been treated as a fringe benefit by the IRS, but there is some concern that the IRS may change their treatment, their tax treatment of this particular fringe benefit and calculate it as part of the employee's income. I have some concerns about that, and the Portman-Cardin bill would codify current practice so that it continues to be a fringe benefit. It is not calculated as part of income and therefore is much more easily given by employers and received by employees.

Mr. PORTMAN. I thank the gentlewoman. Let me also thank her for her help with the catchup provisions in this legislation which we did not have a chance to get into. Ms. Dunn helped us to focus on that issue which allows for every individual coming into the work force at age 50 or above to add an additional $5,000 annually to a defined contribution plan, for instance a 401(k). Who is this going to benefit, all baby boomers but primarily working moms who are coming back into the work force and want to be able to set aside enough of a nest egg. When you are coming in late in the game because of, as Mr. Thomas indicated earlier, the time value of money and compounding interest, you want to give these people an additional incentive.

On the education side, it is a very important provision of the bill. Additionally, I think the impact of having these increased contribution limits and encouraging small companies to get into these plans is based on two things, and this is based on talks with a lot of folks from around the country. One is more education because the way that the nondiscrimination rules work, owners are going to have to get the middle paid and low-income workers involved in the plans in order for the plans to meet the nondiscrimination and top-heavy rules. So education is a more important component of this, which is great for this country and great for workers.

Second would be bigger matches to encourage again these workers who are perhaps not as interested in thinking about their retirement, to have some financial incentive. And those matches are private money going into the system that might not otherwise be there which will help us with regard to our savings rate.

So I thank the gentlewoman for her support and all of her contributions.

Chairman ARCHER. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and I will direct my question to Mr. Portman. I too want to salute you on a couple of issues, and I want to mention the catch-up issue which you have already discussed regarding giving an opportunity particularly to working moms who are trying to make up for missed contributions when they were out of the work force while they were home taking care of the kids. And I think of my own sister Pat, who was out of the work force for years, and who, of course, I believe deserves the opportunity to make up for that missed contribution.

I want to direct my question specifically, Mr. Portman, to the 415 pension issue, and of course I have been working with you and you have a provision in your legislation and I have H.R. 1297, which addresses the 415 issue, which I personally think is an issue of fairness, and Mrs. Johnson is also cosponsoring our legislation.

The 415 pension limits are arbitrary limits which limit the ability of construction workers, those who work for several employers. Many times a construction worker can work for two or three different contractors. That is why they are in multiemployer pension funds, but these limitations unfortunately have really penalized folks who get up early, sweat and toil, get their hands dirty, and in many cases they work so hard at a younger age they are burnt out and worn out. And of course the issue of the 415 when it is brought to my attention is usually by a group of spouses of laborers, ironworkers, operating engineers who have gone to work early and of course they come home late and tired, and they found out that their pension that they were promised was not quite what they—it did not turn out quite as it should be because of the 415 limits.

I have a letter here from Laurie Kohr, wife of Larry Kohr, a construction worker from Peru, Illinois, and I would like to insert this into the record.

Chairman ARCHER. Without objection, so ordered.

[The information follows:]

Congressman Weller,

My husband Larry has been a member of a local union for 21 years. He has worked as a laborer and laborer foreman for a local construction company.

We were delighted when we learned in June 1997 that his hard work had paid off and that he had in his 30 credits to retire.

You can only imagine our disappointment when we were told that he couldn't collect his full pension because of IRC 415. At age 38, and that he attained his credit hours just one company his monthly allotment went from $33330.50/mon. To $1598.21/mon.

For us it was a wake up call. It was the first time we had heard of IRC 415. Since that time and through a lot of research we have learned a lot.

We have learned that government employees are exempt from 415. You only have to be in Congress 2 years to have a secure pension.

We have learned that legislation has been introduced for the last 3 years and still 415 is affecting many people, not only Larry.

We have also learned that hard work and loyalty to one company doesn't always pay-off. This is the hardest lesson of all.

Again, I ask your help. IRC 415 is unfair in more ways than I go into here. So, I count on you as my representative to make it fair, for everyone.

I am sincerely grateful for all you have done and I hope to hear from you soon.

LORI KOHR
Peru, Illinois

Mr. WELLER. Thank you. Laurie points out that her husband, Larry, because of the 415 limits, he has retired after 20 years as a construction worker, and as I pointed out earlier, construction is a pretty physically demanding trade, a tremendous amount of physical activity, and he recently retired. And when he was working, he anticipated that under his pension plan, his multiemployer pension plan, he would receive almost $40,000 per year, about $3,300 a month before taxes. But because of the 415 limits, after 20 years of working hard and contributing because of overtime even more than anticipated into his pension fund, he is only receiving about $19,178 a year or about $1,500 a month and that is less than half of what he is entitled to. So these 415 limits are costing real families like Laurie and Larry Kohr real money and they are being punished.

Mr. Portman, my question is when it comes down to it, would lifting these 415 limits, would they affect the solvency or jeopardize the integrity of these multiemployer pension funds?

Mr. PORTMAN. No, my understanding is that it won't affect the solvency of the plans or the funding of the plans. You are exactly right, the focus of this is not on the higher paid workers, it is on the workers like the example you used. The higher paid workers are not going to worry about the 100 percent of compensation limit because they won't bump up against it. So although this proposal has been opposed by some people in the past as being helpful to higher paid workers, the focus in multiemployer plans is on the person who is the construction worker, who is laying the carpet, because this is the person based on his years of service and the formula the contribution is based on who should get a certain amount but then this arbitrary limit comes in and knocks it down.

Mr. WELLER. These 415 limits were established almost 20 years ago. Essentially, they were to go after some corporate executives who had golden parachutes that they were trying to create for themselves, but over the years these limits have changed, and there are some groups which have been taken out. It is my understanding that both teachers, public employees were affected by the 415 limits and this Committee and this Congress saw the merits of lifting them out from under the 415 limits.

Mr. PORTMAN. That is correct.

Mr. WELLER. I know that Mrs. Johnson played a role in that. I consider this a fairness issue for the little guy and little gal, and I am interested in working with you and the Chairman and others on the Committee to ensure that we address this fairness issue and lift those who work hard and play by the rules, those who work in the construction trades, out from under these 415 limits, and I appreciate your cooperation.

Mr. PORTMAN. I appreciate all of the work that the gentleman has put into the multiemployer issue generally in his own bill which I have cosponsored and in helping ours.

Chairman ARCHER. The Chair again thanks the Members of the panel for their participation. It has been very, very helpful.

The next panel is now invited to come sit at the witness table, Dr. Goodman, Dr. Butler, Mr. Kahn, Ms. Lehnhard, Mr. Wilford, and Ms. Hoenicke. The Chair welcomes each of you and looks forward to your presentation.

Dr. Goodman, would you lead off. And would you for the record identify yourself before you begin your testimony.

STATEMENT OF JOHN C. GOODMAN, PH.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. GOODMAN. My name is John Goodman. I am President of the National Center for Policy Analysis. Mr. Chairman, the number of Americans who are uninsured is 43 million and rising. This is occurring in the midst of a booming economy with unemployment at alltime lows. We are spending an enormous amount of money on this problem, but the more we spend, the worse the problem seems to get. We are spending more than a $100 billion on tax subsidies for private insurance, yet while some companies have lavish health coverage subsidized by the Federal Government to the tune of 50 cents on the dollar, other Americans get no tax relief when they purchase their own insurance. And among families who have insurance, those in the top fifth of the income distribution get 6 times as much help as those in the bottom fifth.

We are also spending an enormous amount of money on health care for the uninsured, by our count more than $1,000 per year for every uninsured person on a hodgepodge of programs, yet there is no overriding mechanism that ensures that resources are matched with needs and there is no way for an uninsured person to take his $1,000 and spend it on private insurance instead. There is a better way.

I propose a compact between the Federal Government and the American people in which the Federal Government defines its financial interest in this question and offers to every individual and every family a fixed-sum refundable tax credit so that people who have health insurance see their taxes reduced and when they cease having health insurance, their taxes are increased. An important part of this proposal is the idea of the local health care safety net. Under the current system, people who are uninsured already pay higher taxes precisely because they don't get the same tax relief as people who have tax-subsidized insurance. By our count, the uninsured pay as much in extra taxes each year as the amount of free care that they get at the Nation's hospitals. The problem is that these extra taxes go to the Treasury and are folded into general revenues while the local hospitals must find the resources to pay for the free care.

As an alternative, I propose that the unclaimed tax credit money be given to state governments in the form of a block grant with only one proviso, that it be spent on indigent health care. So the Federal Government would offer every family a fixed sum of money. We hope that they choose to spend it on private insurance, but if they don't, that money becomes part of a safety net for those people who cannot pay their medical bills.

I propose that we phase in the system in a reasonable way. We should begin immediately to give people who purchase their own insurance the tax credit. We should give the self-employed the option to remain in the tax deduction system or the tax credit system, and we should give every employer the option to remain in the current tax exclusion system or switching to the tax credit system. Once in the tax credit system, we would no longer be subsidizing wasteful health insurance plans. The Federal Government would subsidize only core coverage and people would buy additional coverage with their own aftertax dollars. We would put employer-provided insurance and individually purchased insurance on a level playingfield so that the role of the employer would be determined in the marketplace and not by the vagaries of tax law.

We also need to put third-party insurance and self-insurance through medical savings accounts on a level playingfield. The current system encourages us to give all of our money to HMOs and encourages abuses of managed care and rationing imposed by employers. As an alternative to this, we need to expand existing MSAs, medical savings accounts, and we need to offer every American a new kind of MSA, a Roth MSA. This is an MSA that would wrap around any health insurance plan, an HMO, a PPO, fee-for-service, and so forth.

This plan, Mr. Chairman, also addresses two characteristics of the uninsured that have been ignored by previous plans, and that is most of the uninsured are uninsured only temporarily for part of a year and that the low-income insured need their tax refund money at the time the premiums are due in order to avoid a loss of take-home pay. I believe there are workable mechanisms already in place to solve these problems.

Finally, Mr. Chairman, this plan could be paid for with money that is already in the system. The $40 billion that we now spend on the uninsured is one source. The $100 billion that we are spending on tax subsidies is another source. And we can also carve out existing tax preferences. I see no reason why middle-income families should get the $500 tax credit for a child if the child is uninsured. I see no reason why middle-income families should get the full value of its personal exemption if the family is uninsured, and I see no reason why a low-income family should get a $1,000 EITC, earned income tax credit, refund for a child if that child is uninsured.

Clearly, these choices are political and they are yours to make, but I think the goal is one which the vast majority of Americans would support.

Thank you.

[The prepared statement follows:]

Statement of John C. Goodman, Ph.D., President and Chief Executive Officer, National Center for Policy Analysis

Unwise government policies are largely responsible for the fact that the number of Americans without health insurance is 43 million and rising. Unwise government policies also are responsible for the fact that people who have health insurance are turning over an ever-larger share of their health care dollars to managed care bureaucracies that limit patient choices and sometimes give providers perverse incentives to deny care.

After many discussions with others involved in health care policy, including analysts at other think tanks, representatives of the industry, the medical community and the government, as well as members of Congress and their staffs, we at the National Center for Policy Analysis have concluded that we must fundamentally alter federal government policies to eliminate distorted incentives, empower individuals and create new options in the health insurance marketplace.

What I am proposing would not increase the financial role of government. The federal and state governments already spend more than enough on health care and health insurance through tax subsidies and direct spending programs. Instead, what is needed is a radical reordering of government programs to make them efficient and fair.

I. UNIVERSAL COVERAGE

Whether or not people have health insurance is a national issue in which the federal government has a legitimate interest. Therefore, we propose that the federal government commit a fixed sum of money for health insurance for every American (say, $800 per adult and $2,400 for a family of four). The commitment should be the same for everyone—rich or poor, black or white, male or female.

Everyone who purchases private health insurance would be rewarded with a dollar-for-dollar reduction in income taxes for health insurance costs up to a maximum amount (e.g., $2,400 for a family of four). The credit would be fully refundable, so even those who owe no income taxes would get the same financial help.

The federal role would be purely financial. Private health insurance benefits would be determined by individual choice, competitive markets and state regulations. This plan is not designed to subsidize the full cost of health insurance for an average family. In most cases, the federal tax relief probably would fund only a core benefits package with a very high deductible. Individuals and their employers would be free to purchase more complete benefit packages, but they would pay the difference with aftertax (unsubsidized) dollars.

II. A HEALTH CARE SAFETY NET FOR THE UNINSURED

No one would be forced to purchase private health insurance. But those who failed to buy private insurance would pay higher taxes because they would receive no tax subsidy. Unlike the current system under which higher taxes paid by the uninsured simply become part of the Treasury Department's general revenues, the "tax penalties" paid by the uninsured would be rebated to state and local governments for local Health Care Safety Nets. This would ensure that those who elect to remain uninsured would have access to a social safety net with a guaranteed minimum level of funding.

This federal money for local Health Care Safety Nets would be like a block grant with one condition: the money would have to be spent on indigent health care. However, no uninsured person would have the right to demand a particular health care service from the Safety Net. Local authorities would also be free to charge fees to the uninsured—especially if it appeared that their lack of insurance was willful.

Safety Net services may not be as desirable as services provided by private insurance. Although the commitment of federal dollars to the two alternatives (private insurance or Safety Nets) would be the same, the amount of money per capita available to local Safety Nets is expected to be less than the resources available through private insurance. Thus Safety Net doctors might not always be the very best doctors, Safety Net programs might not be able to meet every health care need, and there might be some waiting. These features are consistent with the overall goal of creating some form of universal coverage while at the same time encouraging private rather than public provision of health care.

These local Health Care Safety Nets could be partly funded with federal health dollars currently going to the states and partly funded by state dollars that currently fund health care for the uninsured. Under this plan, states would receive more federal money if their uninsured population expanded and less money if it contracted—unlike the current system, where there is no necessarily relationship between the amount of federal funding and any objective measure of need. Under the plan I am describing, the federal government could discharge its commitment to the states by counting against that commitment dollars in current programs that fund indigent health care, provided the states gain full freedom and flexibility to use those funds to meet the needs of the uninsured.

Safety Net dollars could also be used to fund high-risk pools. Under current law, states must create opportunities for certain uninsurable individuals—those who were previously insured—to obtain health insurance; and many have satisfied this obligation by creating high-risk pools. This plan would encourage the expansion of such risk pools by allowing Safety Net money to fund them.

III. TAX FAIRNESS

For the first time, individuals who purchase their own health insurance would receive just as much tax relief as is provided to employer-sponsored plans. Under the current system, employer payments for health insurance are excluded from the employee's taxable income—cutting the cost of health insurance in half for some middle-income families. By contrast, many individuals who purchase their own health insurance must do so with aftertax dollars—forcing some people to earn twice as much before taxes in order to purchase the same insurance. This plan would provide the same tax relief to every taxpayer—regardless of how the insurance is purchased.

For the first time, low-and moderate-income families would receive just as much tax relief as is provided to high-income families. Under the current tax exclusion system, those in the highest tax brackets get the most tax subsidy for employer-provided health insurance—the top 20 percent of families get six times as much help from the federal government as the bottom fifth. Under this plan, every family would get the same tax relief—regardless of the family's personal income tax bracket.

IV. A RATIONAL ROLE FOR EMPLOYERS

Under this reformed system, employer-purchased insurance and individually purchased insurance would be put on a level playing field under the tax law. For those who obtain insurance under the tax credit system, amounts spent by the employer on health insurance would be included in the employees' taxable income. However, employees would receive a tax credit on their personal income tax returns—the same tax credit that would be available to people who purchase their own insurance. In this way, people would get the same tax relief for the purchase of private health insurance, regardless of how it was purchased.

The employer's role would be determined in the marketplace, rather than by tax law. Some health reform proposals would require employers to provide health insurance; others would force employers out of the health insurance business. By contrast, this plan would allow the market to determine the employer's role: if employers have a comparative advantage in organizing the purchase of insurance for their employees, competition for labor will force them into that role; if employers have no special advantage, they will avoid that role.

V. PRESERVING EMPLOYER OPTIONS, BUT REWARDING GOOD CHOICES

Employers would have the option of keeping their employees in the current tax regime. Because many employers and their employees have made plans and organized their financial affairs around the current tax law, an abrupt change to the new system could be unfair. However, most employers would have an economic incentive to switch to the tax credit system because that would allow them to cut waste and inefficiency out of their health care plans without losing tax benefits.

Because the current tax exclusion system rewards those in the highest tax bracket the most, it favors high-income employees. Because the tax credit system treats all taxpayers equally, switching to it would help almost all low-and moderate-income employees. Even though their higher-income employees might pay higher taxes as a result, employers who helped their low-income employees by switching to a tax credit regime would be rewarded: the new tax regime would lower the cost of their compensation packages and make it easier for them to compete for employees in the labor market.

VI. INCENTIVES TO REDUCE WASTE AND INEFFICIENCY

The tax credit system described here would give employers and employees new opportunities to reduce health care costs. Under the current tax exclusion system, employees can reduce their tax liability by choosing (through their employers) more expensive health insurance plans. As a result, the federal tax system encourages overinsurance and waste: An employee in a 50 percent tax bracket (including state and local taxes) will tend to prefer a dollar's worth of health insurance to a dollar of wages even if the health insurance has a value of only 51 cents. By contrast, under the tax credit system no one would be able to reduce his or her taxes by purchasing more expensive insurance. Since marginal improvements in a health benefits package under the tax credit system could be purchased only with aftertax dollars, no one would spend an extra dollar on health insurance unless it produced a dollar's worth of value.

The tax credit system would allow employees to manage some of their own health care dollars. Current tax law rewards employees who turn over all their health care dollars to an employer health plan (by excluding such money from taxable income), but penalizes (by taxing) income placed in a Medical Savings Account. The exception is the pilot MSA program for the self-employed and employees of small businesses. As a result, current law favors the HMO approach—in which the health plan controls all the health care dollars and makes all the important decisions—even though individuals might in many cases be better managers of their own health care money.

Under the new plan, individuals who chose the tax credit option would be able to deposit a certain amount of aftertax income—say, $2,000 per adult with a $5,000 family maximum—into a Roth MSA. Contributions to Roth MSAs would be allowed only for individuals who have at least catastrophic insurance. A Roth MSA would be a "wraparound" account, designed to fund the purchase of any medical expense not covered by a health plan; it could be used in conjunction with an HMO as well as fee-for-service insurance. Funds in a Roth MSA could only be used for medical care or would remain in the account to back up a health plan for at least one year. At the end of the one-year insurance period, Roth MSA funds could be withdrawn without penalty for any purpose, left in the account to grow tax free, or rolled over into a Roth IRA.

This change would put third-party insurance and individual self-insurance on a level playing field under the tax law. The Roth MSA option would correct the bias in the current tax law. Beyond a basic level of insurance funded by the tax credit, individuals would choose to spend their aftertax dollars on more insurance benefits or place those same dollars in a Roth MSA. No one would have an incentive to turn over additional dollars to a health plan unless they judged that the extra benefits were more valuable than of depositing an equal amount in a Roth MSA.

Just as the tax exclusion for employer-provided health insurance encourages people to overinsure, the current system of Flexible Spending Accounts (FSAs) encourages people to overconsume. As it now stands, employees make pre-tax deposits to an FSA to pay their share of premiums and to purchase services not covered by the employers' health plan. A use-it-or-lose-it rule requires that employees spend the entire sum or forfeit any year-end balance in the account. This rule encourages wasteful spending on medical care at year-end. Under the new plan, employees in the tax credit system would no longer have an FSA option. Instead, they would have a use-it-or-save-it Roth MSA option.

VII. OPTIONS FOR THE SELF-EMPLOYED

This plan gives the self-employed a new option: a tax deduction for the purchase of health insurance or a tax credit. Currently, the self-employed get a partial deduction for the purchase of health insurance, and eventually will get a 100 percent deduction. As an alternative, this plan would allow the self-employed to take a tax credit.

Under the current system, the self-employed may contribute to a conventional MSA, provided they have catastrophic insurance. Under this plan, the self-employed who elected the tax credit would be able to make deposits to a Roth MSA instead. They would be allowed to contribute to either a conventional MSA or a Roth MSA, but not both during the insurance period.

VIII. SOLUTION TO THE SPECIAL PROBLEMS OF THE UNINSURED

A refundable tax credit for the purchase of health insurance that was previously in the tax code failed because it did not address the cash flow problems of low-income families. It forced those families to rely on their own resources to meet premium payments for the year and wait for reimbursement until the following April 15. As a result, the program did not make funds available for the purchase of insurance at the time the funds were needed. This plan would solve that problem by allowing people to assign their rights to the credit to an insurance company month-by-month. The procedure would be similar to the one under which low-income families can obtain advance funds based on their right to collect the Earned Income Tax Credit (EITC) through a bank loan arranged by a firm such as H&R Block. In this way, individuals would be able to buy health insurance without reducing their monthly income. This plan also would allow the health insurance tax credit to be combined with the Earned Income Tax Credit (EITC), so that families could afford a more generous package of benefits.

Most people who are uninsured are working, and many have the opportunity to join an employer plan but decline to do so. One reason they decline is that they are required to pay a substantial part of the premium. Some join themselves but do not insure their dependents. This plan would solve the problem, using a procedure similar to the one just described. Currently, low-income employees who qualify for the EITC can file a form with their employer and receive their EITC "refunds" month by month. In a similar way, the health insurance tax credit could be accessed month by month and used to pay the employee's share of the premium. Thus low-income employees could insure themselves and their families with no reduction in take-home pay. Employees could also combine the health insurance tax credit with their EITC refund to obtain more generous coverage—again, with no reduction in take-home pay.

Employers would not be required to opt into the tax credit system, but those who did would be able to offer their employees a more attractive compensation package and gain a competitive edge in the labor market.

Most people who are uninsured are temporarily uninsured—usually for a period of less than one year. To meet the needs of these people, health reform must make a refundable health insurance tax credit flexible enough to fund health insurance coverage for part of a year. The techniques described above will allow low-income employees to pay premiums month by month or even pay period by pay period.

IX. HEALTH INSURANCE AND WORKFARE

The reforms proposed here would make Workfare work. For many families, one of the biggest obstacles to getting and staying off welfare is the lack of a private insurance alternative to Medicaid. This plan would make it possible for low-income families to buy into an employer health plan or to purchase insurance on their own.

A related problem concerns people who are laid off or are temporarily unemployed while they are between jobs. Periods of unemployment are typically periods when family financial resources are very limited. The refundable health insurance tax credit could bridge the gap, financing the purchase of short-term insurance or funding COBRA payments that continue coverage under a previous employer's plan. Funds in a Roth MSA also could help solve the problem, since such funds could be used to pay premiums during periods of temporary unemployment.

X. THE ROLE OF STATE AND LOCAL GOVERNMENTS

The plan I have outlined is the first plan that defines the roles of state and local governments in meeting the needs of the uninsured. By keeping the federal role purely financial, which largely continues current practice, the plan would make state governments responsible for regulating the terms and conditions under which health insurance would be bought and sold. However, the plan would retain the ERISA preemption that exempts from state regulation companies that self-insure because such companies are not purchasing insurance in the marketplace and because self-insurance often is a socially desirable alternative to costly state regulations. State governments also would be responsible for operating local Health Care Safety Nets. Once the federal financial obligation was discharged, state and local governments would assume funding responsibility for any remaining problems.

Although state governments would be obligated to spend federal safety net money on the uninsured, they could discharge this obligation in many ways. One way would be to set up clinics that dispense free services to the low-income uninsured. Another would be to enroll the uninsured in an expanded Medicaid program. A third option would be to supplement the federal grant and assist people in obtaining private health insurance.

Many states subsidize the purchase of private insurance by piggybacking on federal practice. They exclude employer payments from employee taxable income and/or create special tax relief for low-income families. These states could continue their current practices or adopt a tax credit at the state level. Most would quickly discover that the latter is a better use of state resources. States also would be allowed to supplement the federal tax credit with a state tax credit of their own design, and many probably would do so.

In general, states will find it in their interest to encourage private insurance, because private insurance will almost always involve an input of private resources through the family premium contributions, whereas the state burden will be greater if people depend on state and local funds to meet all their health care needs.

Many states have contributed to the growing number of uninsured through unwise regulations. These states could continue such practices, but they would pay a heavy (budgetary) price for doing so. Since the federal commitment under the new plan would be fixed, the federal government could not be held hostage to the vagaries of state law.

XI. FUNDING REFORM

Currently, the United States spends more than $100 billion on tax subsidies for employer-provided health insurance, with much of the money subsidizing wasteful overinsurance and rewarding higher-income families who would have purchased insurance without the subsidy. Moving to a tax credit system would allow employers and employees to avoid many wasteful practices without losing tax benefits. As employers and employees shift to more economical health plans, employer tax-deductible expenses for health insurance would fall and taxable wages would rise. The extra taxes the federal government would collect from the larger taxable wage base would be a source of funding to insure the currently uninsured.

Federal and state spending on health programs for the uninsured currently exceeds $1,000 for every uninsured person in America. If all of the uninsured suddenly became insured, this would free up more than $40 billion a year in current spending. Savings made possible by scaling back spending programs (as the need diminishes) would be a source of funds to finance the tax credit and the Safety Net program.

America does not need to spend more money on health care—$1 trillion a year is ample money to meet the nation's health care needs. The goal of health reform should be to redirect government subsidies and government spending so that those dollars are used more wisely and more fairly.

Chairman ARCHER. Thank you, Dr. Goodman. The next witness is Dr. Stuart Butler. The Chair would, number one, thank you, Dr.

Goodman, for keeping your oral presentation to 5 minutes. Your entire printed statements without objection will be entered into the record.

You may proceed, Dr. Butler.

STATEMENT OF STUART BUTLER, PH.D., VICE PRESIDENT, DOMESTIC AND ECONOMIC POLICY STUDIES, HERITAGE FOUNDATION

Mr. BUTLER. Thank you, Mr. Chairman. I am Stuart Butler. I am the vice president for domestic and economic research at the Heritage Foundation.

Mr. Chairman, as Mrs. Johnson and Dr. Goodman have noted, there is a tax no man's land in today's health system between employer-sponsored health insurance and Medicaid. Working families receive an often generous tax exclusion if their employer offers health insurance. But if their employer does not do so or if dependent coverage is too expensive for the worker, families get no help through the tax system for purchasing their own coverage. Also many Americans with coverage feel locked into their current jobs if a more attractive job doesn't provide coverage and they would have to pay for their family's health with aftertax dollars.

Furthermore, there is a growing concern that many Americans who have been leaving welfare and taking entry level jobs will find themselves facing prohibitive health costs when their Medicaid benefits cease. Members of both parties have offered bills or are developing legislation to begin to correct the huge tax bias facing families who must seek their own health insurance. These bipartisan proposals would provide a health tax deduction or credit to working families who lack employer-sponsored coverage. I would urge Congress to take the step this year of enacting a partially refundable tax credit for health expenses.

Let me make a few comments about the issues this Committee should consider in designing such a credit. First, it is important to recognize that a feasible credit this year would only be an initial step, not the complete solution. Mr. Stark has noted that insurance issues have to be addressed, but I believe we should move on the tax side now while we have the opportunity.

Second, while it is true that much of the benefit of a new tax credit would go to working people who are already buying insurance with aftertax dollars, basic fairness and tax equity demands that Americans should receive equal tax relief under the new policy to those not now buying insurance. Congress should not discriminate against those workers who have already made the costly decision of buying insurance to protect their families.

Third, those who argue that the value of the credits under discussion are not enough should note that a Federal tax credit is just one element of the whole solution. If a larger credit could be enacted this year, it would certainly have more impact. But a $1,000 credit for a family in Connecticut or Texas means that we are $1,000 closer to dealing with that family's lack of insurance. States could use the Federal credit as the foundation upon which to use Medicaid, S–CHIP or other programs in a creative way. States can and should also explore innovative pooling arrangements for insurance.

Fourth, a tax credit would not be a threat to successful parts of the employment-sponsored system, especially if it were limited to workers who are not offered employer-sponsored coverage or for the purchase of dependent coverage. Indeed, permitting low-income workers to use a credit to pay for the out-of-pocket costs of dependent coverage would strengthen employment-based coverage while reducing uninsureds.

Moreover, to the extent that some smaller employers and their employees would find it sensible to cash out of an inefficient health plan and let their workers use their credit to buy insurance elsewhere, that would improve the coverage for these families.

I agree with Mr. Stark that it could be a good thing if some parts of the employment-based system were replaced.

Fifth, some people argue that low-income people would not be able to wait until they filed their tax return to obtain the credit, but a family can ask their employer to factor the health credit into their withholdings, just as many do with the child care credit.

In addition, Congress can consider incorporating Senator Daschle's proposal to allow families to assign their credit to an insurance plan in return for reduced premiums. That is not unlike of course the way that the Federal Employee Health Benefits Program operates.

Sixth, different credit designs would have different implications. For the same revenue cost, a credit of a fixed amount would provide the biggest bang for the buck to the low-income workers. On the other hand, the percentage credit is generally more helpful to those who, because of their medical situation, need to buy more care.

In addition, making the credit available against all health costs, not just insurance would mean families could make the economic decision to buy no frills insurance for major medical problems but still get tax relief for routine expenses or savings for health expenses.

It might be best to allow families to choose between a percentage credit for all health expenses up to a maximum amount, and a fixed amount for insurance meeting minimum specifications. Alternatively, Congress could consider a credit which combines both of these features or a combined credit deduction such as Mrs. Johnson proposes.

Finally, a health credit would be reasonably compatible with long-term tax reform, assuming that some tax preference for health care were retained in a reformed Tax Code. For instance, a health credit could be folded into the personal exemption amount and a flat income tax or into an exempt or reduced tax rate feature of a sales tax.

Mr. Chairman, it is not often that there is such broad political support for a tax measure that would begin to make a difference to the daily problems of ordinary Americans. I believe strongly that the Committee should not let this opportunity slip away. I believe you should move ahead with a limited tax credit now and continue the discussions that Mr. Stark and others have had with the leadership about dealing with the tough issues associated with insurance. I believe action now can and should be taken on the tax side.

Thank you.

[The prepared statement follows:]

Statement of Stuart Butler, Ph.D., Vice President, Domestic and Economic Policy Studies, Heritage Foundation

Mr. Chairman, my name is Stuart Butler. I am Vice President for Domestic and Economic Policy Studies at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. Some of the following material is taken from a forthcoming article I have co-authored with David Kendall of the Progressive Policy Institute. Nevertheless, some of the conclusions I draw differ from our joint position, and thus do not necessarily represent his views.

I am pleased that the Committee is giving consideration to incorporating some form of health tax credit into the tax code. There is growing support outside Congress for introducing changes in the tax code to make it more rational concerning health expenditures and to help the uninsured and to help the uninsured, and these proposals often include a tax credit component. Organizations favoring tax-based reforms include the American Medical Association, the National Association of Health Underwriters, and scholars in such research organizations such as Heritage, the Urban Institute, the American Enterprise Institute, the Cato Institute, and the National Center for Policy Analysis. Moreover, many members of this Committee, as well as members of other House and Senate Committees, have either introduced health tax credit bills or are considering such legislation. With this growing interest in the approach, I believe the time is ripe for Congress to act this year on a health tax credit.

The interest in introducing a health care tax credit stems from two related features of the current health care system. First, there is a growing recognition that the current employer-based system (which is heavily subsidized by the tax exclusion for employer-sponsored health insurance) is a very inadequate vehicle for providing health coverage in certain sectors of the economy. A new health insurance tax credit would help stimulate the creation of a parallel health insurance system for working people who are not well served by employer-sponsored insurance. Second, the support for a tax credit (rather than, say, a widening of the exclusion or the introduction of a deduction) recognizes the inefficiency and ineffectiveness of the tax exclusion as a device to help Americans afford health care.

The growing level of uninsurance in this country underscores the need for at least modest steps to be taken, and its causes reinforce the belief that a tax credit would be a sensible step to take. As the Committee is well aware, the number of uninsured individuals is over 43 million, with uninsurance reaching epidemic proportions in some communities. Approximately one third of Hispanic-Americans are uninsured, for example, and about one half of the working poor. Significantly, the uninsured are predominantly within working families. Only about 16 percent of the uninsured are outside such families. And while 24 percent are in families with workers employed part-time or part of the year, 60 percent are in families with an adult working full-time year round.

Surveys indicate that about 75% of the uninsured say they simply cannot afford coverage, or they have lost coverage that was once available through their employer.

While millions of Americans enjoy the certainty of good, predictable coverage through their place of work, it is becoming increasingly clear that the place of employment is not an ideal method of obtaining coverage for many Americans, particularly in the small business sector. Unfortunately, current tax policy is heavily biased against any other method of obtaining coverage.

Consider the following:

- In an economy with increased job mobility, for an ever-larger proportion of the population an employment-based group is no longer a stable, long-term foundation for health insurance. Even if a family can expect to receive coverage whenever the main earner changes jobs, typically there will be some change in the benefits available or the physicians included in the plan. The higher the degree of job mobility for a family or in an industry, the higher the degree of change and uncertainty associated with employment-based health insurance.
- While major employers, with a large insurance pool and a sophisticated human resource department, may be considered a logical institution through which to obtain health insurance, this is not the case with most smaller employers. These employers typically lack the economies of scale, and usually the expertise, to negotiate good coverage for their employers, and it should be no surprise that uninsurance is heavily concentrated in the small business sector. In 1996, just under half of firms below with 50 employees offered insurance, while the figure was 91 percent for those with 50–99 employees and 99 percent of those with more than 200. For

those firms below 50 employees where most workers earned less than $10,000, only 19 percent were offered health benefits. Further, Hay/Huggins has found that, in 1988, average administrative costs exceeded 35 percent of premiums for firms with fewer than 10 employees, compared with 12 percent for firms with over 500 workers.

- Other large, stable groupings exist that could be sponsors of health insurance, but these are discriminated against in the current tax system. For example, unions could carry out exactly the same functions as an employer regarding health insurance. Indeed, the Mailhandlers union and other unions or employee associations act as plan organizers in the Federal Employees Health Benefits Program. But union-sponsored plans are quite unusual outside the federal government, because enrollees in union-sponsored plans typically are not eligible for the tax benefits associated with employer-sponsored insurance. Yet, many workers who have only a loose affiliation with their employer, or work for smaller employers who do not provide insurance, have a long-term, close connection with their union. Moreover, the union would be a very large potential insurance pool. Similarly, large religious organizations, such as consortia of Churches in the African-American community, would be a far more logical vehicle for which to obtain health insurance, thanks to the size of the insurance pool and the sophistication of the church leadership, than most of the businesses employing members of such churches. Yet again, the tax system is biased against these alternatives.

HOW THE TAX SYSTEM EXACERBATES FAILINGS OF EMPLOYMENT-BASED COVERAGE.

Under the current arrangement for working-age families, employees receive a tax exclusion if they allow their employer to allocate part of their compensation for a health insurance policy owned by that employer. This arrangement helps cause uninsurance in several ways. For example:

- Since this tax exclusion is available only for employer-sponsored coverage, a working family without employer-sponsored insurance has no subsidy through the tax code to help offset the cost of buying its own coverage or health care. Thus families who lose their work-based insurance for any reason, such as cutbacks in benefits or jobs by the employer, suffer a double blow—not only do they lose the insurance, but they also no longer receive a tax subsidy to pay for care. Not surprisingly, high degrees of uninsurance are prevalent among working families with moderate and low incomes
- The tax benefits available for employer-provided coverage are a very inefficient method of helping low-income workers to afford care. Since compensation in the form of employer-sponsored insurance is excluded from an employee's taxable income (avoiding payroll taxes as well as federal and state income tax), by far the largest tax benefits go to more affluent workers on the highest tax brackets. Those at the lowest income levels (especially those who do not earn enough to pay income tax) receive little or no tax subsidy. According to John Sheils and Paul Hogan (Health Affairs, March/April 1999) the value of the tax exclusion in 1998 was over $100 billion at the federal level (including income and payroll taxes) and an additional $13.6 in relief from state and local taxes. While the average tax benefit per family was just over $1000, the tax benefits were heavily skewed towards higher-income families. Sheils and Hogan estimate that families with incomes in excess of $100,000 benefited to the tune of an average of $2,357, while families with incomes of less than $15,000 received benefits worth an average of just $71 (although this includes uninsured families receiving no tax breaks at all). Some 68.7 percent of all the tax benefits in 1998 went to families with incomes in excess of $50,000.

HOW A TAX CREDIT WOULD HELP.

Introducing a tax credit for health expenditures for families lacking employer-sponsored insurance would begin to rectify the deficiencies in the current tax system and in doing so would begin to stimulate the provision of health insurance through organizations other than employers. Non-employer sponsored coverage would not be intended to replace successful company-based plans, but to provide an alternative for families who do not have access to insurance through their place of work, or where their employer-sponsored coverage is clearly inadequate or inappropriate.

A tax credit would have three key benefits. First, it would be worth at least as much to lower-income families as upper-income families, unlike the tax exclusion which is worth far more to people in higher tax brackets. Second, it could be made refundable at least against payroll taxes in addition to income taxes. This means workers without an income tax liability could still claim the credit, thereby providing some help to nearly all the uninsured. In contrast, an individual tax deduction for health insurance has the potential for reaching only about one-third of the uninsured, since it would not be refundable and many low-income workers do not have any income tax liability. Third, a credit would be available regardless of job status and would make coverage more affordable for workers between jobs.

Various credit designs proposed in recent years possess these key features. Credit can be a fixed amount or can vary according to a variety of factors including a worker's expenditure on insurance, income, demographic and geographic factors, and health risks. Major tax credit proposals in the past have ranged from a sliding-scale credit based on income and health expenditures, such as the bill introduced in 1994 by Sen. Don Nickles (R–OK) and Rep. Cliff Stearns (R–FL), a fixed-sum tax credit such as the bill introduced recently by Rep. John Shadegg (R–AZ), or a percentage credit against costs, such as the bill introduced by Reps. James McDermott (D–WA) and James Rogan (R–CA).

The McDermott-Rogan proposal would provide a refundable tax credit for 30 percent of a family's expenditure on health insurance, which is based on the value on the current tax subsidy for a taxpayer in 15 percent income tax bracket plus the exclusion from FICA taxes. The Shadegg proposal would provide a dollar-for-dollar, refundable credit of up to $500 for individuals ($1,000 for families) for the purchase of health insurance.

These different forms of tax credit have subtly different effects. For example, a tax credit for a given percentage of the cost of insurance could encourage overspending by some families, just as the current open-ended subsidy does in employment-based coverage although this effect is reduced if there is an income cap, or if the total credit is capped. A simple percentage credit also could leave low-income people still unable to afford coverage. On the other hand, a tax credit for a fixed-sum of health care coverage can concentrate the most help on the needy and encourages spending only up to that amount. That minimizes overinsurance, but families facing high costs would incur the full marginal price of needed extra services or coverage mentioned earlier. For workers with a serious health condition facing higher premiums, the ideal tax credit would be a sliding scale credit adjusted upward according to the ratio of cash and income. Such a credit would have the need to subsidize higher risk workers through community rating laws that perversely benefit high-income, high-risk workers at the expense of low-income, low-risk workers. Most states permit insurance premiums to vary at least somewhat according to health risks and demographic factors in both the individual and small group markets, the two markets mostly likely to be affected by a refundable tax credit. Thus, a tax credit for a percentage of spending (especially a sliding scale credit) would take better account of these differences.

A fixed or percentage tax credit could be provided without regard to income. But clearly that would mean a lower degree of assistance for the poor—for the same total revenue cost—than a targeted credit. A tax credit that is targeted toward those who can least afford coverage, however, means there must be some form of phase-out based on income. Such phase-outs necessarily create higher effective marginal tax rates for taxpayers who fall in the phase out range. This problem is especially pronounced for certain low-income workers, who can face marginal tax rates of 100 percent or more due to the phase-out of several income-based programs such as the earned income tax credit, welfare, day care and Medicaid subsidies, housing subsidies, and food stamps. This problem occurs with any subsidy arrangement, of course, not only with tax credits. More sweeping tax credit reforms, such as the Nickles-Stearns bill, resolved this to a large degree by changing the entire tax treatment of health care, thereby permitting a very gradual phase-out of the credit.

SOME QUESTIONS AND ANSWERS ON HEALTH TAX CREDITS

Q. Would a tax credit undermine successful employment-based coverage?

A. Not if designed properly. It would help provide an alternative with the characteristics of successful employer-sponsored plans for those currently outside the employment-based system—such as large, stable group insurance pools and administrative economies of scale. But it is important that prudent steps be taken to combine a credit with a "wall of separation" strategy to limit the probability that successful employer plans would be dismantled, either because of a decision made by the employer, or because individual workers preferring the credit undermined the firm's insurance pool.

Certain design elements could be incorporated into a credit to minimize the risk to good employer-sponsored plans. For example, the credit might be made available only where insurance is not available from the employer.

Q. Would workers with little cash be able to front the cost of insurance before they could claim the tax credit?

A. Yes. The idea that a tax credit means employees would have to wait until the end of the year to obtain tax relief is a myth. Just as mortgage interest tax relief, or a child care credit, is obtained by most families over the whole year by an adjustment to their withholdings, the same would be true of a credit. In addition, a novel idea proposed by Sen. Tom Daschle (D–SD) would simplify things even further for many families. Daschle would let the insurer reduce its own tax withholdings for each person who voluntarily assigns the value of their credit to that insurer for the purpose of purchasing health insurance. This approach could be particularly helpful to the unemployed if it applied to COBRA plans as well.

Q. Would a credit be an efficient way to provide help? Wouldn't much of the money devoted to financing the credit actually go to people who are already buying insurance?

A. While millions of families are uninsured, there are many families who lack employer-based coverage but have decided to purchase their own insurance, typically with no tax relief. Clearly, these families would immediately take advantage of any available tax credit to offset the cost of their current coverage and/or improve it. For this reason, a significant part of the revenue cost of a tax credit would go to these families, meaning that only a portion of the revenue costs would be used by uninsured families to obtain insurance. Depending on the size of the credit (the larger the amount, the more likely uninsured families are to take advantage of it), the proportion of "tax expenditures" leading to actual reductions in the uninsurance rate could vary widely.

Some critics of the tax credit approach conclude that a tax credit would be "inefficient" in that many people who today buy their own insurance would simply use the credit to offset their cost without increasing their coverage. But this presupposes that equity is not an appropriate objective, in part, of the tax credit strategy. Yet one of the aims should be to make sure that people of similar circumstances receive the same help, and that it should not be considered a policy flaw if tax relief is provided to families who have saved elsewhere in their household budget to pay for coverage today.

Q. Would a credit be large enough for low-income people to afford coverage?

A. To be sure, studies and surveys suggest that millions of low-income Americans still would consider coverage to be prohibitively expensive even with a refundable tax credit of, say, 30 percent. This observation is used to argue that the credit approach would be ineffective. But a tax credit approach should not be seen in isolation as a complete solution for all the uninsured. Other subsidies and programs exist and are needed—but these other approaches are more likely to be successful if a family can add part of the cost through a federal tax credit. In particular, states have been using their own and federal resources (such as Medicaid and SCHIP) to provide assistance to families needing health insurance. A refundable federal tax credit of, say, $1,000 for a family should be seen as a foundation on which to build with these other programs and resources. A $1,000 credit means that we are $1,000 closer to financing the cost of insurance for a family.

Q. Can other organizations really be as effective as employers in organizing coverage?

A. Yes and no. Many large corporations today have the sophistication, scale of buying power, and presence in the community to outperform any other organization in organizing good, economical health coverage. In the system envisioned by the authors these would be the logical vehicles for coverage, at least if employment tended to be long term in the firm. Moreover, a tax credit system could also allow families to buy into the health plans of corporations for whom they do not even work, if this makes sense for the corporation. Many large firms have made the decision to turn an internal service into a profit center for outside customers. The Sprint telephone company, for example, grew out of the internal communications system of the Southern Pacific Railroad. And John Deere & Co. spun off its health benefits operation as an HMO in Iowa. If families could obtain tax relief to buy coverage outside their own firm, one could imagine large corporations with huge health plans deciding in the future to offer a competitive insurance service to non-employees.

In many situations, non-employment based groups would have a comparative advantage and would be more logical and skilled organizations. Moreover, these groups are not merely potential pools for coverage. In many instances they have a "community of interest" connection with families that means they could be expected to work for the long term interest of these families. Consider, for instance, the potential of union-sponsored insurance in the restaurant and small hotel sector. In this sector, firms tend to be small and employee turnover high, while unions are available that are large and sophisticated. Unions in general have considerable expertise in bargaining for health care and would be the health care sponsor of choice for many Americans—even for those who do not wish to be active union members. In the FEHBP, for instance, the Mailhandlers union provides coverage to many federal workers who join the union as associate members merely to avail themselves of the health plan.

Groups of churches in the African-American community also could be preferred sponsors of care in a system in which subsidies and tax benefits were not confined to employment-based plans. In many communities served by these churches, employers are small and employee turnover is high, yet families have a strong and continuous affiliation with the church. Moreover, America's black churches have a long history of serving the secular as well as the spiritual needs of their congregations, by providing housing, education, insurance and other services.

To be sure, there are legitimate concerns to be addressed in considering the role of such organizations in health care. One is the stability of the insurance pool—if individuals can easily affiliate or end their affiliation it may be difficult to secure coverage without wide price fluctuations over time (of course, this is also a problem with small employer pools in some industries). Another, linked to this, is the worry that adverse selection may undermine the group.

It is unclear how large these problems are. In the FEHBP, for instance, many plans operated by organizations (such as the Mailhandlers mentioned earlier) allow individuals from outside the base group to affiliate for a small fee simply to obtain coverage, and all enrollees are charged the same community rate. Yet the groups are surprisingly stable, perhaps due in part to the relatively high costs for individuals to calculate and make plan choices based on their own predictions of their own health care costs. Yet even if stability and adverse selection is accepted as a serious concern, steps at the state or federal level could be taken to increase the stability of the group. For instance, there could be waiting period after joining the group before the family could join its health plan. In addition, one-year minimum enrollment contracts could be required. Another protection might be to place a minimum requirement on the membership of the pool, which might be achieved through a multiyear consortium of several churches, say, to make the pool large enough to withstand the inflow and outflow of members. The groups also could operate under insurance pooling and rating requirements developed by states.

Q. Would a health care tax credit be a further impediment to tax reform?

A. In a simpler, flatter tax system, there would be no tax preference at all for health expenses. If the current tax expenditures for health care were to be used to help "finance" an across-the-board rate reduction, it could significantly lower the rates in a flat income tax or sales tax, which would of itself make health insurance more affordable.

If, however, it is assumed there is little prospect of eliminating the tax preference for health costs, a tax credit—especially a credit of a fixed amount per family—would be reasonably consistent with tax simplification. If over time, the tax treatment of health care were gradually shifted from today's exclusion and deduction system to a credit, this would be more compatible with a flat tax or sales tax than the current system. The reason for this example, the health tax credit could be subsumed into the general exemption for families in a flat income tax.

Growing rates of health uninsurance in the United States are unacceptable and will lead to steadily rising pressure on Congress to take action. After recognizing the root causes of this problem, which lie in the combination of a tax bias toward employer-sponsored insurance and the inadequacy of that insurance system in certain sectors of the economy, it would be prudent for Congress to move quickly but carefully to correct the problem. A limited tax credit for expenditures on insurance not provided through the place of employment would be a sensible step that Congress could take this year. It would not mean a radical drop in the number of uninsured, unless there was a very large commitment of funds, but would be an important first step helping the uninsured and to achieving the general reform of tax benefits for health care. It would also stimulate the creation of parallel institutions which would sponsor insurance in those sectors of the economy where employers are a very inadequate vehicle for coverage. But if Congress does not take the first step this year, when federal finances are in surplus and the economy is strong, it is likely to face far more difficulties in taking a step in the future if the economy weakens and deficits return.

Chairman ARCHER. Thank you, Dr. Butler.

Our next witness is no stranger to the Committee, we are happy to have you back before us, Chip Kahn. We will be pleased to receive your testimony.

STATEMENT OF CHARLES N. KAHN III, PRESIDENT, HEALTH INSURANCE ASSOCIATION OF AMERICA

Mr. KAHN. Thank you, Mr. Chairman. I am Chip Kahn, president of the Health Insurance Association of America. HIAA commends the Committee for focusing on the pressing issues of health and long-term care insurance coverage. Efforts to encourage coverage in both these areas should be priority for the Congress. The Tax Code already recognizes the cost of coverage as justifiable deductible expenses for individuals and businesses. The Committee should consider ways to broaden deductibility for insurance premiums to increase tax equity and to provide additional incentives to increase the number of Americans protected by health and long-term care insurance.

In response to double-digit inflation in the eighties, employer became more cost-conscious purchasers of health care. As a result, premium increases dropped dramatically in the late nineties. These changes not only kept 5 million more Americans insured, but between 1993 and 1997, the number of Americans covered by employer-paid insurance increased from 145 million to 152 million Americans. Despite what some may say, the employer-based private health care system has been remarkably successful in expanding coverage. Regardless of this progress, however, the number of Americans without health coverage has also climbed. This is unprecedented in times when the economy is strong and premium growth is modest.

Today over 44 million Americans are uninsured. That number may grow to 53 million Americans in the next 10 years. If the economy sours, one in four working-age Americans could find themselves without health care coverage. HIAA has developed a proposal to increase health care coverage, InsureUSA. This plan combines targeted subsidies, tax relief and tax equity. Through its implementation, HIAA believes coverage can be expanded to reduce the number of this Nation's uninsured by two-thirds and we can provide tax relief to assure that all Americans are treated equitably by the Tax Code regarding their expenses for health premiums.

The tax policies proposed in InsureUSA would affect over 100 million Americans. This does not come at a modest cost, but it could be more affordable if phased-in over a number of years, as the Committee has done with other health-related tax relief.

In my written testimony I outlined the details of HIAA's InsureUSA, but today I will comment briefly on the core principles underlying the InsureUSA initiative.

First, to increase coverage, health insurance must be more affordable for certain Americans through some type of premium subsidization. The primary reason for the high rate of uninsurance in this country is that many individuals or their employers lack the financial wherewithal to purchase health care coverage.

Two, uninsurance is a multifaceted problem which requires a series of targeted approaches. While affordability is the primary reason people lack insurance, the uninsured have many faces. There is still no silver bullet solution to covering more Americans.

Third, the current private health care market should remain a cornerstone of our health care system. The public policy debates over health care have taught that expanded coverage can only be achieved with policy that does not threaten the private coverage that the vast majority of Americans already enjoy.

Finally, perhaps most importantly, I feel we should build on the employer-based system without undermining it. Nine in every ten Americans with private coverage get their health insurance through their employer. It is a system that works for most Americans.

Mr. Chairman, as the Committee considers policy to ramp-up for the advent of the baby-boomer retirement, it is critically important to recognize that most Americans have not adequately prepared for the cost of long-term care when they need it, and many are not aware that Medicare does not cover long-term care. Private insurance already plays a critical role in providing long-term care protection, and we applaud the administration and the Members of Congress who have put forth proposals recognizing the role that private coverage can play in expanding protection against long-term disabilities.

Such an expansion will restrain the growth in Federal and State expenditures for long-term care over time. Tax policy clarifications included in the Health Insurance Portability and Accountability Act of 1996 were an important first step. However, because HIPAA provides a tax deduction only for coverage purchased in the employer-based market, additional measures are needed. Individuals purchase 80 percent of long-term care policies. Therefore, a deduction for individual purchase of long-term care insurance would make it more affordable to many Americans as well as promote interest in the coverage.

HIAA urges the Committee to include in its tax bill Representatives Nancy Johnson and Karen Thurman's measure, the Long-Term Care and Retirement Security Act of 1999. If enacted, their proposal would make a significant contribution toward increasing the number of Americans who seek protection against future long-term care expense.

Thank you, Mr. Chairman, for the opportunity to testify today.

[The prepared statement follows:]

Statement of Charles N. Kahn III, President, Health Insurance Association of America

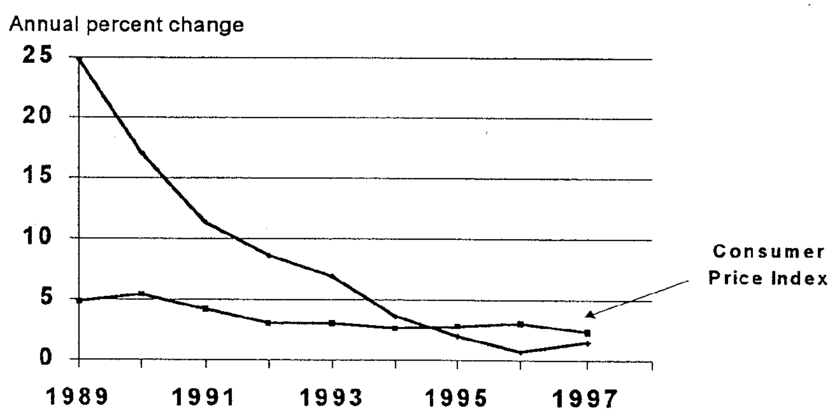
INTRODUCTION

Chairman Archer, members of the Committee, I am Charles N. Kahn III, President of the Health Insurance Association of America (HIAA). HIAA represents 269 member companies providing health, long-term care, disability income, and supplemental insurance coverage to over 115 million Americans. I appreciate this opportunity to speak to you today about the critical role tax initiatives could play in making private health insurance more affordable for all Americans and further expanding access to private long-term care insurance.

DESPITE EXPANDING ECONOMY AND SUCCESS CONTROLLING COSTS, GROWING NUMBER OF UNINSURED

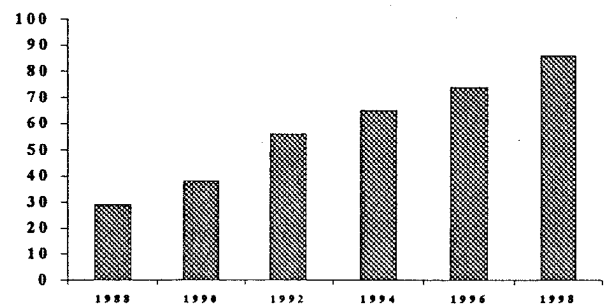
In response to double-digit health care inflation in the 1980s, employers became much more aggressive purchasers of health coverage. As a result, the nation has experienced a dramatic decline in the growth of health insurance premiums over the past ten years. Double-digit inflation in excess of 20 percent in the late 1980s dropped dramatically to low single digit rates in the late 1990s, more in line with general consumer price index trends. This decline in premium growth during the 1990s coincides with dramatic increases in market penetration of managed care. Enrollment in PPOs, HMOs, and other forms of managed care has tripled during the past 10 years from 29 percent in 1988 to 86 percent in 1998.

Employer Premiums: Dramatic Fall in Rate of Increase



Source: For 1989 - 1991, HIAA Employer Survey; for 1992 - 1997, KPMG Employer Survey

Growth in Managed Care
(percent)



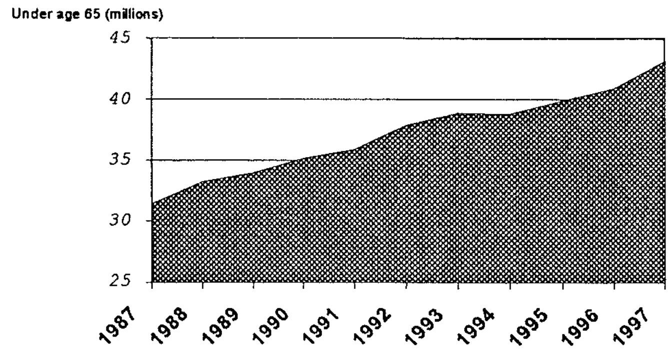
Source: KPMG Health Benefits Survey for years: 1992 - 1998
HIAA for years: 1988 - 1990

It is estimated that the impact of lower insurance prices resulting from the growth of managed care and other private sector innovations saved consumers between $24 billion and $37 billion in 1996, and that this savings will grow to over $125 billion by the year 2000. These savings are critically important because the cost of insurance relative to family income is the most important factor in determining whether people will be insured. Without these savings, some employers would not have been able to afford private insurance and would have been forced to discontinue coverage for their workers. In fact, it is estimated that there would be 3 to 5 million additional uninsured Americans right now were it not for these lower premium trends during the past few years.

Despite this progress, however, the number of Americans without health insurance coverage has continued to increase during the last decade.

Individuals Without Health Insurance:

Up 36% in Last Decade



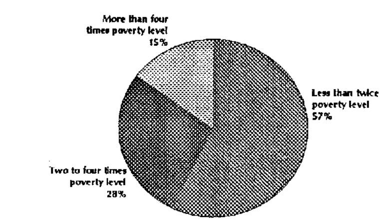
Source: William S. Custer Ph.D., Center for Risk Management and Insurance Research, Georgia State University, using data from the Current Population Survey

It is relatively unprecedented for the ranks of the uninsured to be growing at a time when our nation's economy is expanding and health insurance premium trends are moderating.

There are nearly 170 million non-elderly Americans who currently enjoy the security of private health insurance, and the vast majority receives its coverage at the workplace. But for too many Americans, private health insurance is unaffordable, and often, government programs like Medicaid do not cover these adults.

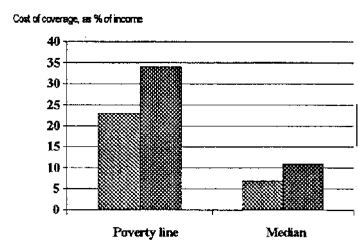
Affordability is the key deciding factor when purchasing health insurance. Almost six of every ten uninsured individuals live in families with incomes less than 200 percent of the federal poverty level. In addition, the number of people with insurance has declined as health care inflation has continued to outstrip the growth in real family income.

For Uninsured Americans, Affordability Is the Obstacle to Coverage



Source: William S. Custer, Ph.D., Center for Risk Management and Insurance Research, Georgia State University

Affordability Has Fallen



Source: William S. Custer, Ph.D., Center for Risk Management and Insurance Research, Georgia State University

There are over 44 million Americans without health insurance, and by the end of the next decade that number will grow to at least 53 million—one in every five non-elderly Americans. If health care costs increase at a faster than projected rate, and the economy experiences a downturn, the number of uninsured could rise to 60 million—or one in four working-age Americans.[1] Clearly, this is a disturbing trend that we, as a nation, cannot afford to let continue.

[1] Custer, William S., "Health Insurance Coverage and the Uninsured," December 1998, Center for Risk Management and Insurance Research, Georgia State University, for the Health Insurance Association of America.

HIAA'S INSUREUSA INITIATIVE

Last month, the HIAA Board of Directors approved InsureUSA, a major initiative to help expand health insurance coverage. Building on the success of employer-based health coverage, this plan would increase health coverage through a combination of targeted subsidies, tax incentives, cost-control measures, and education. We already have provided a copy of our plan to all members of Congress, including members of this Committee. In addition, we have developed a special website, *www.InsureUSA.org*, that provides detailed information about the plan and about the uninsured. And, of course, HIAA staff would be happy to meet with members of Congress at any time to discuss the proposal.

HIAA's member companies developed InsureUSA after nearly one year of deliberations. The plan was shaped considerably by research data prepared on behalf of HIAA by William S. Custer, Ph.D., as well as other research on the uninsured.

There are five basic precepts underlying the InsureUSA initiative.

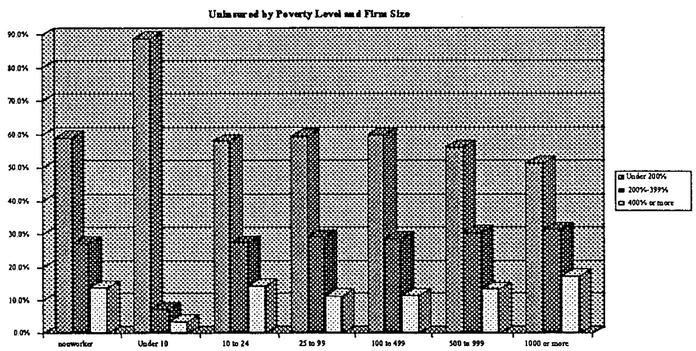
- *The time is ripe for action.* Despite expansions of the employment-based health insurance market in recent years, the number of Americans without health insurance coverage will continue to grow by about 1 million people per year. As noted previously, one in every four working age Americans could lack coverage by the end of the next decade if steps are not taken immediately to stem this tide. Having said that, the individual components of InsureUSA could be phased-in over a number of years. In addition, because the proposal attacks the core causes of uninsurance, specific elements of the proposal could be enacted first, without jeopardizing others.
- *To increase coverage, health insurance must be more affordable for more Americans.* The main reason that Americans are uninsured is because they cannot afford health insurance coverage. Many well-intentioned attempts at insurance market reform have had the effect of increasing the cost of coverage and increasing the net number of individuals without health insurance. Reform, therefore, should both reduce the costs of health insurance and provide financial support for those who otherwise cannot afford coverage.
- *Multifaceted problem requires multifaceted approach.* While affordability is the primary reason people lack health coverage, there are many reasons people lack coverage. Rather than advocating a singular approach to insuring more Americans, we are advocating a diverse program designed to attack the underlying reasons that people are uninsured.
- *A strong, vibrant private health insurance market should remain a cornerstone of our health care system.* Expanded coverage must be achieved through means that do not threaten the coverage of other Americans or damage the existing private market. Competitive markets remain the most efficient and responsive mechanisms to provide consumers with coverage. Regulations that stifle innovation, flexibility, and responsiveness to consumers should be strongly discouraged.
- *Reforms should make health coverage more affordable within the context of the employment-based private health care system, rather than undermining it.* Nine in every 10 Americans with health coverage get their health insurance through their employer. And while coverage has declined overall, the percentage of Americans with employment-based health coverage has increased during the past few years. Therefore, InsureUSA would build upon this base, by providing targeted subsidies and incentives for those who are less likely to benefit from employment-based coverage.

For the purposes of today's hearing, I would like to highlight the tax initiatives proposed in the InsureUSA plan. As I mentioned earlier, affordability is a key factor for many Americans when purchasing health insurance, and tax incentives will help make affordable coverage a reality for those who do not have insurance. In addition, these tax initiatives will help provide greater equity in the purchase of health insurance for small business owners, the self-employed and individuals without access to employer-sponsored health insurance. The cost of these tax incentives is large, but HIAA estimates that they would broadly benefit over 100 million Americans who experience inequity under the current tax code.

TARGETED TAX CREDITS FOR SMALL BUSINESSES

First, I would like to discuss the proposal's tax credits for small businesses. Studies show that firm size is one of the major factors affecting the cost of health insurance. Smaller employers face higher costs when providing health benefits than larger firms because their size limits their ability to (1) spread risk, (2) self-insure and avoid expensive state mandates and taxes, and (3) manage high administrative costs incurred because of a lack of staff devoted to health benefits. The smallest firms tend to have low-wage employees who live in low-income families. In fact, 90 percent of the uninsured whose family head works for an employer with fewer than 10 employees also live in families whose income is less than 200 percent of the federal poverty level.[2]

Uninsured by Income and Firm Size



Source: William S. Custer, Ph.D., Center for Risk Management and Insurance Research, Georgia State University

Therefore, InsureUSA would like to propose a tax credit for small employers that could be phased-in beginning with the smallest firms:

- 40 percent credit for employers with fewer than 10 employees
- 25 percent credit for employers with 10–25 employees
- 15 percent credit for employers with 26–50 employees

These credits could help the nearly 39 million Americans who belong to families whose head of household works for a company with ten (or fewer) employees. If eligibility for such credits was extended to all companies with 50 or fewer employees, the total would rise to 71 million Americans.

Furthermore, InsureUSA proposes that all employee contributions for health insurance be excluded from taxable income (even if not made through a section 125 cafeteria plan). This would primarily benefit small employers for whom it is often administratively difficult to set up cafeteria plans.

TARGETED TAX CREDITS FOR INDIVIDUALS AND THE SELF-EMPLOYED

InsureUSA also includes tax incentives that target individual health insurance purchasers and the self-employed. It is a fact that people without access to employer-sponsored plans have a higher likelihood of being uninsured. Nearly a quarter (24 percent) of self-employed Americans are uninsured, and almost three out of ten (28 percent) non-elderly Americans in families headed by an unemployed individual lack health care coverage.

Under current tax law, individuals cannot deduct their out of pocket health insurance premiums until their medical costs exceed 7.5 percent of their income, and the self-employed will not have full deductibility until 2003. HIAA's proposal would extend full tax deductibility of premiums to *everyone* purchasing individual health insurance policies and would take effect upon the date of enactment rather than 2003. As a result, coverage would become more affordable for over 12 million self-employed workers and for nearly 25 million Americans living in families headed by a non-worker.

MEDICAL SAVINGS ACCOUNTS (MSAs)

While there has not been significant enrollment in medical savings accounts (MSAs) under the demonstration authorized by the Health Insurance Portability and Accountability Act of 1996 (HIPAA), statistics compiled by the Department of

[2] Custer, William S., "Health Insurance Coverage and the Uninsured," December 1998, Center for Risk Management and Insurance Research, Georgia State University, for the Health Insurance Association of America.

Treasury show that a large proportion of those with MSAs were previously uninsured. Therefore, InsureUSA proposes that Medical Savings Accounts (MSAs) be made more attractive by:

- simplifying the MSA rules under HIPAA,
- eliminating the "sunset" provision for MSAs available to the self-employed and small employers,
- extending availability to large employers,
- permitting both employees and employers to contribute to MSAs, and
- making it easier for PPOs and other network-based plans to offer MSAs.

COST OF INSUREUSA TAX INCENTIVES

Overall, HIAA estimates that changing the current tax system to encourage greater health insurance coverage and make health insurance more affordable for over 100 million Americans, would cost approximately $30 to $36 billion annually. We estimate that 71 million people (20 million of whom are currently uninsured) would be eligible for the tax credit, either through their employer or the employer of their family head. As a result of this credit, between 2.6 and 4.1 million uninsured will gain coverage at a cost in revenue expenditures of between $23.8 and $29.3 billion annually. These figures are broken down by firm size in the table below.

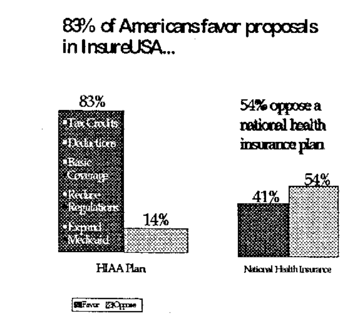
Firm Size	Eligible Individuals	Receiving Credit		Newly Insured		Cost	
		Low	High	Low	High	Low	High
Under 10	38.6	20.4	26.3	1.9	3.1	15.7	20.2
10 to 24	18.3	11.1	12.5	0.5	0.8	5.3	6.0
25 to 50	14.1	9.9	10.7	0.2	0.3	3.0	3.1
Total	71.0	41.4	49.5	2.6	4.1	23.8	29.3

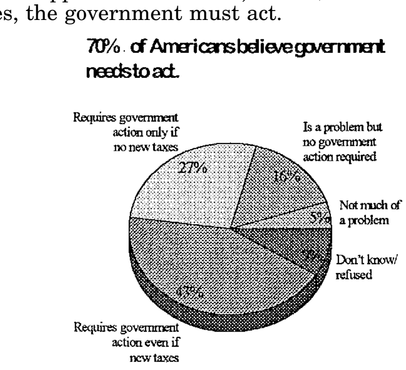
An additional 1.5 and 3.5 million individuals would gain coverage through the individual market. Costs to the Federal government would be between $7.8 and $8.7 billion in annual lost income tax, and the previously uninsured would account for between $670 million and $1.5 billion.

The uninsured have many faces, and tax initiatives will not benefit all of them. These incentives that HIAA is proposing are part of a broader initiative that includes government program expansion to low-income individuals, subsidies for the working poor, and a series of actions that would lower health care costs and educate consumers.

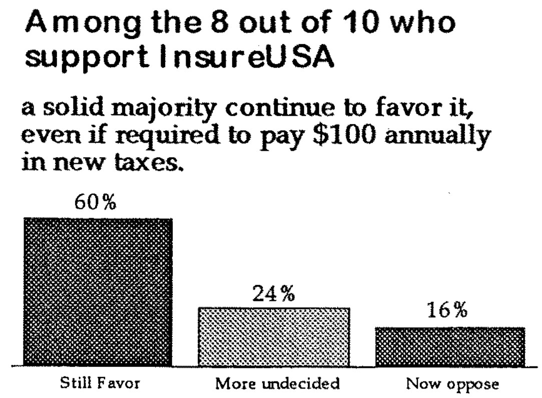
POLLING DATA

HIAA released a public opinion survey showing that more than 4 out of 5 Americans support the elements of the InsureUSA proposal and that 7 out of 10 believe the large number of uninsured Americans is a significant national problem requiring immediate action. While not all were in support of new taxes, most (43 of the 70 percent) felt that, regardless of new taxes, the government must act.





Of the 83 percent of Americans who favor the proposals in InsureUSA, 60 percent say they would still favor the plan even if they were required to pay an extra $100 annually in new taxes.



Source: Public Opinion Strategies for HIAA

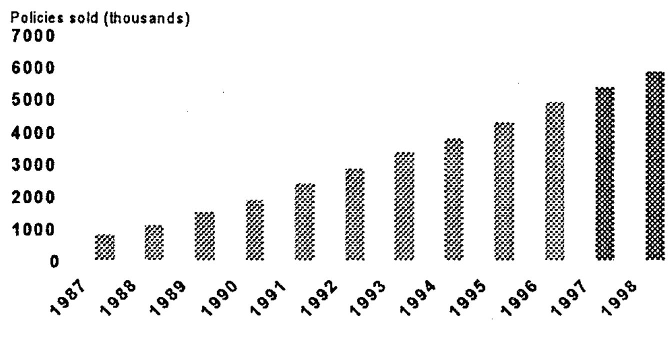
Based on these polling results, it is apparent that the majority of Americans believe the time is right for the government to address the growing uninsured problem, but more importantly, they are confident in the InsureUSA proposal, and feel that it meets the challenge.

LONG-TERM CARE

In addition to the critical need to curb the growing number of uninsured Americans, policymakers must address what many people consider to be the most pressing financial problem—long-term care coverage. Long-term care is the largest unfunded liability facing Americans today, and despite the tremendous need for long-term care protection, there is a clear lack of adequate planning for it.

The long-term care insurance market is growing, and the policies that are available today are affordable and of high quality. There is a critical role for private insurance to provide a better means of financing long-term care for the vast majority of Americans who can afford to protect themselves. Continued growth of the market will alleviate reliance on scarce public dollars, enhance choice of long-term care services for those who may need them in the future, and promote quality among providers of long-term care. HIAA estimates reveal that today over 100 companies have sold over 6 million long-term care insurance policies, and the market has experienced an average annual growth of about 20 percent. These insurance policies include individual, group association, employer-sponsored, and riders to life insurance policies that accelerate the death benefit for long-term care.

Market Trend: Remarkable Growth -- Half Million More Policies Each Year



Source: HIAA LTC Survey for 1987 - 1996; HIAA projection for 1997 and 1998

HIAA would like to applaud the Administration and the 106th Congress' call for programs that would encourage personal responsibility for long-term care, help people currently in need of long-term care, and increase educational efforts on long-term care. Administration and Congressional proposals all have an important common factor, the recognition that private long-term care insurance plays a vital role in helping the elderly and disabled, as well as baby boomers, pay for their future long-term care costs.

The heightened public awareness brought about by these proposals coupled with the passage of incentives for the purchase of long-term care insurance in the Health Insurance Portability and Accountability Act of 1996 (HIPAA) have been essential first steps in solving our nation's long-term care crisis; however, these preliminary tax initiatives are not enough. HIPAA provides little added incentive for individuals to purchase long-term care insurance because the tax breaks are only applicable to employer-sponsored long-term care coverage and fail to address the individual market where 80 percent of all policies are purchased.

LTC Insurance Products by Percentage of Policies Sold & Average Age of Buyer

Long-Term Care Product	Percent of Companies	Percent of Policies Sold	Average Age of Buyer
Individual	82.9	80.0	67
Employer-sponsored	17.9	13.2	43
LTC Rider to Life Insurance	17.1	6.7	44

Under current law, tax benefits can range from a full exclusion from income if one's employer pays the premiums to no tax benefit if an individual pays and does not have sizeable medical expenses. These disparities lead to inequitable results. For many, current law's tax deduction is illusory. Today, an individual purchasing an LTC policy can deduct premiums only if they itemize deductions and only to the extent medical expenses exceed 7.5 percent of adjusted gross income. Only 4 percent of all tax returns report medical expenses as itemized deductions.

Recent developments have improved the political climate for long-term care insurance, but they are not panaceas and will not, by themselves, achieve the optimum public-private partnership for long-term care financing. HIAA believes that other equally important tax-related changes, at both the federal and state levels, could make long-term care insurance more affordable to a greater number of people. The expansion of this market will restrain future costs to federal and state governments by reducing Medicaid outlays.

Providing additional tax incentives for these products would reduce the out-of-pocket cost of long-term care insurance for many Americans, increase their appeal to employees and employers, and increase public confidence in this relatively new type of private insurance coverage. In addition, it would demonstrate the government's support for and its commitment to the private long-term care insurance industry as a major means of helping Americans fund their future long-term care needs.

As you know, Representatives Nancy Johnson and Karen Thurman recently introduced H.R. 2102, "The Long-Term Care and Retirement Security Act of 1999." This legislation would:

- Provide an above-the-line tax deduction for LTC insurance premiums. The deduction would begin at 50 percent, but rise each year the insured keeps the policy in force until the deduction reaches 100 percent. (Joint Tax Committee cost estimate: $4.0 billion over 5 years and $12.5 billion over 10 years)
- Provide a $1,000 tax credit to individuals with LTC needs, or to their caregivers. The credit would be phased-in over a three-year period. (Joint Tax Committee cost estimate: $5.1 billion over 5 years and $14.0 billion over 10 years)
- Authorize the Social Security Administration to carry out a public education campaign on the costs of LTC, limits of coverage under Medicare and Medicaid, the benefits of private LTC insurance, and the tax benefits accorded LTC insurance
- Encourage more states to establish LTC partnerships between Medicaid and private LTC insurance along the lines of those operating in Connecticut, New York, Indiana, and California.

HIAA believes that the provisions of "The Long-Term Care and Retirement Security Act of 1999" are the critical next steps to begin preparing individuals, families, and our society for the increased LTC needs we know are coming. Congress needs to ensure that any tax legislation passed this year incorporates provisions to help private LTC insurance assume an increasingly prominent role in protecting families from LTC costs and easing the financial burden on public programs. By the year 2020, the Congressional Budget Office has estimated that, at current growth rates in private LTC insurance:

- Medicaid will save $12.4 billion (14% of total program nursing home expenditures);
- private LTC insurance will reduce out-of-pocket costs by 18%; and
- private LTC insurance will also reduce Medicare spending by 4%.
- Savings to individuals and public programs will be much greater in subsequent years, as those presently purchasing private policies approach and pass 85 years of age. If Congress enacts legislation that gives Americans enhanced incentives to protect themselves against the costs of LTC, savings to individuals and public programs will be still greater.

In summary, HIAA supports policy that would:

- Enhance the deduction for long-term care insurance premiums, such that premium dollars are not subject to a percentage of income. The deduction should not be limited to situations where employer-provided coverage is unavailable. If an employer decides to provide premium contributions, employees should be entitled to deductions for the portion that they pay.
- Allow children to deduct premiums paid to purchase a policy for their parents and/or grandparents without regard to whether the child is providing for their support.
- Permit premiums to be paid through cafeteria plans and flexible spending accounts.
- Permit the tax-free use of IRA and 401(k) funds for purchases of long-term care insurance.
- Provide a tax subsidy for the purchase of long-term care insurance.
- Encourage state tax incentives for the purchase of long-term care insurance.

Long-term care tax incentives would largely benefit two groups: those who did not have the opportunity to purchase such coverage when they were younger and the premiums were lower, and as a result, now face the greatest affordability problems because of their age; and those younger adults, our current baby boomers, who need incentives or mechanisms to fit long-term care protection into their current multiple priorities (e.g., mortgage and children's college tuition) and financial and retirement planning.

Educational effects of such tax incentives could far outweigh their monetary value by educating consumers about an important issue and, as a result, would help change attitudes. In an effort to inform all Americans about the value of long-term care insurance, HIAA formed the Americans for Long-Term Care Security (ALTCS), a broad based coalition of organizations sharing a common vision to educate policy makers, the media, and the general public about the importance of preparing for the eventual need of long-term care and viable private sector financing options. When state and federal legislation opportunities to advocate private sector options—such as tax incentives to purchase long-term care insurance—arise, members of ALTCS will encourage swift passage through a variety of advocacy, media, and lobbying means.

Furthermore, ALTCS believes that the government must continue to provide a safety net for the truly needy. At the same time, the government should provide incentives for private sector solutions, such as long-term care insurance, so that individuals and families are encouraged to take personal responsibility for long term care planning.

CONCLUSION

The health insurance industry, working with employers, has been extremely effective in recent years in slowing premium increases, improving health care quality, and expanding coverage in the employment-based market. Yet, without additional financial support from the government, the number of Americans without health insurance coverage will continue to grow by about one million people each year into the next decade.

Unfortunately, a series of legislative initiatives being considered at both the state and federal level would move us in the opposite direction. These mandates and so-called "patient protection" measures would put affordable private coverage out of reach for even more Americans. Instead, we need to work together to make the uninsured "job one."

Additionally, tax incentives are needed to spur the growth of private long-term care insurance and help the next generation of Americans better protect themselves from costs of long term care. HIAA supports the use of broad-based state and federal funding to subsidize the cost of health insurance for those who cannot otherwise afford it. We have witnessed the success of favorable tax treatment in helping to expand coverage to a large percentage of working Americans. Therefore, we believe that providing greater equity under the tax code for individuals and the self-employed is a reasonable way to make health coverage more affordable for a large number of the 41 million Americans who currently do not have coverage. H.R. 2102 and other similar measures would be a very good start. We also would encourage Congress to consider tax credits, vouchers and other subsidies as a means of making coverage more affordable for even more Americans.

Again, we are encouraged that Congress is addressing the issue of the uninsured and considering ways to make private health coverage more affordable. We look forward to working with you as you consider ways to expand private health coverage and provide equitable treatment under the tax code for individuals who have taken responsibility for their own health care coverage.

We look forward to working with the members of this committee, and other members of congress, to help find ways to expand health insurance coverage in the months and years ahead.

Mr. Chairman, that concludes my testimony. I would be happy to answer any questions you may have.

Chairman ARCHER. Thank you, Mr. Kahn.

Our next witness is Mary Nell Lehnhard.

STATEMENT OF MARY NELL LEHNHARD, SENIOR VICE PRESIDENT, BLUE CROSS AND BLUE SHIELD ASSOCIATION

Ms. LEHNHARD. Mr. Chairman, Mr. Rangel, Members of the Committee, I am Mary Nell Lehnhard, senior vice president of the Blue Cross and Blue Shield Association. We appreciate the opportunity to testify today.

Blue Cross and Blue Shield plans across the country have long supported public and have been active in private initiatives to expand coverage to more Americans. We believe coverage for the 43 million people who remain uninsured should be the top Federal health care priority. We are very pleased that the Committee is examining tax-based solutions to this problem. In February of this year we released a proposal for reducing the number of uninsured built on tax credits and full deductibility. Let me get quickly to our recommendation.

We think the single most effective thing Congress could do this year would be to target low-wage workers and small businesses. Our proposal would provide tax credits to small businesses for their low-wage workers. Small firms have lower rates of health coverage than large employers. 35 percent of workers and firms with less than 10 employees are uninsured. And if you look at the problem of small firms with low-wage workers, it is worse. Only 38 percent of small business with low-wage workers offer coverage compared to 78 percent of small businesses with high-wage workers.

We believe that expanding—providing a tax credit to small businesses for their low-wage workers would make the most effective use of scarce resources. By building on the current employer-based system, the idea would be simple to implement. We recommend Congress focus on low-wage workers and businesses of fewer than 10 employees and expand the program as resources permit.

In addition to this tax credit we have proposed full deductibility for the self-employed, providing tax deductibility for people without employer-sponsored coverage and providing Federal grants to States to fund other initiatives that expand coverage.

As I said earlier, we are pleased that Congress is now considering a number of tax proposals to expand coverage. The most comprehensive of these would delink health insurance from employment and move toward an individual coverage-based system.

These proposals embody the notion of individual enpowerment and merit full consideration. However, altering fundamental offerings in the way millions of Americans now receive coverage will require careful consideration by Congress. In all likelihood, moving to this type of comprehensive reform will be a long-term process that involves much debate and analysis and hopefully a good transition period. Other tax proposals such as accelerating full deductibility for the self-employed and full deductibility for those who don't have access appear to be generating bipartisan interest and could be enacted this year, and we support both of these proposals.

We are concerned about some of the proposals for providing parity of coverage between the individual and group markets. For example, we are concerned that providing full deductibility of individual coverage for those who already have access to employer-sponsored plans and proposals that require employers to provide the equivalent value of employer-provided benefits for employees who opt out of their current employer plan and purchase individual coverage in the individual market.

Our concern is that these proposals would create serious unintended consequences for the current employer-based system. By allowing individuals to opt out of the employer-based plans, these proposals would undermine the tremendous advantages of the natural pooling that occurs in an employer plan. Under these proposals, younger workers with fewer medical costs would be most likely to leave the group and the premiums for those who remain would increase significantly. Congress should avoid this type of adverse selection against employer plans by providing tax incentives for the purchase of coverage in the individual and nongroup market only if an individual doesn't have access to employer coverage. For example, eligibility could be limited to those employees whose employers have not offered coverage for some period of time, such as Mrs. Johnson has done in her bill.

Congress should also consider other ways to keep coverage as affordable as possible. Our proposal calls on Congress to adopt a new litmus test. Under this test, Congress would reject legislation such as managed-care regulation, benefit mandates, and antitrust exemptions that would increase premiums and consequently the number of uninsured.

In summary, Blue Cross and Blue Shield Association and its member plans believe expanding coverage should be the Congress' top priority, and we urge Congress to enact targeted tax proposals this year.

[The prepared statement follows:]

Statement of Mary Lehnhard, Senior Vice President, Blue Cross and Blue Shield Association

Mr. Chairman and members of the committee, I am Mary Nell Lehnhard, Senior Vice President of the Blue Cross and Blue Shield Association. BCBSA represents 51 independent Blue Cross and Blue Shield Plans throughout the nation that together provide health coverage to 73.3 million Americans. I appreciate the opportunity to testify on the increasing number of uninsured and what Congress should do to address this problem.

Since the debate over President Clinton's national health plan, when Congress last engaged in a serious discussion about the uninsured, Congress has focused much of its health care reform efforts on those people fortunate to have access to health insurance (e.g., passing health insurance portability reforms and debating managed care regulation). Meanwhile, despite a robust economy and low unemployment rates, the number of Americans without health coverage has grown to over 43 million.

BCBSA and Blue Plans across the country have long supported public and private initiatives to expand health coverage to more Americans. Many Blue Plans have created Caring Programs to make available free health coverage to low-income children and have initiated a variety of other programs to help the uninsured. In addition, BCBSA recently joined the White House, other federal officials and children's advocates to launch a national outreach program promoting the new Children's Health Insurance Program (CHIP), which Congress enacted in 1997.

But with the number of uninsured continuing to increase, the Blues recognize the need for additional action. Blue Cross and Blue Shield Plans have taken their commitment to the uninsured a step further by creating a two-part program to address this challenging public policy problem. BCBSA's Board of Directors approved this two-part program in January of 1999, and we strongly urge its adoption by Congress.

I will be making three points during my testimony.

- First, Congress should enact a tax-based solution to address the problem of the uninsured.
- Second, Congress should carefully assess the impact of alternative tax-based proposals.
- Third, Congress should adopt a "new litmus test" to reject legislation that would increase health care costs and, consequently, increase the number of uninsured.

I. CONGRESS SHOULD ENACT A TAX-BASED SOLUTION TO ADDRESS THE PROBLEM OF THE UNINSURED

Scope Of The Uninsured Problem:

Before devising its uninsured proposal, BCBSA gathered and analyzed the latest information on who the uninsured are and why they lack coverage. Most Americans receive health coverage through private health insurance—either through an employer or by purchasing health insurance on their own. Others receive health coverage by enrolling in a government program. But over 43 million people are without health coverage. The number of uninsured has grown steadily during the past decade and, without legislative action, is expected to continue to increase in the years to come.

While the uninsured fall into very different geographic, age, and racial/ethnic categories, they do have some common characteristics. One of the most significant subgroups of the uninsured are working Americans.

The term "uninsured" may conjure up images of people out of work, but the data suggest otherwise. According to a 1997 study from the Kaiser Family Foundation, 73 percent of uninsured adults are either employed or married to someone who is employed. The working uninsured tend to be those who work in low-paying jobs, those who work for small firms, and those who work in part-time jobs or in certain trades.

- *Low-Wage Workers.* The cost of health insurance can be prohibitive for low-wage workers who must purchase it on their own or pay a significant share of an employer-sponsored health plan. Almost half (43.5 percent) of the uninsured are in families earning less than $20,000 a year, and 73 percent of the uninsured are in families earning less than $40,000. Moreover, low-income workers are less likely to have access to coverage on the job.
- *Workers in Small Firms.* The working uninsured are likely to be employed by firms with fewer than 25 employees—43% of the uninsured employed in the private sector work for firms with fewer than 25 employees. They are also likely to be self-employed or dependents of such workers. One of every four self-employed individuals and nearly 35 percent of workers in firms with fewer than 10 employees are without coverage.
- *People In Families with Part-Time Workers.* Since employment-based coverage is usually only provided to full-time workers, the risk of being uninsured increases for people who only work part-time. More than one-quarter of people in families with only part-time workers are uninsured.
- *Workers in Seasonal Trades.* Workers in the agricultural, forestry, fishing, mining, and construction trades are more likely to be uninsured, probably reflecting the seasonal employment and the small firms that are characteristic of these trades. One third of the 12.5 million workers in these trades are without health insurance.

Other significant subgroups of the uninsured are young adults and minority racial and ethnic groups. Adults between the ages of 18 and 24 are more likely to be uninsured than any other age group, including children. Young adults are vulnerable to being uninsured because they may no longer be covered under their families' policy or Medicaid, may not yet be established in the workforce, and may earn less than older adults.

Hispanics and African Americans are also more likely to be uninsured than the rest of the population. While Hispanics and African Americans represent 12.3 percent and 13.1 percent of the nonelderly population, respectively, they represent 24.4 percent and 16.5 percent, respectively, of the uninsured.

Targeted Tax-Based Reforms That BCBSA Urges Congress To Enact:

BCBSA believes Congress needs to adopt targeted reforms that will reduce the existing number of uninsured. Extending health coverage to those without it can be achieved quickly and most effectively through legislation that is aimed at the specific subgroups of the uninsured, such as low-income workers, and that builds on the existing employment-based health system.

BCBSA believes these targeted solutions should include:

- Tax Credits To Small Employers For Their Low-Income Workers. Employees in small firms are more likely to be uninsured than those employed by larger companies. The primary reason for this higher uninsured rate is that small firms are more likely to have a larger share of low-income workers than larger firms. About 42 percent of workers in small firms (0–9 employees) earn less than 250 percent of the poverty level, compared to only 27 percent of employees in firms with 100 or more employees. Offering tax credits to small firms for their low-income workers would decrease the number of uninsured by making health coverage more affordable for small businesses and their low-wage employees.

Focusing on low-wage workers as a subset of those in small firms targets those most in need of assistance. Workers in small firms with a high proportion of low-wage workers are half as likely to be offered health coverage as workers in small firms with high-wage workers. Only 38 percent of small businesses with low-wage employees offer health coverage compared to 78 percent of small businesses with high-wage employees. A recent analysis by the Alpha Center (see attached graph) underscores the importance of focusing on low-wage workers in small firms. It shows that low-wage workers (e.g., those earning less than $20,000) have considerably lower rates of employer-sponsored health coverage than those with higher wages and illustrates that low-wage workers in the smallest firms are least likely to have employer-sponsored coverage.

By limiting the tax credit to only low-income employees of small businesses, the proposal would avoid subsidizing those who should be able to afford coverage on their own (e.g., lawyers working for a small firm). BCBSA recommends, given scarce resources, that Congress focus on low-income workers in businesses with fewer than 10 employees and then expand the program as resources permit.

Employers would administer the tax credit on behalf of qualifying employees. Because cash flow is critical for small firms, the proposal envisions that employers would provide the credit in the form of reductions in the withholding taxes that the employer would normally pay. The administrative burden of such a system on the employer would likely be very low since most employers contract payroll functions to outside firms that are easily able to administer such credits on behalf of employees.

Offering tax credits to small firms with low-income workers also has the advantage of building on the successful employer-based health coverage system. The majority of Americans receive health coverage through an employer. By building on the current employer-based system, BCBSA's tax credit proposal could be implemented immediately.

- *Full Tax Deductibility For The Self-Employed.* Expanding the groups of people who can deduct the cost of health insurance from their taxable income would assist many of the uninsured. Enabling the self-employed to fully deduct the cost of health coverage would help the one in four self-employed people who have no health insurance. Congress has already enacted legislation to phase in full deductibility for the self-employed. BCBSA believes this phase-in should be accelerated.
- *Full Tax Deductibility For People Without Employer-Sponsored Coverage.* Some people, including young adults and early retirees, are uninsured because they do not have access to employer-sponsored coverage. Making health coverage more affordable for those without access to employer-sponsored coverage would contribute to an increase in the overall rate of insurance. This can be achieved by allowing them to deduct the full cost of insurance. It would also address parity concerns regarding the tax treatment of health coverage received through an employer and health insurance purchased on one's own.
- *Federal Grants for Initiatives That Expand Coverage or Provide Care to the Uninsured.* Targeted solutions should also be developed for groups that may remain uninsured despite tax credits and deductibility, including some non-citizens, minorities, young people and other low-income groups. These targeted solutions can best be carried out by offering grants to states to fund a variety of initiatives, including private programs to expand health coverage, community health centers that provide health care to the uninsured, and subsidies to state high-risk pools, which make coverage more affordable for those requiring extensive medical care.

We believe this proposal, which is based on tax credits and deductibility to targeted subgroups of the uninsured, is the most appropriate way to address this problem. BCBSA's proposal has several advantages:

- *It Could Be Enacted Quickly.* BCBSA's proposal does not try to reinvent today's health coverage system. It recognizes that the current employment-based system works well for most Americans and would expand coverage through this system. By building upon the current system, BCBSA's proposed actions could be implemented quickly. These proposals could be enacted without the prolonged congressional debate that would be required of more controversial proposals that seek to restructure the entire system.
- *It Would Be Simple To Implement.* Building on the current employment-based system would also assure simplicity in the execution of BCBSA's proposed reforms. Employers and employees are already familiar with the employment-based system. Under BCBSA's proposal, there would be no need to educate health care purchasers and consumers about new ways of receiving health coverage. Using the infrastructure that is already in place would also obviate the need to create a new, complex bureaucracy to carry out the functions now performed by employers.
- *It Would Make The Best Use Of Scarce Resources.* By targeting specific subgroups of the uninsured (e.g., low-income workers in small firms), BCBSA's proposed reforms would assure that limited government funds would be directed to those most in need of assistance and those most likely to take advantage of such assistance.

II. Congress Needs To Carefully Assess The Impact Of Alternative Tax-Based Proposals

Numerous proposals to reduce the number of uninsured are now being considered in Congress. These proposals range from modest reforms to comprehensive restructuring of the market. They should each be carefully evaluated in terms of the potential to improve our health care financing system as well as the risk of creating unintended consequences.

The most comprehensive proposals are those that would "de-link" health insurance coverage from employment and move toward an individual-based system. These proposals embody the powerful notion of individual empowerment and merit full consideration. However, there are many issues that must be considered when one contemplates a move that would fundamentally alter the way millions of Americans now receive health coverage. Assessing the implications of changing to an individual-based system in all likelihood will be a long-term process that involves much debate and analysis.

I will limit my comments today to tax changes that could be enacted this year since Congress is expected to move forward with incremental tax provisions to improve the affordability of health coverage this year. We are encouraged by many of the tax proposals that are under development. For example, there appears to be growing interest in accelerating the full deductibility of coverage for the self-employed and providing full deductibility for those who do not have access to employer-sponsored health coverage, both of which we support.

Many in Congress are also considering proposals to provide for "parity" in coverage between the individual and group markets. These proposals range from providing full deductibility of individual coverage for those who have access to employer-sponsored plans—to requiring that employers provide the equivalent value of employer-provided benefits to employees who "opt out" of their employer-sponsored plan and purchase their own health coverage in the individual market.

We are concerned, however, that, while the intent of the parity proposals is to provide individuals with more choice, they would create unintended consequences for the current employment-based system. We are concerned that proposals that would allow individuals to opt out of the employment-based system in favor of individual coverage would undermine the advantages of the natural pooling that occurs in the group health insurance market. Given the opportunity to opt out of employer-sponsored plans, low-cost workers may be more likely to leave these group health plans, resulting in premium increases in these groups' rates. The result would be adverse selection, which would destabilize group plans.

While not perfect, the current employment-based system is successfully providing health coverage to the majority of Americans. For example, one of the advantages of the current employment-based system is that it facilitates significant cross subsidies. To illustrate, an employer who has a mix of young and old, healthy and not so healthy employees will not vary the contribution based on expected use of medical services. This represents an accepted mechanism for creating the cross subsidies that are essential for providing health insurance. Without a strategy to assure stable cross subsidies, the insurance market would deteriorate.

To avoid the problems with the parity provisions, BCBSA strongly believes Congress should provide tax breaks for the purchase of health coverage in the individual market only if the individual does not have access to employer-sponsored coverage. For example, eligibility for the tax breaks could be limited to those whose employers have not offered coverage for some defined period of time, have retired or are unemployed.

Congress must be aware that changes—even seemingly minor changes—that affect the employment-based system could make the current problem of the uninsured worse. To avoid these unintended consequences, BCBSA's short-term proposal strengthens the employment-based system. We believe that Congress should move quickly on some of these proposals while debate continues on more comprehensive reform strategies.

III. Congress Should Adopt A "New Litmus Test" To Reject Legislation That Increases Health Care Costs And The Number Of Uninsured

In addition to looking at tax-based solutions to the uninsured problem, Congress should consider other ways to preserve the affordability of private health insurance. BCBSA believes Congress should adopt a "new litmus test" to reject legislation that would increase premiums and, consequently, the number of uninsured. Federal managed care legislation, new benefit mandates and antitrust exemptions for health professionals are examples of proposals that would make health coverage less affordable for employers and consumers. Congress should reject these proposals so that it will not exacerbate the uninsured problem.

In analyzing the uninsured issue, BCBSA found that the cost of health coverage is the key determinant of whether working Americans have employer-sponsored coverage. We found that high annual premium increases were associated with drops in employment-based coverage and flat premiums were associated with improvements in employment-based coverage. Examining premium increases and coverage rates over the past decade illustrates this point.

When health care costs were rising at double-digit rates during the late 1980s, the percentage of nonelderly Americans with employment-based coverage declined. While 69.2 percent of workers had health coverage through an employer in 1987, only 64.7 percent had employment-based coverage in 1992.

According to the nonpartisan Employee Benefit Research Institute (EBRI), employers have been more likely to offer workers health coverage in recent years when health care cost increases have been relatively flat. Since 1993, there has been an increase in the percentage of people receiving employer-sponsored health coverage. While approximately 63 percent of nonelderly Americans received health coverage through an employer in 1993, that figure increased to 64.2 percent by 1997. Not surprisingly, the average annual increase in health benefit costs during this period was only 2.3 percent.

The first step in addressing the uninsured is to not make the problem worse. Given the link between higher costs and reduced coverage, Congress should pledge to enact no law that will make health coverage more expensive.

IV. Conclusion

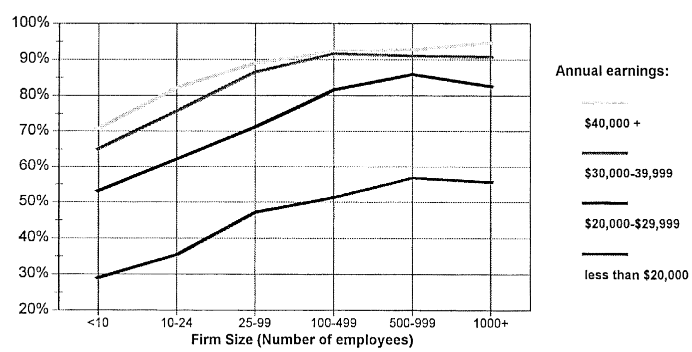
Expanding the number of Americans with health coverage should be our nation's top health care priority. No single solution will solve the uninsured problem, but the targeted solutions advocated by BCBSA would effectively reduce the number of uninsured.

We urge Congress to take a series of actions to reduce the number of uninsured, including providing tax credits to small firms for their low-wage workers, full tax deductibility for the self-employed and those without access to employer-sponsored coverage, and federal grants to states to fund targeted initiatives to expand health coverage. We also believe Congress should not enact legislation that would increase health care costs. Increasing health care costs will only increase the number of uninsured.

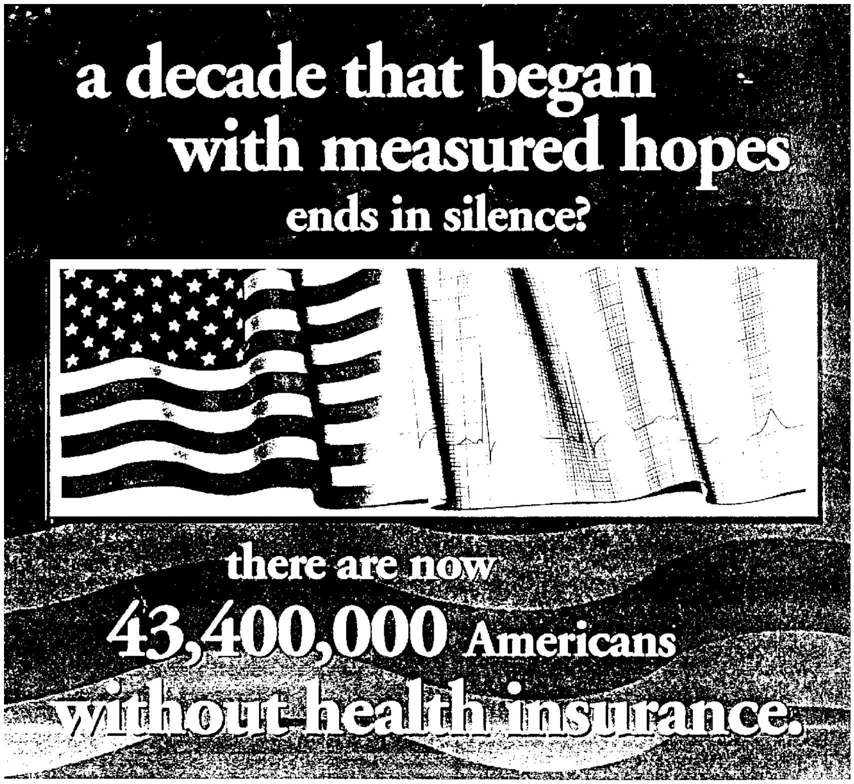
BCBSA's tax-based proposal could be enacted quickly, implemented simply and would make the best use of scare resources. It also avoids the problems that could be created by alternative proposals, such as tax proposals that would all employees to opt out of employment-based health plans.

Thank you for the opportunity to speak to you on this important issue. BCBSA looks forward to working with Congress to address the needs of the uninsured.

Percentage of Workers with Employer Health Coverage
by Wage and Firm Size, 1997



Source: Alpha Center tabulations of the March 1998 Current Population Survey (U.S. Bureau of the Census).



There are immediate steps we as a nation can take to reduce the number of Americans without health care coverage. These measures can make a difference.

More than 83% of uninsured Americans have jobs, a spouse or a parent who works. **The problem is greatest among the smallest businesses, where 35% of workers are uninsured.** America needs to provide greater incentives for employers to offer coverage for their now uninsured employees. This can happen.

Blue Cross and Blue Shield Association believes that by offering tax credits for low-income workers of small employers and full deductibility of insurance premiums for both self-employed individuals and for those without employer sponsored coverage, health insurance will be more accessible to more Americans.

At the same time, the government in Washington must resist the many public policy schemes that will increase the cost of health care. These policies can only result in more Americans without health insurance.

This is a situation where the government can foster solutions ... or aggravate an already grievous national problem.

Health care coverage for more Americans. It can happen.

BlueCross BlueShield Association

An Association of Independent Blue Cross and Blue Shield Plans

Mrs. JOHNSON of Connecticut [presiding]. Thank you very much. Mr. Wilford.

STATEMENT OF DAN WILFORD, PRESIDENT, MEMORIAL HERMANN HEALTHCARE SYSTEM, HOUSTON, TEXAS; ON BEHALF OF AMERICAN HOSPITAL ASSOCIATION

Mr. WILFORD. Thank you, Madam Chairman. I am Dan Wilford, President of the Memorial Hermann Healthcare System in Houston, Texas. I am testifying today on behalf of the American Hospital Association and its 5,000 hospitals, health systems, networks and other providers of care.

The American Hospital Association's vision is a society of healthy communities where all individuals reach the highest potential for health. Health care coverage itself does not ensure good health or access to services, but the absence of coverage is a major contributor to poor health.

Therefore, the American Hospital Association and its members have a long tradition of commitment to improving the health care coverage and access for America's uninsured and underinsured. AHA has supported incremental steps that can at least move our Nation closer to health care coverage for all, examples being the Health Insurance Affordability and Accountability Act of 1996, the children's health insurance program for 1997, and AHA's own campaign for coverage which enlisted 1,500 hospitals and health systems in an effort to extend coverage in their communities.

It has been said already that 43 million Americans are without health coverage. In Houston, 31 percent of our citizens have no insurance coverage compared to 16 percent on a national average. That is the largest percentage of a major metropolitan city in the United States.

Congress has a unique opportunity to ease this situation. The Federal budget surplus offers opportunities to look for and to fund ways to increase health care coverage for Americans. With 84 percent of the uninsured living in families that are headed by someone who has a job but no health coverage, the low-income working uninsured should be our next priority.

There is a growing consensus that changes in the Tax Code can make health care coverage more affordable for the working uninsured. Congress will be considering several options. We would like to present our views and some ideas that are aimed at getting health coverage to more Americans. First, make it affordable to people who cannot afford their employer's coverage or whose employers don't offer coverage to get insurance coverage from another source. This can take the form of a refundable tax credit for low-income tax payers who qualify for a credit against their income tax for all or part of what they spend for health insurance. It can be varied by income and family status.

We can offer tax credits to small employers that purchase group coverage. This will give small businesses additional financial resources to provide coverage for their employees and we can accelerate the deductibility of health payments for self-employed. Under current law, self-employed taxpayers are not able to get full deductibility of their insurance payments until the 2003.

In addition to Tax Code changes, other reforms can make coverage more accessible to the working uninsured. These include creating purchasing cooperatives and grants for State high-risk pools.

In addition, States and the Federal Government can make it easier for families to enroll in public programs like CHIP and Medicaid.

In conclusion, Madam Chairman, the fact is that people without health insurance are more likely to become seriously ill with injuries and illnesses that had they had proper health insurance could have been a minor problem. Our emergency departments see this every day.

That is why we support an effort to stem the rising tide of uninsured and to bring appropriate medical coverage to all who need it. With the working uninsured growing in numbers, we agree with the concept of changing the Tax Code to make it possible for more low-income workers and their families to have health care coverage. We look forward to working with you on specific legislation that will do that job properly.

Thank you.

[The prepared statement follows:]

Statement of Dan Wilford, President, Memorial Hermann Healthcare System, Houston, Texas; on behalf of American Hospital Association

Mr. Chairman, I am Dan Wilford, president of Memorial Hermann Healthcare System in Houston, Texas. I am testifying today on behalf of the American Hospital Association (AHA) and its 5,000 hospitals, health systems, networks, and other providers of care. We are pleased to have this opportunity to discuss the critical national goal of getting health care coverage to more Americans.

The AHA's vision is a society of healthy communities, where all individuals reach their highest potential for health. While health care coverage by itself does not ensure good health or access to health care services, the absence of coverage is a major contributor to poor health. Therefore, the AHA and its members have a long tradition of commitment to improving health care coverage and access for America's uninsured and underinsured.

According to the Employee Benefit Research Institute (EBRI), the percentage of uninsured Americans has increased steadily since 1987. In 1997, 43 million Americans were without health care insurance. Congress has a unique opportunity to ease this situation right now. According to the Congressional Budget Office, the federal budget surplus was $70 billion last year, will be $107 billion in 1999, and is projected to reach $209 billion by 2002 and then continue to grow. *Now is the time to look for—and to fund—opportunities to increase health care insurance coverage for Americans*.

We've already made headway in several areas, including expanding coverage for America's children. With 84 percent of the uninsured living in families that are headed by someone who has a job but no health insurance, the low-income, working uninsured should be our next target.

INCREMENTAL PROGRESS

The AHA believes that every American deserves access to basic health care services, services that provide the right care in the right setting at the right time. But we also know that, as the 1994 health care reform debate clearly demonstrated, a single, comprehensive proposal to bring coverage to all Americans is unlikely to be successful. Incremental steps are a more likely means for increasing coverage, and the AHA has supported those steps that we believe can at least move the nation closer to health care coverage for all.

The AHA supported the Kassebaum/Kennedy legislation that became known as the Health Insurance Portability and Accountability Act. We recognized that the immediate impact on reducing the number of uninsured was not likely to be overwhelming. Nevertheless, we judged it critically important to demonstrate that practical, public initiatives could help reduce the loss of insurance coverage.

And we were strong supporters of the Children's Health Insurance Program (CHIP). This effort was part of the Balanced Budget Act of 1997, and helps states provide health care coverage to low-income children. Fifteen percent—or nearly eleven million—of children in this country went without health insurance in 1997.

Under CHIP, states can help alleviate this problem by purchasing insurance, providing coverage through Medicaid, or through some combination of both options. The federal government has appropriated $24 billion through 2002 for the program.

Those funds are allocated based on the number of uninsured children in each state, with the state matching the federal allotment.

With almost every state, plus the District of Columbia and Puerto Rico, opting in to the program, CHIP got off to a good start. In fact, the Health Care Financing Administration (HCFA) has reported that, in its first year of operation, the CHIP program enrolled nearly one million children. This is momentum that is just beginning, and we urge Congress to resist any temptation it may feel to divert or reduce federal funds that have been allocated for this purpose.

The AHA, our state association partners, and individual hospitals and health systems have been working hard to help enroll eligible children in CHIP and Medicaid. Last year, the AHA, HCFA, the March of Dimes and WJLA–TV, the local ABC affiliate, teamed up with Maryland and Washington, D.C. governments to develop public service advertisements urging low-income families to sign their children up for free or low-cost health insurance. Our partnership with HCFA is ongoing, and another joint outreach initiative is planned for this autumn.

And as part of the observance of National Hospital week from May 9–15, the AHA urged all hospitals to continue their commitment to enroll children in Medicaid and CHIP, by encouraging participation in the national campaign to Insure Kids Now. The campaign has a toll-free hotline with information on the low-cost state health insurance programs, and the AHA provided hospitals with Insure Kids Now posters with the 1–877–Kids Now number for their emergency departments or other appropriate locations.

AHA'S CAMPAIGN FOR COVERAGE

The AHA's commitment goes beyond these recent efforts. The AHA Board of Trustees, after the demise of national health care reform, was concerned that the American public had resigned itself to the fact that large numbers of Americans were, and seemingly always would be, uninsured. The AHA explored a number of approaches with many of the leading health policy thinkers at a series of policy forums addressing coverage, access, and improving population health status. Each of the policy forums concluded that:

- incremental initiatives were the most likely path to progress in reducing the number of uninsured, and
- state and local initiatives would provide the most immediate benefit.

In the absence of comprehensive federal action, the AHA Board of Trustees in January of 1997 adopted a concrete goal of reducing the number of uninsured people by four million by the end of 1998—the AHA's Centennial year. We took on this challenge because the primary task of hospitals and health systems is to improve the health of their communities. While they care for people who are both insured and uninsured, our members see every day that the absence of coverage is a significant barrier to care, reducing the likelihood that people will get appropriate preventive, diagnostic and chronic care.

The *AHA's Campaign for Coverage—A Community Health Challenge* asked each of our members to help reduce the number of uninsured people in their communities. Our state hospital association partners worked to reduce the number of uninsured in their states. Community-based efforts were key, and included encouraging hospitals as employers to provide coverage to all employees; working with local employers to develop affordable coverage; providing care in a school-based or church-based clinic; working with the state Medicaid program to increase the participation rate among eligible people; and much more.

The number of hospital and health system participants in the Campaign grew to about 1,500. They found ways to extend coverage to nearly 2.5 million uninsured people, and to improve access to health care services for another 3.4 million people. And through their partnerships with local physicians, other caregivers, schools and businesses, health care leaders continue to carry the Campaign's message: getting more people covered is not a one-time project, but a lifetime's work.

The next chapter of our campaign is being written. The AHA has joined with EBRI, the Milbank Memorial Fund, and the Association of American Medical Colleges to form the Consumer Health Education Council (CHEC), an organization dedicated to expanding coverage for the uninsured. This new organization is educating consumers and employers about the need for coverage, developing tools to help people choose a health plan, and providing the media and public policymakers with information about health care coverage.

THE NEXT STEP

Eighty-four percent of the uninsured live in families that are headed by workers, some with full-time jobs, others with part-time positions. Finding ways to make health insurance more affordable for small companies and for low-income workers could significantly slow the number of uninsured Americans, by getting coverage to the workers and to their families.

According to an article in Health Affairs journal co-authored by Jon Gabel, vice president of health systems studies at AHA's Hospital Research and Educational Trust, higher-wage firms are more likely than lower-wage firms to provide health coverage for their employees.

During the past six years, writes Gabel, the U.S. economy added more then 12 million jobs, and the unemployment rate fell to its lowest level since 1969. Yet, at the same time, the number of uninsured increased from 35 million to 43 million. In 1997 alone, a year in which the unemployment rate fell from 5.3 percent to 4.6 percent, the number of uninsured increased by nearly 2 million.

Part of this is due to low-income workers not being offered health insurance by their employers. Using data from KPMG Peat Marwick's 1998 survey of employers about job-based health insurance, Gabel and his colleagues calculated that only 39 percent of small firms (those with fewer than 200 workers) with low-wage employees offered health benefits. Among small firms that pay high wages, 82 percent offered health benefits.

The findings suggest that low-wage families are more likely to be insured if they work in firms where most of the employees earn higher wages. Further analysis points to cost as another ingredient in the growth of the uninsured. While real wages declined for low-wage workers, employee contributions for single and family coverage rose more than threefold from 1988 to 1996. The result is that fewer workers could afford to accept their employer's health care coverage, and opted to go without coverage.

INCREMENTAL SOLUTIONS TO TARGET THE WORKING UNINSURED

A look at how our current tax system stimulates health insurance coverage can help explain the broader question of the uninsured. Of the 84 percent of the population with health insurance, employment-based coverage provides the majority with health care coverage. The most significant tax incentives for employer-based health insurance are: health coverage as a deductible business expense; health coverage as an exclusion from an employee's gross income; and health coverage as an exclusion from employment tax computations such as Social Security, Medicare or unemployment compensation.

The tax incentives are less generous for self-employed and individual taxpayers. Self-employed taxpayers may deduct payments for health insurance from their adjusted gross income. The tax deduction is currently only 45 percent of the amount of the insurance, but will increase to 100 percent in 2003. Individuals who itemize can deduct any unreimbursed medical expenses only if those expenses exceed 7.5 percent of gross income. Questions have been raised over how our federal tax system creates inefficiencies and market distortions, and favors individuals who work and have higher incomes.

Congress, in particular, should investigate the question of how the inequities in the tax code have contributed to the current diminishment of health care coverage. However, necessary reforms will take years to be fully vetted. The need to ensure access to health care for many low-income working uninsured is far too pressing to wait. The EBRI data shows us that:

- Eighty-four percent of the uninsured lived in families that are headed by workers, some with full-time jobs, others with part-time positions.
- Adults between the ages of 18–64 accounted for almost all of the most recent increase in the uninsured, between 1996 and 1997.
- The decline in Medicaid coverage for working and non-working adults accounted for the overall increase in the uninsured between 1996 and 1997.
- The uninsured are concentrated disproportionately in low-income families—over 40 percent earn less than $20,000.
- Nearly half of the working uninsured are either self-employed or working in small businesses with fewer than 25 employees. A growing consensus is emerging to look at incremental steps through the tax code to make health care coverage more affordable for the working uninsured. The AHA believes there are several solutions that can help more employees afford health care coverage. Congress will be considering several tax credit options. We would like to present our views on some ideas we support that are aimed at getting health care coverage to more Americans.

Reform the Tax Code

Make coverage more affordable for the working uninsured

• Make it affordable for low-income people who cannot afford their employer's coverage, or whose employers don't offer coverage, to get health care insurance from another source. This could take the form of a refundable tax credit. Low-income taxpayers would qualify for a credit against their income tax for all or part of the amount that they spend on health insurance. The tax credit can be varied by income and family status. For low-income taxpayers the tax credit is preferable to tax exclusions and deductions, which favor higher income workers. The tax credit, essentially a direct transfer from the government, will help low-income workers purchase insurance.

Assist employers in offering insurance

• Offer tax credits for small employers that purchase group coverage premiums. This would give small businesses additional financial resources to provide coverage to their employees.

• Accelerate the deductibility of health payments for the self-employed. Under current law, self-employed taxpayers will not be able to fully deduct their health insurance payments until 2003.

Other Reforms

In addition to changes in the tax code, there are other reforms that would help make insurance more accessible to the working uninsured. These include:

Create a mechanism that allows more-affordable insurance

• Create purchasing cooperatives that, through strength in numbers, can give small firms more leverage in negotiating health care insurance contracts.

• Offer grants for state high-risk pools. High-risk pools would allow access to insurance for people with greater health care needs.

Make it easier for families to enroll in public programs

• Give states the option to expand CHIP to include families of CHIP-eligible children. Encourage states to use temporary Medicaid coverage for individuals that are moving from welfare-to-work.

• Expand coverage for low-income pregnant women, legal immigrant low-income pregnant women and legal immigrant low-income children

• Continue the federal commitment to fund CHIP; states are demonstrating strong commitments to CHIP, and momentum would be lost if federal dollars are removed

• Encourage outreach to enroll eligible children in CHIP and state Medicaid programs

Finance reforms and expansions through the federal budget surplus

The financing of such reforms is a critical policy question. The booming economy, and a projected federal budget surplus of $107 billion this year alone, offer a unique opportunity to help fund many of these initiatives. By investing surplus dollars, Congress can realize a substantial return as more Americans receive the right health care, at the right time, in the right place.

CONCLUSION

Mr. Chairman, America's hospitals and health systems believe that every man, woman and child in this country deserve basic health care services, and that no one should lack these services because they cannot pay for them. It is a fact that people who do not have health care insurance are more likely to become seriously ill with an illness or injury that, had it been treated properly and early, could have been a minor annoyance instead of an expensive condition. Our emergency departments see this every day.

That is why we support any effort to stem the rising tide of the uninsured, and bring appropriate medical care to all who need it. With the working uninsured growing in numbers, we agree with the concept of changing the tax code to make it possible for more low-income workers and their families to have health care coverage. We look forward to working with you on specific legislation that would do the job properly.

Mrs. JOHNSON of Connecticut. Thank you very much, Mr. Wilford.

Ms. Hoenicke.

STATEMENT OF JEANNE HOENICKE, VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, AMERICAN COUNCIL OF LIFE INSURANCE

Ms. HOENICKE. Thank you, Madam Chairman. I am Jeanne Hoenicke, vice president and deputy general counsel of the American Council of Life Insurance. The nearly 500 member companies of the ACLI offer annuities, life insurance, pensions, long-term care, disability income insurance and other retirement and protection products.

My statement echoes some of the speakers you have heard before me. It is also a prelude to the retirement panel that follows. Over the next 35 years, the number of Americans over age 65 will more than double and nearly half of those will reach the age of 90. Many of us will spend more than 25 years in retirement. This calls for broader and more flexible preparation. That preparation includes having assurances of many things: That you will not outlive your income; that you will not become impoverished even if you need long-term care; and that your retirement savings will be protected during your working years even if you become disabled or suffer the death of a key wage provider, child care provider or homemaker.

ACLI believes that we need a comprehensive approach to retirement security, one that recognizes the increasing reliance on private sector solutions, personal responsibility, and retirement risks. As leading providers of both accumulation and protection products, we are uniquely qualified to assist in developing strategies that help Americans adapt to the happy advent of a long retirement, but one that has less formal guarantees and more uncertainties.

Retirement security is our number one issue. Social Security as it exists today may not continue to provide a sufficient level of benefits for the coming generations. Policymakers should address this issue now while the economy and demographics provide a window of opportunity. At the same time, actions taken to preserve and strengthen Social Security must not unintentionally weaken the private retirement system.

Fortunately, the private pension system continues to grow, increasing from less than 10 percent of national wealth in 1980 to close to 25 percent in 1993. Our retirement system must continue to respond to America's changing work patterns, including the growing importance of small businesses, coupled with shorter job tenures, both of which have important implications for the future. The ACLI applauds Representatives Portman and Cardin for their leadership in ensuring not only the maintenance but the expansion of the voluntary employer-sponsored retirement system. We strongly support their legislation, H.R. 1102, and urge Congress to enact it as quickly as possible.

We are also keenly aware that tax incentives have played a key role in the growth of annuities and IRAs. These retirement products are especially important to the self-employed, a growing segment of the work force. Over 80 percent of individual annuity owners have household incomes under $75,000, close to half have incomes under $40,000. The current tax treatment of annuities during the retirement savings phase must be maintained and we are very grateful to this Committee for its staunch support against efforts to weaken tax incentives for individuals who plan responsibility for their full lifetime needs through these retirement annuities.

More Americans need to understand the importance not just of accumulating savings, but of planning to protect those savings against the uncertainties of what life might hold. We should do more to encourage everyone to accept the dual challenge of accumulating savings and managing risks to those savings. To manage risks, Americans need to have some portion of their retirement income in a guaranteed stream of payments for their whole life: from Social Security; from employer-sponsored pensions; and from personal annuities. The Tax Code should provide incentive for individuals to guard against outliving their savings.

Tax policy should also promote responsibility for guarding against the devastating costs of a long-term illness. The ACLI believes that the Code should be amended to permit individuals to deduct long-term care insurance premiums for themselves and family members as an adjustment to income like the IRA deduction. We strongly support the bill introduced last week by Representatives Johnson and Thurman which includes this important tax incentive.

Madam Chairman, the future is not what it used to be. We urge you to adopt tax policies that reward personal responsibility and provide more flexibility for retirements that will be longer and very different from the past. Accumulating savings for retirement is vitally important. Protecting those savings before and in retirement is equally important.

Thank you for providing us with this opportunity to express our views, and I would be happy to answer questions.

[The prepared statement follows:]

Statement of Jeanne Hoenicke, Vice President and Deputy General Counsel, American Counsel of Life Insurance

Thank you, Mr Chairman. I am Jeanne Hoenicke, Vice President and Deputy General Counsel of the American Council of Life Insurance. The nearly 500 member companies of the ACLI offer life insurance, annuities, pensions, long term care insurance, disability income insurance and other retirement and financial protection products. Our members are deeply committed to helping all Americans provide for a secure life and retirement.

Over the next 35 years, the number of Americans over age 65 will more than double, and nearly half of those will reach the age of 90. This means many of us will spend over 25 years in retirement. This fast approaching reality calls for broader and more flexible preparation. That preparation includes having assurance of many things: that you will not outlive your income even if Social Security is less than expected and you have no company lifetime pension; that you will not become impoverished even if you need long-term care; and that your retirement nest egg will be protected during your working years even if you become disabled, or suffer the death of a key wage provider, childcare provider or homemaker.

Congress has provided an important safety net for the truly needy, and has encouraged individuals to take appropriate steps to secure their own retirements. The success of today's retirement system rests on a healthy Social Security system and on federal income tax incentives for private pensions and retirement savings. The government role in these programs remains essential.

ACLI believes, however, that we need a more comprehensive approach to retirement policy, one that recognizes the increasing reliance on private sector solutions, personal responsibility, and retirement risks.

As leading providers of *both* accumulation and protection products, the life insurance industry is uniquely qualified to assist in developing strategies to help Americans adapt to the happy advent of a long retirement, but one that has less formal guarantees, and more uncertainties. Retirement and financial security is our number one issue.

Social Security as it exists today may not continue to provide a sufficient level of benefits for the coming generations. We believe policymakers must address this issue while the economy and demographics provide a window of opportunity. At the same time, actions taken to preserve and strengthen Social Security must not unintentionally weaken the private retirement system.

Fortunately, the private pension system continues to grow, increasing from less than 10 percent of national wealth in 1980 to close to 25 percent of national wealth in 1993. By 1997, assets in the private pension system were nearly $7 trillion, including significant growth in defined contribution plans. The nation's retirement system has, and must continue to, respond to the dynamic nature of Americans' changing work patterns, including the growing importance of small businesses and the service sector, coupled with the trend toward shorter job tenures, all have important implications for the future. Tax policymakers need to take these trends into account.

We have provided the Committee with much information on employer-provided pensions, for example, that 77 percent of participants have earnings below $50,000 (1997). The ACLI applauds Representatives Portman and Cardin for their leadership in ensuring not only the maintenance, but the expansion of the voluntary employer-sponsored retirement system. We strongly support their legislation, H.R. 1102 (the Comprehensive Retirement Security and Pension Reform Act), and urge Congress to enact it as quickly as possible. The ACLI particularly supports the Portman/Cardin proposals to raise the limitations on contributions to and benefits from pension plans to or above their former levels and increase the limits on compensation considered for these purposes. In addition, the ACLI strongly supports repeal of the current liability funding limit which restricts the ability of an employer to ensure a well-funded plan. We also support similar provisions offered by representatives on this Committee and throughout Congress.

At the same time, we are keenly aware that tax incentives have also played a key role in the growth of IRAs and annuities. These retirement products are especially important to the self-employed, a growing segment of the American workforce, and to those without employer-sponsored pensions. Over 80 percent of individual annuity owners have household incomes under $75,000; close to half have incomes below $40,000. The current tax treatment of annuities during the retirement savings accumulation phase must be maintained. We are grateful to this Committee for its staunch support against efforts to impose tax dis-incentives for individuals who plan responsibly for their *full* lifetime needs through these important annuity retirement products.

More Americans need to understand the importance not just of accumulating savings, but of planning to protect one's savings against the uncertainties of what life might hold; uncertainties such as becoming disabled or a family provider dying early; uncertainties such as outliving one's income or needing long-term care. We should do more to encourage all Americans to accept the dual challenges of accumulating retirement savings and managing risks to these savings.

To manage retirement risks, Americans need to have some portion of their retirement income in a guaranteed stream of income for life from Social Security, from employer-sponsored pensions, and from personal annuities. The Tax Code should promote individual responsibility for guarding against outliving one's savings.

Government tax policy should also promote individual and family responsibility for guarding against the devastating costs of a long-term, chronic illness. The ACLI believes that the Tax Code should be amended to permit individuals to deduct long-term care insurance premiums for themselves and family members as an adjustment to income, like the IRA deduction. We strongly support H.R. 2102, the bill introduced last week by Representatives Nancy Johnson and Karen Thurman which includes this important tax incentive.

Mr. Chairman, the future is not what it used to be. We need to adopt tax policies that reward personal responsibility and provide more flexibility for retirements that will be longer and very different from the past. The life insurance industry is the only private industry that can provide life insurance protection against leaving family members without money should a wage provider, childcare provider or homemaker die early; that can provide annuities which guarantee income for every month a person and his or her spouse lives, no matter how long; and that can protect a nest egg from being wiped out due to disabilities, or long-term care needs through disability and long-term care insurance. Accumulating savings for retirement is vitally important; protecting those savings before and in retirement is equally important.

Thank you for providing us with this opportunity to express our views and I would be happy to answer any questions.

The Importance of Pension Benefits to Middle Income Retirees

For Ways & Means Hearing on Reducing Taxes on Retirement Security
June 16, 1999

By Janemarie Mulvey, Ph.D.
Director, Economic Research

American Council of Life Insurance

Overview

- Definition of Pension Benefits
  - Includes employer-sponsored plans, federal, state and local and military (does not include lump sum payments)
- Definition of Middle Income Retirees
  - Married couples with income between $30K to $50K
  - Widows/widowers with income between $15K to $25K
- Describe Pension Benefits Among Current Retirees

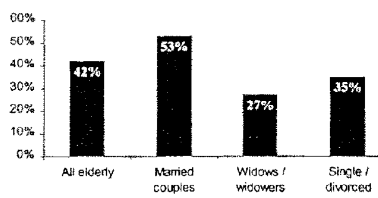
American Council of Life Insurance

2

Over 40 Percent of the Elderly Receive A Pension Benefit

- **Coverage varies by marital status**
  - Over 50 percent of elderly married couples received pension income
  - About one-third of widows/widowers received pension income
  - Over 35 percent of single/divorced received pension income

Percent Receiving Pension Benefits By Marital Status, 1997



Source: ACLI analysis of 1998 Current Population Survey

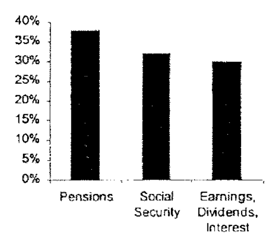
American Council of Life Insurance

3

Pension Benefits Are the Largest Source of Income Among Pension Recipients

- Pension income comprised nearly 40 percent of income for those receiving a pension
- The average pension benefit was $10,000 in 1997
- The median pension benefit was $7,050 in 1997

Sources of Retirement Income For The Elderly, 1997



* Includes Veteran Benefits, Public Assistance and SSI.

Source: ACLI analysis of 1998 Current Population Survey

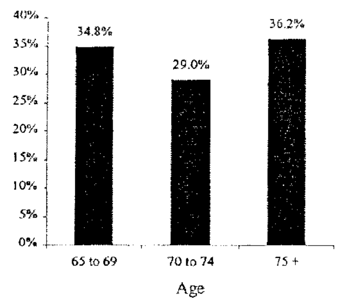
American Council of Life Insurance

4

Distribution of Benefits by Age and Sex

- The majority of pension benefits are concentrated among those aged 75 and older (36 percent)
- Elderly women are less likely to have a pension in their own name as compared to men -- sixty percent of elderly pension recipients are men

Percent of Total Pension Benefits, 1997

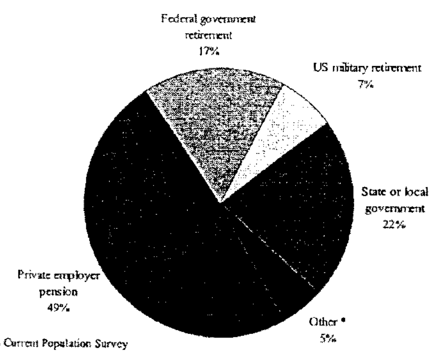


Source: ACLI analysis of 1998 Current Population Survey

American Council of Life Insurance

Half of Pension Benefits Are From Private Employer Plans

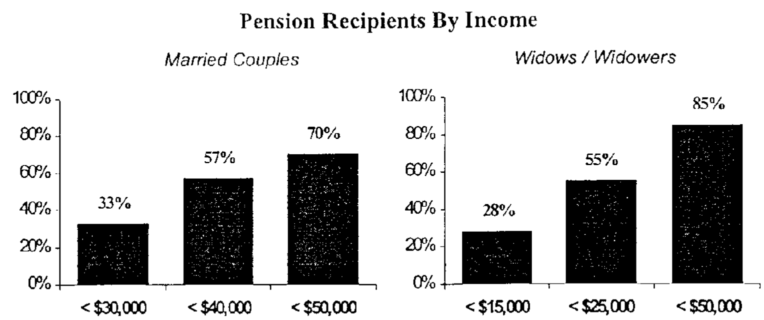
Pension Benefits By Type of Plan, 1997



Source: ACLI analysis of 1998 Current Population Survey

American Council of Life Insurance

Most Pension Recipients Are Middle Income



Source: ACLI analysis of 1998 Current Population Survey.

American Council of Life Insurance

7

Pension Dollars By Income Class

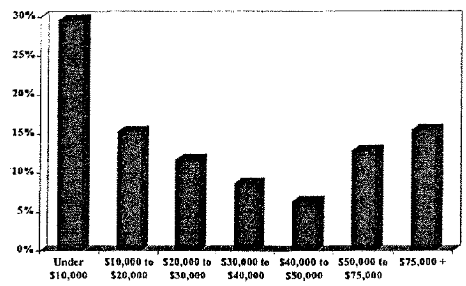
- Among married couples:
  - 50 percent of pension dollars go to families with incomes below $50,000
  - 30 percent of pension dollars go to families with income below $40,000
- Among widows/widowers:
  - Over 55 percent of pension dollars go to widows/widowers with incomes below $40,000
  - One-third of pension dollars go to widows/widowers with incomes below $25,000

American Council of Life Insurance

8

Over 50 Percent of Pension Benefits Go to Elderly With AGI Below $30,000

Percent of Pension Benefits by Adjusted Gross Income, 1997



Source: ACLI analysis of 1998 Current Population Survey.

American Council of Life Insurance

9

Conclusions

- Pension benefits are an important source of income to middle income elderly and will become increasingly important in the future
- Among married couples nearly 70 percent of those receiving a pension had incomes below $50,000
- Among widows/widowers over 55 percent of pension recipients had incomes below $25,000

American Council of Life Insurance

10

Mrs. JOHNSON of Connecticut. I thank the panel for their presentation. It certainly is true that the future is going to be quite different from the past, and one of the stark differences is the many, many years that people are going to live in retirement, and our failure to this point at least to appropriately respond to the changed nature of retirement in our public policies.

Social Security reform, as important as it is, is really the easy piece of that. Unless we do a lot of things that we have talked about here today, we really won't have retirees that are as secure and capable and a strong part of the economy in decades ahead.

I wanted to ask you, Ms. Hoenicke, because the concept of annuities has not been popular with the Treasury in recent years and come under attack as a source of new revenues in a number of subtle ways, could you just talk about the benefits of annuity products as opposed to other kinds of products as we look toward retirement security?

Ms. HOENICKE. Surely. The annuity product we believe is very important and we are grateful to this Committee's support for it over the years. The unique feature that makes it so important to this retirement security issue that you are considering today is that it is the only product that can provide individuals a guarantee against outliving their income. If the savings pool they have gathered will not necessarily provide them enough money throughout their life, if they have purchased an annuity, the insurance company will, with the money that they have used to purchase that annuity, provide that stream of income. That is very important because we do not know how long we are going to live, and we may live a long time, happily.

Mrs. JOHNSON of Connecticut. Thank you. On the subject of the uninsured, I appreciate the many ideas that are now coming forth in covering the uninsured. Certainly as we look at the problems in Medicare, the confluence of Medicare payment problems and the rise in the number of uninsured are posing a new threat to hospital services. Hospitals are uniquely impacted by the rise of the uninsured, both in terms of your emergency room costs and in terms of hospital stays that are not compensated by virtue of lack of insured coverage.

So it is of enormous importance to our hospital system that we move aggressively to reduce the number of the uninsured, not just from the point of view of their needing better preventive care and early intervention, but also in maintaining the strength of the institutional capability that this Nation has to provide very sophisticated acute care hospital services.

But as we move to work on the uninsured, a number of you have talked about this problem of how do you cover the uninsured and not erode the strength of the employer sector.

One of the critical issues that is not addressed by any of our legislation but I think is very relevant is how do we stimulate the private sector to provide a broader array of policies? We are beginning to see some change. I am beginning in my district to see very exciting pairing of medical savings accounts with the traditional employer provided accounts giving people the option of a medical savings account and then the retirement savings that offers in years of low health care costs.

Aetna recently came out with a whole different approach to insuring health costs. One of the reasons we can't reach the uninsured individual is because the costs are high, whether it is for the individual or for the small business, and how can we create a greater challenge to the individual market to think through the real needs of the variety of people who are uninsured and stimulate a broader market, at the same time do something to help with the cost. But if we just help with the cost, we maintain in a sense the continued rigidity of the product in the health market. I am not sure that we are going to achieve our goal so it is kind of a nebulous question, but I would appreciate your comments on it.

Mr. GOODMAN. I would suggest two changes. Two changes. One, I think it is important that we have the same tax system applying to individuals and to small businesses so that we have a level playingfield under the tax law. And as long as we have a level playingfield, we are going to find out what the employer's role should be in the marketplace and not by the artificial mechanism of tax law.

The other important change largely has to come at the State level. In Texas, we are looking very seriously at the idea of allowing small businesses to buy their employees into individual insurance pools. So you get all the economies of group purchasing, whatever economies there are there, and then what the employee has is a policy which he owns and can, in principal, take from job to job.

I think if we can open up that mechanism, we will get small business more in the role of helping people get into pools instead of tying to run its own health insurance plan which a small business is not really able to do.

Mrs. JOHNSON of Connecticut. Dr. Butler.

Mr. BUTLER. I agree with that. I think providing subsidy or tax credit will of itself stimulate a lot of activity.

It is very interesting, for example, that in the FEHBP, the Federal Employee Health Benefit Program, you see a plethora of employee-sponsored organizations including unions being very much involved in a provision of care. Why is that so and not so in the rest of the market? Because those plans are eligible for the subsidies under the FEHBP.

If you provide a credit or other kinds of assistance that have been mentioned, I think you will see the development of those kinds of alternatives. I think if you look at organized labor, or if you look at church-based organizations, particularly in the African-American community, there are natural groupings that are already there as a basis on which to build larger pools. I think the way to encourage or even work directly with States on a demonstration basis to allow pooling to develop. But the credit, which means giving the same tax treatment for nonemployment based plans, is the key financial step to stimulate this kind of activity.

Mrs. JOHNSON of Connecticut. Mr. Kahn.

Mr. KAHN. I think at the end of the day the kind of subsidization that is being discussed here is critically important. It will make the difference. But I must say, I think there is sort of a countervailing trend. On the one hand, plans, and plan purchasers are trying to be cost conscious. On the other hand consumers and the employees are demanding more choice.

So more open network plans are where the growth is, where the products are and they tend to be more expensive than either closed-network HMOs or more high-deductible plans. I think over time, particularly in the small employer market, for it to work, you are going to see these products, whether they are HMOs or very high deductible plans, being the only ones that you can have that you can keep affordable. Because at the end of the day, whether it is better pooling or whatever, health care is expensive and people are going to want a combination of coverage for various kinds of illnesses and diseases that will be expensive.

Mrs. JOHNSON of Connecticut. I do think it is sort of a remarkable failure of the American system that we have been unable to create pools for individuals, and I have been working on that for years and many others in the Congress have. I am interested that you think tax equity would help stimulate or create the opportunity for a different kind of pooling.

I think we need to be thinking about pools that also can register people for Medicaid. So they both are sort of, in a sense public private because we have so many Medicaid-eligible people who are not in the Medicaid system. I think only if we begin to really have a more comprehensive approach to coverage can we do that. As you develop ideas along that line, I would appreciate it if you would get back to me.

Mr. Rangel.

Mr. RANGEL. I have no questions. I want to thank the panel for their excellent testimony.

Mrs. JOHNSON. Mr. Foley.

Mr. FOLEY. This may be slightly off the mark but maybe one of you can help me. We are in a debate now on minimum wage and increasing minimum wage, and oftentimes at that level the employees themselves don't have any health care coverage whatsoever. I think if given the option of a dollar in their paycheck per hour or some type of health insurance policy, they will quickly take the dollar in the paycheck and go without coverage.

One of the big problems in the insurance industry and the health care industry and the hospital industry is the fact that there is an immense amount of cost shifting to those who have the ability to pay who have Medicare or Medicaid or some other form. And we are now aggressively debating how should we increase minimum wage.

One of the thoughts I had was rather than necessarily give a dollar increase, I would rather figure a way to require health insurance coverage thereby reducing the burden that is spread amongst society in getting employees covered. Now, it may fall on deaf ears in several sectors, but I wondered if any of you had looked at that potential kind of policy implementation rather than just throwing money to the wind and saying now we are going to elevate everybody's paycheck in order to keep things consistent in America.

Can anybody give me an idea about that?

Mr. GOODMAN. I can tell you that I prefer the kind of approach which encourages people to both have a job and to have health insurance. I would be opposed to an approach which artificially raises the cost of labor, and therefore is going to cause people to be unemployed, especially as we go into an economic downturn. So I prefer the tax credit approach that is available to people regardless of their wage and for people at the bottom of the income ladder, since they are fully refundable, it means essentially the Federal Government is going to be paying for their insurance.

Mr. BUTLER. I agree with that. Assuming for the sake of argument that one supports increasing the minimum wage, if you go forward with earmarking that for a specific kind of insurance coverage, it will create more problems than it solves for lots of people because you won't be able to get a one-size-fits-all solution.

On the other hand, and whether or not you have an increase in minimum wage, the tax credit which offsets the cost of coverage gives you a lot more flexibility to do it either within the employment base system or outside the employment base system. You don't have to have the same degree of regulation and one-size-fits-all approach to how people are going to use that money for health coverage.

I think Dr. Goodman's point is correct. If you offer credit and people for whatever reason don't take it, then you can look at a rebate to the States equivalent to that revenue which has not been lost by the Federal Government as a way of dealing with people who somehow refuse to take the credit.

Mr. KAHN. I guess I would have a little concern about critical mass of dollars. If someone is actually at the minimum wage and you say only a dollar or some small portion of that has to go to health insurance, I am not sure there is enough critical mass. And, if the employer is not already providing them coverage, I think it is problematic. I am not sure where it gets you unless you come in with either deductions or vouchers for people that are under a certain level of income as we have in our InsureUSA Proposal or something to get them enough bucks to get a policy that has substance to it and would give them the kind of coverage that would sort of move them down the field toward decent health care.

Mr. WILFORD. Mr. Foley, I believe the people we experience in our emergency departments that come in with no coverage that are minimum-wage people probably would put their money in their pocket like you are proposing. I think one possible alternative might be that the employer be required to provide some kind of at least catastrophic coverage for that group so that the major catastrophic illnesses could be covered and the more minimum coverages be covered in public clinics or other services.

Mr. FOLEY. Catastrophic would be helpful, but the problem is, as you know, with State mandates on all insurance policies it causes the premium to go so high, most people can't afford them.

There are so many things that are added on into a required policy. Anybody else want to comment on it? Again, it was just an idea. I know the complications are in fact very real. I am not suggesting I am for a minimum wage increase, but I think as we go down this road, we continue to find ways to increase wages and still negate the basic problem that is with us all in America, that is the failure to obtain health insurance and then it falls on society.

Nobody is rejected from an emergency room in a hospital. They are treated. Somebody pays for it. It is the hospital, it is Blue Cross, somebody is going to absorb that cost to society; and I just sense that that is a real, real problem in insurance coverage. As the fewer become insured, the more the burden goes to the insured, the higher the premiums, the fewer continue to maintain coverage and the spiral continues. And I have got to vote in 3 minutes.

Mrs. JOHNSON of Connecticut. Some of us do have to vote. I recognize Mr. Cardin for questioning while we are gone. Others wanted to come back for questions so we will see how that develops. Otherwise we will recess until the next panel.

Mr. CARDIN. I will try to filibuster until a Republican gets back, but I am more than happy to take the Chair if you would like me to take the Chair.

Mrs. JOHNSON of Connecticut. We sort of do that by default, Mr. Cardin. Before I leave I did want to mention two things.

First, I think Mr. Wilford's comment about—I hope you all think about this—we have to do something to require States to offer at least—because some States don't offer catastrophic coverage because catastrophic coverage combined with the community health system, which is very significantly federally funded, does represent an alternative for—would have represented an alternative for many. So there are ways in which we need to better knit together the resources we have.

But last I would like to ask your help once my bill gets in in evaluating how many of the uninsured it would cover because it is so much a richer credit than anything that has been offered. The attempt is to make it equal in goods delivered, not in tax value, but in goods delivered to those who get employer-provided insurance, and so unfortunately I do have to go vote but I would look forward to your input on that once we get it in and I will recognize Mr. Cardin for as much time as he may choose to consume.

Mr. CARDIN [presiding]. Thank you, Madam Chair. It is nice to have the whole Committee. We might decide to mark up Social Security reform first, and then we will go from there.

Let me first thank all of you for your testimony and for your work on trying to deal with the problems of the uninsured. I would just like to first get your observations on one argument that many of you frequently make, that when we pass policies here in Washington that could add to the cost of a health care premium such as the Patients Bill Of Rights, the argument is always made for those who oppose that action that by adding to the cost of the insurance premium, we will add to the number of people who are uninsured.

And I accept that as basic economic principal that the higher the cost, the more likely that a company will not offer health benefits or will terminate or do something else. My question is, though, that the projections that I have seen show that health cost inflation will go up over the next several years at a higher rate than general inflation in our society.

Therefore, the cost of the current system will continue to rise. Does that mean that the number of uninsured will continue to grow unless we take some policy direction here in Washington to compensate for the additional cost of our system? Is that likely to occur?

Mr. GOODMAN. I think it is and it is not simply because of what is happening in Washington. It is also what is happening at the State level, and two bad things are happening. We are passing unwise legislation that unnecessarily raises the cost of——

Mr. CARDIN. Suppose we do nothing. Suppose we do absolutely nothing. Let's say we don't pass these bills. Medical inflation goes up at what is projected to be at least three or four or five points above what inflation goes up. So the effective cost to an employer is going to continue to escalate to maintain the current plan. The employer is going to be either, according to your economic analysis, either going to have to cut back some place, have the employees pay more, or not provide the benefits. Is that what is going to happen? And, therefore, people are going to be underinsured or uninsured in greater numbers if Congress does nothing.

Mr. GOODMAN. I think it is a little more complicated than that. Other things being equal, high health care costs give people incentive to want to be insured against them. So rising medical costs can contribute to more people buying health insurance and, in fact, that was probably what was happening a decade or so ago.

Mr. CARDIN. Then I am a little bit troubled by your argument that when we provide certain protections to patients that could add to the health care premium cost, that that adds to the number of uninsured. That doesn't seem to be logical from your—because health care cost is expensive.

Mr. GOODMAN. What I am saying is we have passed a lot of laws which raise the cost of insuring against those health care costs. In other words, for an individual to get basic health care coverage, he has to buy into a very expensive package that could be less expensive if we didn't have a lot of State mandates, a lot of what I think are unwise regulations.

But the two things that are going to cause the number of uninsured to rise are: The increasing cost of the health insurance itself as opposed to the cost of health care for healthy people.

And, number two, we are making it increasingly easy for people to wait until they get sick before they get health insurance.

Mr. CARDIN. Mr. Kahn.

Mr. KAHN. I think you present a dilemma, but clearly if you have a base inflation and then you build on top of that, particularly in a given year in one fell swoop, it does affect coverage. Now, in what you are describing you are saying the logical conclusion of the argument we have been making is a death spiral, that there is a point at which you are just getting to lose and lose and lose. Actually, you can look at the last few years and in many areas there have been zero premium increases and there has been, as I described, a marginal increase of the number of people covered by employment.

I am concerned over time that, yes, if we don't keep premium increases corralled, that we are going to have the problem you are describing but to add on top of that the mandates in all their various forms, I would argue it just makes that more severe.

Mr. CARDIN. I think I would counter by the fact that if we keep premiums low by either shifting costs to the patient or consumer or by denying adequate health care in the policy, that we are—we are going to have underinsured individuals which can be just as serious a problem as uninsured. If I can't afford—if my plan doesn't cover for an emergency visit, and I need to have emergency care because of their restrictive definition of what is an emergency visit, and I have to pay for that out of pocket, I am uninsured; aren't I?

Mr. KAHN. I think we will have to agree to disagree about the extent to which people receive coverage. I think on your other point, though, about cost sharing, that study after study shows that a little cost sharing is a good thing, and that it involves the individual in the cost of care and makes them cost conscious, whether it is at the premium level or the coinsurance and deductible level.

At the other level, I guess I am personally, and obviously the companies I work for, are not convinced that the set of requirements are going to assure patients that what you are describing is their perception of what full coverage is. I think we will just have to disagree.

Mr. CARDIN. Karen, you want to help me out on this.

Ms. LEHNHARD. I think there is no question that as premiums go up, they will go up on their own even without any changes here in Washington.

As premiums go up, we are going to see more shifting—the primary thing we will see is more shifting to the employee to pay part of the premium and the dilemma is the part they pay is not deductible and I have actually—we didn't think of this. Some of the proposals actually provide for that deduction which some people won't like because that is not creating maybe in their minds tough cost sharing, but I think we are getting up to the point where it is 50-percent premium sharing by individuals.

That is why in our proposal, we said go ahead and give a tax credit to a low-wage worker in a small firm even if their employer provides coverage because chances are they are paying a significant part of the premium, even if they have got coverage.

The other thing I would mention, and I don't expect it to change anybody's mind; but what our plans are telling us it is not just patient protection cost, it is confidentiality, administrative simplification, year 2000, patient protection Federal and State, and the administrative costs are significant. But not only that, they are taking the creative people who would be developing new products and putting them into major systems changes, reinventing how we pay claims in some cases and that is what—we are in all lines of business, and I hear that the diversion from product development is significant.

Mr. CARDIN. I think that is a good point. I don't disagree with the points of making the system as cost effective as possible and some of the beneficiaries payments do make the system more cost effective. You raise a good point about premium deduction by those employers who do offer health care plans.

Of course, we are trying to balance between getting more people adequately insured and just making it easier for employers to work with employees not to provide health benefits because they have the tax advantages without the employer-sponsored plan. So there is a balancing point here, but I think most of us agree that the Tax

Code should help those people who currently don't have health insurance become insured.

Mr. Chairman, thank you.

Mr. ENGLISH [presiding]. Thank you. And I appreciate the opportunity to extend a few questions to the panel myself.

A number of you have made, I think, a very compelling argument for a tax credit as part of an initiative toward universal access to affordable care which, to me, is a more realistic goal than universal coverage, although some of you may disagree with that.

I would like to get my arms around your notions of how to design such a credit to have the maximum impact and maximum effectiveness. Dr. Butler, how large a credit do you think would be appropriate and what income limits would you suggest?

Mr. BUTLER. You know, Mr. English, I think that almost begs the question of what kind of revenue costs are you contemplating, because the simple fact is that the larger the credit you provide, the larger the impact is going to be on the uninsured. There is no question about that.

There is also no question that if you give a relatively small credit, you are not going to affect many people who are currently uninsured, but you are going to ease the burden on people who are struggling paycheck to paycheck to buy insurance outside the place of work. So, in a sense, it is kind of hard to answer your question. The proposals that have been put forward that would, say, provide a 30-percent credit would probably reduce uninsurance by somewhere between 1.5 and 2 million, something of that order. Much of the value of that credit would go to people who are currently buying insurance out of pocket, after tax which I think is a good thing in itself. So it is a little difficult to answer your question.

Mr. ENGLISH. Let me assume then for a moment that we have a $1,000 credit. How far would that go in providing an adequate level of buying power for most families assuming an interaction with other programs such as Medicaid?

Mr. BUTLER. Well, if you assume an interaction with other programs like CHIP and Medicaid and so on, then it would get you quite a long way toward your goal. But if you are looking at people only having that credit available to buy insurance, and no other method of assistance, then clearly as you go down the income level the net cost to the person taking the credit is still getting to be a very substantial portion of their income. And for some it is probably going to be prohibitive, so they are not going to accept the credit under those kinds of cases.

That is why I think the approach is to try to combine a fixed amount, a larger fixed amount for people at the low end, maybe in combination with a percentage credit is probably the right way to go. When we looked at a much more substantial reform a few years ago which would have replaced the entire tax exclusion with a credit system, we looked at a sliding scale refundable credit which would go up to, I believe it was 60 to 70 percent of the cost for those who were at the lowest end. That would substantially reduce the uninsurance rates.

Mr. ENGLISH. If we were—Ms. Lehnhard, did you want to add something to that?

Ms. LEHNHARD. I would just add we actually did modeling on this at $1,200 tax credit for very small firms less than 10 at 225 percent of poverty. As a conservative modeling, we were very struck by the number of people who don't pick up coverage. The model showed about 1.9 people out of 7 million potentials pick up coverage which suggests you really almost have to pay the full cost, and then you still don't pick up the entire population.

Mr. ENGLISH. Dr. Butler, to follow up, I think what you are contemplating here is clearly refundable tax credit.

Mr. BUTLER. At least partially refundable against payroll tax——

Mr. ENGLISH. Do you see any potential fraud problems with a credit like that, or is that going to be relatively easy to enforce?

Mr. BUTLER. It depends how you design it. A fully refundable credit does raise lots of issues because you are dealing with people who don't file taxes and so on. There is a long history of problems with those kinds of subsidies via the tax system.

I think if you are looking at a system which is essentially run through the withholding system, which you can do with a refundable credit against income taxes and payroll taxes, then proof of insurance becomes an element. The employer can at least be your first line of defense in terms of what is this person actually using it for. I think you can deal with a lot of problems.

I also mentioned in passing a proposal that Senator Daschle offered a while ago to say as an additional, as an alternative, the idea of transferring the credit to an insurer in return for a lower premium to that person may also be a way of dealing with less likelihood of fraud in those kinds of situations. Again, that is not unlike what happens in the FEHBP where you get an after-subsidy price as an employee.

Mr. ENGLISH. That brings me to one other question; but first Mr. Kahn, did you have something to add?

Mr. KAHN. Yes, Mr. English. I think you might want to look at this structurally differently though. To focus on how big the credit has to be I think maybe—it is a legitimate question but maybe the wrong question.

Instead when we did our proposal, we looked at the poorest of the poor, and those near poor, under 200 percent of poverty and basically said that either an expansion of the CHIP Program or some kind of voucher but something that was done probably through the States probably through the welfare system in terms of determining what their income was is better than using the tax structure.

Trying to help people at that level through the tax structure, one, as you say, leads to fraud and abuse issues, and two, leads to issues such as to how do you locate them. Also in our plan, we would give a credit to certain small employers directly if they purchase insurance. It is a costly proposal, but on the other hand it gets to the issue that Mary Nell Lehnhard was talking about which is it is the smallest employers who provide many of the jobs, particularly for the poorest people, who cover the least people and, in a sense, if you can get the bucks to the employer through the tax system, that may be a more efficient way than trying to get some of these dollars through to people in a credit that is going to be very difficult to design.

Ms. LEHNHARD. We took one more twist on that. We said just don't do it for all workers in small firms. Do it for the low-income workers in small firms.

Mr. ENGLISH. Mr. Goodman.

Mr. GOODMAN. First on the fraud question, there is fraud in the EITC program. The most frequent form of fraud is people claim kids that aren't their kids. But if you are claiming a tax credit for health insurance and you have the insurance company there, well, the insurance company presumably knows who it is insuring, who it is not.

If an employer is involved as Dr. Butler said, the employer would be monitoring. So you bring more monitors into the system. The more monitors in the system means a lot less fraud. Now, as to the efficient way to do this, almost no one really is talking about—when they are talking about refundable tax credit—talking about handing people cash and saying go buy health insurance.

I think we are all talking about a system under which you go through employers and you go through insurance companies in order to reduce the premium to the employee or to the buyer and pay for that with tax relief and the employer does the financial transaction or the insurance company does the transaction.

So we don't have to go find people who are uninsured. It will happen through the place of work.

Mr. ENGLISH. Very good. Any other contributions?

Mr. BUTLER. I would just add one point about the credit to employers, which I am fairly skeptical about because I think that one of the key issues, as has been discussed before, is how to get people into larger groups and larger pools.

Look at a very small employer with five employees who is trying to buy insurance today in a pretty dismal market that they face. To say we will give them a credit and argue that that is more efficient than allowing the employee a credit to go and join a larger pool somewhere else, I don't think that argument holds. An individualized credit is much more appropriate for the very small business sector than subsidizing the employee-employer through a credit or any kind of system.

Mr. ENGLISH. Ms. Lehnhard, briefly.

Ms. LEHNHARD. I would just make one quick point. On the pooling of small employers, you don't have cases any more where groups of five are on their own. Every State has passed laws which require an insurance company to pool all of their small employers.

It used to be you would have different products. You would segregate your risks. You can't do that anymore. Each Blue Cross and Blue Shield Plan will have all of its small employers in one pool. So the States have done a great public policy by stabilizing the small group market and requiring that pooling.

Mr. KAHN. I guess I would argue if you had more money in the system for those smaller employers so there were more people participating, it would only enhance the pools that are being described that are already in the small group market.

Mr. ENGLISH. Thank you.

Thank you very much for your participation today, and I will dismiss this panel. Let me turn this over and recognize Mrs. Thurman to inquire.

Mrs. THURMAN. Thank you, Mr. Chairman. You like that sound?

Dr. Butler, I am intrigued because yesterday of course we had a panel before the medical—or the Health Subcommittee that talked again about the 43 million and yesterday we did some press on the issue of expansion of Medicare for 55 to 64 and with the issue that you brought up where you talk about nonemployment base groups actually are more logical and skilled in their organization, do you feel that way about opening up some of those government programs that are available to help expand some of the coverage in these areas?

Mr. BUTLER. I don't think the two points are connected. What I argued was: First one has got to think about what are the best vehicles to provide insurance. And there are several criteria, one of which is there should be a long-term affiliation, so you are not going in and out of the pool. It should be large so that it is big enough to spread the risks and so on. I pointed out that there are organizations that currently exist to fulfill a lot of those functions, and maybe we ought to explore how to deal with some of the wrinkles that you have to deal with. I mean labor unions, churches, other kinds of groups like that.

Mrs. THURMAN. Would this be one that you would feel should be explored then for the 55-year-old to 64-year-old going into Medicare because in some cases it could be a spouse who is now 65 whose spouse is younger and has no affiliation because whatever job or employment they were at no longer exists. So the idea would be to expand it in some of those areas particularly for Medicare——

Mr. BUTLER. I don't think it is necessary to reach the condition I mentioned because, for example, if you did have people who had a union-sponsored plan and had tax relief and a tax credit, whether or not they were employed, then that system would function for the people who are 60 to 65 who are not currently in Medicare.

Those people would be able to continue coverage under the existing organization that they are affiliated with and would get tax relief if the kind of recommendations we have made would continue. I think when you start talking about bringing Medicare down into that group, and I know this is an issue that has been proposed and we have argued about it before, I think you have got all sorts of questions about who would choose to do that, what the liability would be for the government, what kind of adverse selection would occur against Medicare, whether Medicare is best for them or whether they should continue in something we already have.

I don't think it makes a lot of sense to say to somebody who turns 60 and has good coverage, say through a labor organization, you are basically going to have to drop this and go in to Medicare.

Mrs. THURMAN. I don't think that has been called for.

Mr. BUTLER. The ideal situation would be to allow people to join organizations when they are working, throughout their working life and to continue into Medicare. My argument would be that we should look at making Medicare much more flexible so that these kinds of more indigenous organizations could become a central part of the Medicare delivery system rather than doing the opposite.

Mrs. THURMAN. I was just looking at your definition of what you had considered.

Let me ask the panel, the CRS has done a fairly extensive report on all of the tax benefits in current law as for providing insurance through, for example, the employment base plans. There are some tax deductions, medical expense deduction, all of us know that is a very difficult threshold to meet, but in fact it is there. You have got cafeteria plans. You have got self-employed deductions. You have got flexible spending accounts, medical savings accounts, both military and Medicare, none of which is considered as part of our income.

I mean, it seems to me that we have a hodgepodge in many ways of tax credits available to us today, and still we have 43 million people not getting health care. And I personally asked the question yesterday, and I am going to ask this panel. In these different categories of insurance tax deductions that we have, are they working today? How many of that 43 million people have the advantage of these tax credits that are not using them, and have we looked at why they are not using them?

Mr. KAHN. I believe, Mrs. Thurman, that they are working today but there are a lot of gaps. There are people who don't work in large firms or firms that take advantage for their employees of all those. And second, if you look at the problem of uninsurance, it is primarily a problem of income and people who work in small firms.

Mrs. THURMAN. I understand the small firm but let's say for example, the self-deduction—I mean for somebody who is—owns their own business. Do we know how many people out there who are not taking advantage of that? And that is a very small firm. Those are some issues that I am really concerned that we are——

Mr. KAHN. We are taking advantage of that based on income. Law firms that are all partners and they are self-employed, they are taking advantage of it and Joe's bar and grill that is just two people, self-employed, are probably not. So I think it comes down to income at the end of the day. You can only use a tax benefit if there is income there to enjoy it. That is one of the issues that is important.

Mr. GOODMAN. But it is a hodgepodge on the tax side almost as bad as the hodgepodge over on the spending side. It seems to me like there is a very strong case to be made with treating everyone the same, fairness. You say we are going to give a tax break to you if you buy health insurance and it is going to be *x* dollars and it is going to be the same whether or not you get it through an employer or you are self-employed or you have to go buy it on your own.

We strongly favor having that tax credit be just as generous for the low-income person as the high-income person whereas today it is all geared to the people in the higher brackets.

Mr. BUTLER. The overwhelming volume of the tax relief available for health care is for people who are connected to the health insurance system through their place of work or are affluent because for the 7.5-percent threshold, for example, you have got to itemize, you have got to have significant expenses, and you have got to be able to afford those expenses. So the huge gap is the people who are outside the employment base system and are relatively low income.

That is why I think all of these proposals that have been put forward are focusing on that group, and I think they should do.

Mr. KAHN. If I could make one other point too. That 7.5 percent was totally arbitrary, and it was done in tax reform.

Mrs. THURMAN. Why does that not surprise me?

Mr. KAHN. Because they needed the money to make the whole tax reform work, and it was one of the areas. It was lower for years, I mean, for eons. I can remember the day, I was working for Senator Durenberger at the time, and I said don't do that and he went and did it as other Members did.

But the point is that is arbitrary and I think actually if you are looking at things to help people, that is one item that even though obviously you have to itemize is arbitrary and probably too high.

Ms. HOENICKE. If I could add one thing and my only role on the health side of this panel is with respect to long-term care, and I think that is clearly an area where there is a huge gap in the Tax Code. There is no deduction for long-term care and that is a medical expense.

Mrs. THURMAN. Nancy and I are working on that.

Ms. HOENICKE. We know you are, and I wanted to say thank you again as we did in our statement. Thanks.

Mr. ENGLISH. I thank the gentlelady for her contribution. Do any other Members wish to inquire? The Chair recognizes Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Chairman. I would only make one point. Dr. Goodman, toward the end of your remarks, sir, you point out that the income tax credit apparently should apply to the low income as well as the high income. That is not a tax credit at the low income. Tax credit is applied to income. Once you go to someone who doesn't have the income but gets the tax credit instead, that is a welfare program so you should distinguish between the two.

Mr. GOODMAN. I don't mind if you rhetorically distinguish it that way, but what I am saying is presuming the government has an interest on whether people insure because if they don't insure, they can show up at hospitals and incur medical bills that have to be paid for by the rest of us.

Mr. MCINNIS. I will reclaim my time. I don't disagree with that, but I think we need to distinguish and I think you need to distinguish, doctor, when you talk about that at some point you need to subsidize it in the form of a welfare instead of a tax credit against income. That concludes my question, Mr. Chairman, thank you.

Mr. ENGLISH. Thank you, Mr. McInnis. I want to thank this panel for their extraordinary contribution to the discussion here today and I would like to invite forward the next panel which will consist of Jack Stewart, assistant director for Pension, Principal Financial Group of Des Moines, Iowa, on behalf of the Association of Private Pensions and Welfare Plans; Paula A. Calimafde, chair of the Small Business Council of America, Bethesda, Maryland, and a member of the Small Business Legislative Council, and also on behalf of the American Society of Pension Actuaries and the Profit Sharing/401(K) Council of America; J. Randall MacDonald, executive vice president for human resources and administration of the GTE Corp. of Irving, Texas, and a member of the board of directors of the ERISA Industry Committee; and Jim McCarthy, vice president and product development manager of the Private Client Group for Merrill Lynch & Co., Inc., Princeton, New Jersey, on behalf of the Savings Coalition of America.

I welcome this panel.

You are invited to give your testimony up until the red light blinks. We would encourage you to stay within the time parameters. We still have one more panel to go afterward and we look very much forward to your contribution. I recognize Mr. Stewart.

STATEMENT OF JACK STEWART, ASSISTANT DIRECTOR, PENSIONS, PRINCIPAL FINANCIAL GROUP; DES MOINES, IOWA; ON BEHALF OF ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. STEWART. Thank you, Mr. Chairman. I am Jack Stewart, assistant director of Pension at the Principal Financial Group of Des Moines, Iowa. I am here on behalf of APPWP, the Association of Private Pension and Welfare Plan, the Benefits Association.

APPWP is a public policy organization representing principally Fortune 500 companies as well as other organizations such as Principal that assist plan sponsors in providing benefits to employees. It is a privilege for me to testify before the Committee and I want to extend the APPWP's thanks for your personal commitment to the issue of helping American families achieve retirement security.

You have shown steadfast dedication to seeing that all legs of our retirement income stool, Social Security, employer-provided pensions, and personal savings are made strong for the future.

I want to focus my comments on steps we can take together to strengthen the pension and savings legs of this stool. As the Committee begins to craft the upcoming tax bill, we urge you to include in that bill, H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act of 1999, introduced by Representatives Portman and Cardin. H.R. 1102 will extend the benefits of pension coverage to more American workers and will offer new help to American families saving for retirement. Ninety Members of Congress have now cosponsored this bill including 26 Members of this Committee. And the coalition supporting it includes 64 organizations ranging from major employer groups such as APPWP to the Building and Construction Trades Department of the AFL–CIO, to the National Governors' Association.

I want to focus my remarks on what APPWP considers to be the backbone of H.R. 1102, how the Federal Government can encourage employers to create and maintain tax-qualified retirement plans. I will briefly touch on five areas of the bill that are critical to this effort, restoration of contribution and benefit limits, simplification of pension regulations, small business incentives, enhanced pension portability, and improved pension funding.

One of the most significant reforms in 1102, and in Representative Thomas' H.R. 1546, is the restoration to previous dollar levels of several contribution and benefit limits that cap the amount that can be saved and accrued in workplace retirement plans. These caps have been reduced repeatedly for budgetary reasons and are lower today in actual dollar terms—to say nothing of the impact of inflation—than they were many years ago.

Based on my 22 years of experience in the retirement plan arena, I am convinced that restoring these limits will result in more employers offering retirement plans. Restored limits will convince businessowners that they will be able to fund a reasonable retirement benefit for themselves and other key employees, will encourage these individuals to establish and improve qualified retirement plans, and will result in pension benefits for more rank-and-file workers.

Restored limits are also important to the many baby boomers who must increase their savings in the years ahead in order to build adequate retirement income. The catchup contribution contained in the bill, which would permit those employees who have reached age 50 to contribute an additional 5,000 each year to a defined contribution plan, will likewise address the savings needs of baby boomers and will provide an especially important savings tool for the many women who return to the work force after raising children.

Another vitally important component of H.R. 1102 is the simplification of many Tax Code sections and pension rules that today still inhibit our private retirement system. I have found that these complicated rules deter many small employers from offering retirement plans and make plan administration a costly and burdensome endeavor for companies of all sizes. The bill simplification measures include needed flexibility in the coverage and nondiscriminations tests, repeal of the multiple use test, and an earlier funding valuation date for defined benefit plans and reform of the separate lines of business rules.

H.R. 1102 also contains several important measures aimed at making it easier for small businesses to offer retirement plans. First and foremost, the bill streamlines and simplifies top-heavy rules. The legislation also assists small businesses with plan startup administration costs through a tax credit, reduced PBGC insurance premiums and waived IRS user fees as well as simplified reporting.

Based on my experience working with small companies, I am convinced that these changes will make our retirement system more attractive to small employers.

APPWP is also pleased that H.R. 1102 would repeal the 150 percent of current liability funding limit imposed on defined benefit plans. This would cure a budget-driven constraint that has prevented employers of all sizes from funding the benefits they have promised to their workers. In conclusion, I want to thank you again for the opportunity to appear today to share APPWP's views on ways to enhance retirement security for American families.

We look forward to working with you in the weeks ahead to enact the reforms contained in 1102 as part of your broader effort to make our Nation's tax laws simpler and less burdensome. Thanks.

[The prepared statement follows:]

Statement of Jack Stewart, Assistant Director, Pensions, Principal Financial Group; Des Moines, Iowa; on behalf of Association of Private Pension and Welfare Plans

Mr. Chairman and members of the Committee, I am Jack Stewart, Assistant Director—Pension at the Principal Financial Group of Des Moines, Iowa. I am here today as the representative of the Association of Private Pension and Welfare Plans (APPWP—The Benefits Association). APPWP is a public policy organization representing principally Fortune 500 companies and other organizations such as the

Principal that assist employers of all sizes in providing benefits to employees. Collectively, APPWP's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

It is a privilege, Mr. Chairman, for me to testify before the Committee today and I want to extend APPWP's thanks for your personal dedication to the issue of helping American families achieve retirement security. You have shown steadfast dedication to seeing that all legs of our retirement income stool—Social Security, employer-provided pensions and personal savings—are made strong for the future.

I want to focus my comments on the steps we can take together to strengthen the pension and savings legs of this stool. As you and the Committee begin to craft the upcoming tax bill, APPWP believes there is a clear step that you can take to extend the benefits of pension coverage to even more American workers and to offer new help to American families saving for retirement. That step is inclusion and passage of H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act of 1999, which was introduced in March by Representatives Rob Portman (R–OH) and Ben Cardin (D–MD) together with a large group of bipartisan cosponsors. Representatives Portman and Cardin have once again rolled up their sleeves and done the heavy lifting that is required to master the intricacies of our pension laws and to craft reform proposals that are responsible and technically sound. With this bill, they have continued their long-standing commitment to retirement savings issues and have demonstrated both leadership and vision in setting a comprehensive course for improvement of our nation's employment-based retirement system. Eighty-four Members of Congress have now cosponsored H.R. 1102—including 25 members of this Committee—and the coalition supporting it includes 64 organizations ranging from major employer groups such as APPWP to the Building and Construction Trades Department of the AFL–CIO to the National Governors Association.

Mr. Chairman, while H.R. 1102 contains a whole series of important reforms, I would like to focus on the five areas of the bill that APPWP believes are of particular importance for advancing our nation's pension policy—(1) restoration of contribution and benefit limits, (2) simplification of pension regulation, (3) new incentives for small employers to initiate plans, (4) enhanced pension portability, and (5) improved defined benefit plan funding.

Restoration of Contribution and Benefit Limits

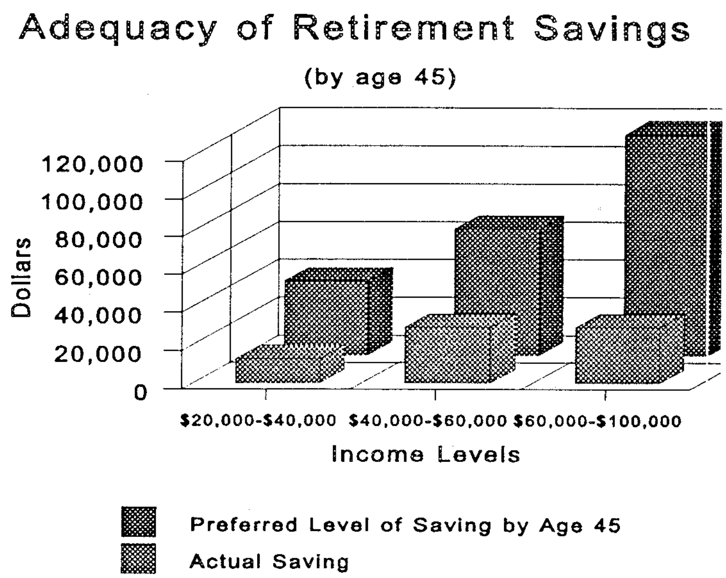
One of the most significant reforms in H.R. 1102 is the restoration of a number of contribution and benefit limits to their previous dollar levels. These limits cap the amount that employees and employers may save for retirement through defined contribution plans as well as limit the benefits that may be paid out under defined benefit pension plans. Many of these dollar limits have been reduced repeatedly since the time of ERISA's passage. Today, they are far lower in actual dollar terms—to say nothing of the effect of inflation—than they were many years ago.

During the 1980's and early 1990's, Congress repeatedly lowered retirement plan contribution and benefit limits for one principal, if frequently unstated, reason: to increase the amount of revenue that the federal government collects. It is time to put an end to that type of short-term policy-making. It is true that under federal budget scorekeeping rules, proposals that encourage people to contribute more to retirement savings cost the federal government money in the budget-estimating window period. Yet incentives that effectively increase retirement savings are among the best investments we can make as a nation. These incentives will pay back many times over when individuals retire and have not only a more secure retirement, but also increased taxable income. Increased retirement savings also generates important investment capital for our economy as a whole.

It is time that retirement policy—rather than short-term budgetary gains—guide Congress'actions in the plan limits area. H.R. 1102 wisely takes this approach by restoring a series of contribution and benefit limits to their intended levels. H.R. 1546, introduced by Representative Thomas, also restores a number of these limits. These limit restorations give practical significance to the calls by the President, Vice President and bipartisan congressional leadership last June at the National Summit on Retirement Savings to allow Americans to save more effectively for their retirement.

Restored limits are critical for a number of reasons. They would help return us to the system of retirement plan incentives intended at the time of ERISA's passage. In our voluntary pension system, it has always been necessary to incent the key corporate decision-makers in initiating a qualified retirement plan in order that rank-and-file workers receive pension benefits. An important part of generating this interest is demonstrating that these individuals will be able to fund a reasonable retirement benefit for themselves. The contribution and benefit limit reductions of recent years have reduced the incentives for these decision-makers, giving them less stake in initiating or maintaining a tax-qualified retirement plan. Based on my 22 years of experience in the retirement arena, particularly my work with small and mid-sized companies, I am convinced that restoring these limits will result in greater pension coverage. Restored limits will convince business owners that they will be able to fund a reasonable retirement benefit for themselves and other key employees, will encourage these individuals to establish and to improve tax-qualified retirement plans, and will thereby result in pension benefits for more rank-and-file workers.

Restored limits are also important so that the many baby boomers who have not yet saved adequately for retirement have the chance to do so. A reduced window in which to save or accrue benefits clearly means one must save or accrue more, and restoring limits will allow this to occur. Of particular concern is the fact that it appears that older baby boomers are not increasing their level of saving as they move into their mid-to-late 40s. Rather, they are continuing to fall further behind—with savings of less than 40 percent of the amount needed to avoid a decline in their standard of living in retirement.



Every day's delay makes the retirement savings challenge more difficult to meet, and every day's delay makes the prospect of catching up more daunting. Individuals who want to replace one-half of current income in retirement must save 10 percent of pay if they have 30 years until retirement. These same individuals will have to save 34 percent of pay if they wait until 15 years before retirement to start saving.

Required Saving as a Percent of Income

Desired Retiree Income as a % of Annual Salary	Years Until Retirement 10	15	20	25	30	35
30%	36%	21%	13%	9%	6%	4%
40%	48%	27%	18%	12%	8%	6%
50%	60%	34%	22%	15%	10%	7%
60%	72%	41%	26%	18%	12%	9%
70%	84%	48%	31%	21%	14%	10%

Source: T. Rowe Price, as printed in Committee for Economic Development Statement "Who Will Pay For Your Retirement – The Looming Crisis" 1995

Along with restored limits, H.R. 1102 contains a specific tool to help workers meet this savings challenge. The catch-up contribution contained in the bill—which would allow those who have reached age 50 to contribute an additional $5,000 each year to their defined contribution plan—will help address the savings needs of baby boomers and will be an especially important savings tool for women. Many workers find that only toward their final years of work, when housing and children's education needs have eased, do they have enough discretionary income to make meaningful retirement savings contributions. This problem can be compounded for women who are more likely to have left the paid workforce for a period of time to raise children or care for elderly parents and thereby not even had the option of contributing to a workplace retirement plan during these periods.

The catch-up provision of H.R. 1102 recognizes these life cycles and also acknowledges the fact that, because Section 401(k) plans have only recently become broadly available, the baby-boom generation has not had salary reduction savings options available during much of their working careers. The catch-up provision would help ensure that a woman's family responsibilities do not result in retirement insecurity and would help all those nearing retirement age to meet their remaining savings goals. While some catch-up contribution designs would create substantial administrative burden for plan sponsors, the simple age eligibility trigger contained in the Portman-Cardin bill does not and will result in more companies offering this important savings tool to their workers.

There is an additional savings enhancement contained in the bill that APPWP wishes to highlight briefly. Under current law, total annual contributions to a defined contribution plan for any employee are limited to the lesser of $30,000 or 25% of compensation. Unfortunately, the percentage of compensation restriction tends to unfairly limit the retirement savings of relatively modest-income workers while having no effect on the highly-paid. For example, a working spouse earning $25,000 who wants to use his or her income to build retirement savings for both members of the couple is limited to only $6,250 in total employer and employee contributions. By removing the percentage of compensation cap, H.R. 1102 would remedy this unfortunate effect of current law and remove a barrier that blocks the path of modest-income savers.

Some have expressed concern that restoration of benefit and contribution limits would not be a good use of tax expenditure dollars and that dollars spent in this way would disproportionately benefit high-income individuals. We at APPWP believe this concern is misplaced and that analyzing pension reforms purely from a current year tax deferral perspective misses the point. It should be no surprise, after all, that in our progressive tax system where many lower-income individuals have no tax liability, pension tax preferences like other tax preferences flow in large part to those at higher-income levels. Yet in reforming the pension system, we should focus not on who receives the tax expenditure but rather on who receives the pension benefit. And with respect to pension benefits, our employer-sponsored system delivers them fairly across all income classes. Of married couples currently receiving retirement plan benefits, for example, 57% had incomes below $40,000 and nearly 70% had incomes below $50,000. Of those active workers currently accruing retirement benefits, nearly 45% had earnings below $30,000 and over 77% had incomes below $50,000.[1] Restoration of benefit and contribution limits will bring more employers into the private system, and, as these figures demonstrate, this system succeeds at delivering benefits to the working and middle-income Americans about whom we are all concerned.

SIMPLIFICATION

Another vitally important component of H.R. 1102 is the series of simplification proposals that will streamline many of the complicated tax code sections and pension rules that today still choke the employer-provided retirement system. Unfortunately, in my many years dealing with small and mid-sized employers, I have seen that the astounding complexity of today's pension regulation drives businesspeople out of the retirement system and deters many from even initiating a retirement plan at all. Not only are businesspeople leery of the cost of complying with such regulation, but many fear that they simply will be unable to comply with rules they cannot understand. We must cut through this complexity if we are to keep those employers with existing plans in the system and prompt additional businesses to enter the system for the first time. Simplifying these pension rules will also further your goal, Mr. Chairman, of making our tax code simpler and more understandable for American citizens and businesses.

A more workable structure of pension regulation can be achieved only by adhering to a policy that encourages the maximization of fair, secure, and adequate retirement benefits in the retirement system as a whole, rather than focusing solely on ways to inhibit rare (and often theoretical) abuses. This can be accomplished by ensuring that all pension legislation is consistent with continued movement toward a simpler regulatory framework. In short, simplification must be an ongoing process. Proposals that add complexity and administrative cost, no matter how well intentioned, must be resisted, and the steps taken in earlier pension simplification legislation must be continued. Current rules must be continuously reexamined to weed out those that are obsolete and unnecessary. Representatives Portman and Cardin have led past congressional efforts at simplification, and APPWP commends them for continuing this important effort in their current bill.

As I indicated, Mr. Chairman, H.R. 1102 contains a broad array of simplification provisions to address regulatory complexity. Let me briefly mention a few that APPWP believes would provide particular relief for plan sponsors. First, the legislation would provide flexibility with regard to the coverage and non-discrimination tests in current law, allowing employers to demonstrate proper plan coverage and benefits either through the existing mechanical tests or through a facts and circumstances test. Second, the bill would repeal the duplicative multiple use test, which will eliminate a needless complexity for employers of all sizes. Third, the bill would promote sounder plan funding and predictable plan budgeting through earlier valuation of defined benefit plan funding figures. And fourth, the bill would reform the separate lines of business rules so that these regulations serve their intended purpose—allowing employers to test separately the retirement plans of their distinct businesses.

APPWP believes that the cumulative effect of the bill's regulatory reforms will be truly significant. Reducing the stranglehold that regulatory complexity holds over today's pension system will be a key factor in improving the system's health and encouraging new coverage over the long-term. As H.R. 1102—and pension legislation generally—progress through this Committee and the Congress, Mr. Chairman,

[1] Source: Analysis of the March 1998 Current Population Survey performed by Janemarie Mulvey, Ph.D., Director, Economic Research, American Council of Life Insurance

we would urge you to keep these simplification measures at the very top of your reform agenda.

SMALL BUSINESS INCENTIVES

While the various changes I have outlined above will assist employers of all sizes, H.R. 1102 also contains several important measures specifically targeted at small businesses. As you may be aware, Mr. Chairman, pension coverage rates for small businesses are not as high as they are for larger companies. While the number of small employers offering retirement plans is growing,[2] we need to take additional steps to make it easier and less costly for today's dynamic small businesses to offer retirement benefits to their workers.

H.R. 1102 takes a multi-faceted approach to making it easier for small employers to offer retirement plans. First and foremost, H.R. 1102 streamlines and simplifies the top-heavy rules, which are a source of unnecessary complexity for small employers and are one of the largest barriers deterring small companies from bringing retirement plans on-line. The legislation will also assist small companies with the costs of initiating a retirement plan. Small employers will be offered a three-year tax credit for start-up and administration costs, they will be eligible for discounted PBGC premiums on their defined benefit plans, and they will no longer be required to pay a user fee for obtaining a letter of tax qualification from the IRS for their plan. Based on Principal's extensive experience in the small business market, and my own personal work with small companies, I am convinced that these changes, in combination with the limit restorations and simplifications described above, will make our private retirement system substantially more attractive to American small business. The important result will be access to employer-sponsored retirement plans for the millions of small business employees who today lack the opportunity to save for retirement at the workplace.

PORTABILITY

Another important advance in H.R. 1102 is the cluster of provisions designed to enhance pension portability. Not only will these initiatives make it easier for individual workers to take their defined contribution savings with them when they move from job to job, but they will also reduce leakage out of the retirement system by facilitating rollovers where today they are not permitted. In particular, the bill's provisions allowing rollovers of (1) after-tax contributions and (2) distributions from Section 403(b) and 457 plans maintained by governments and tax-exempt organizations will help ensure that retirement savings does not leak out of the system before retirement.

The bill's portability initiatives will also help eliminate several rigid regulatory barriers that have acted as impediments to portability. Repeal of the "same desk" rule will allow workers who continue to work in the same job after their company has been acquired to move their 401(k) account balance to their new employer's plan. Reform of the "anti-cutback" rule will make it easier for defined benefit and other plans to be combined and streamlined in the wake of corporate combinations and will eliminate a substantial source of confusion for plan participants. We specifically want to thank Representatives Portman and Cardin for the refinements they have made to their portability provisions in response to several administrative concerns raised by APPWP and others. We believe the result is a portability regime that will work well for both plan participants and plan sponsors.

DEFINED BENEFIT PLAN FUNDING

APPWP is also pleased that H.R. 1102—as well as H.R. 1546—includes an important pension funding reform that we have long advocated. The bills' repeal of the 150% of current liability funding limit for defined benefit plans would remove a budget-driven constraint in our pension law that has prevented companies from funding the benefits they have promised to their workers. The calculation of this funding limitation requires a separate actuarial valuation each year, which adds to the cost and complexity of maintaining a defined benefit plan. More importantly, the current liability funding limit forces systematic underfunding of plans, as well as erratic and unstable contribution patterns. Limiting funding on the basis of current liability disrupts the smooth, systematic accumulation of funds necessary to provide

---

[2] A 1996 survey by the Bureau of Labor statistics revealed that 42% of full-time employees in independently-owned firms with fewer than 100 employees participated in a pension or retirement savings plan. This was up from 35% in 1990. See *Pension Coverage: Recent Trends and Current Policy Issues,* CRS Report for Congress, #RL30122, April 6, 1999.

participants' projected retirement benefits. In effect, current law requires plans to be funded with payments that escalate in later years. Thus, employers whose contributions are now limited will have to contribute more in future years to meet the benefit obligations of tomorrow's retirees. If changes are not made now, some employers may be in the position of being unable to make up this shortfall and be forced to curtail benefits or terminate plans. Failing to allow private retirement plans to fund adequately for the benefits they have promised will put more pressure on Social Security to ensure income security for tomorrow's retirees.

The problems caused by precluding adequate funding are compounded by a 10 percent excise tax that is imposed on employers making nondeductible contributions to qualified plans. This penalty is clearly inappropriate from a retirement policy perspective. Employers should not be penalized for being responsible in funding their pension plans. The loss of an immediate deduction should, in and of itself, be a sufficient deterrent to any perceived abusive "prefunding."

The net effect of the arbitrary, current liability-based restriction on responsible plan funding, and the 10 percent excise tax on nondeductible contributions, is to place long-term retirement benefit security at risk. With removal of this limit and modification of the excise tax, H.R. 1102 would provide the enhanced security for future retirees that comes with sound pension funding.

ADDITIONAL PROPOSALS TO BOOST RETIREMENT SAVINGS

Our testimony today has focused on only a few of the important changes contained in H.R. 1102. There are many other proposals in the bill that would help American families to save for retirement, and I want to touch briefly on a few of them before concluding.

- First, the bill includes an important change in the tax treatment of ESOP dividends that would provide employees with a greater opportunity for enhanced retirement savings and stock ownership. Under current law, deductions are allowed on dividends paid on employer stock in an unleveraged ESOP only if the dividends are paid to employees in cash; the deduction is denied if the dividends remain in the ESOP for reinvestment. Under H.R. 1102, deductions would also be allowed when employees choose to leave the dividends in the plan for reinvestment, encouraging the accumulation of retirement savings through the employee's ownership interest in the employer.
- Second, H.R. 1102 creates a new designed-based safe harbor—the Automatic Contribution Trust (ACT)—which encourages employers to enroll new workers automatically in savings plans when they begin employment. Automatic enrollment arrangements such as the ACT have been shown to boost plan participation rates substantially, particularly among modest-income workers.
- Third, the legislation would remedy the uncertainty and complexity that today surrounds the tax treatment of employer-provided retirement counseling. All employer-provided retirement planning, including planning that does not relate to the employer's plans, would be excludable from employee's income under H.R. 1102. The bill would also make clear that employees could purchase retirement counseling through salary reduction on a pre-tax basis. Since many employers provide retirement education to their employees or would like to do so, it is critical that the law surrounding the tax treatment of this benefit be clear. Moreover, given the importance and popularity of 401(k) plans, where the primary responsibility for saving and investing falls on employees, employers should continue to be encouraged to provide information and education about these plans.

CONCLUSION

Mr. Chairman, the complexity of America's workplace and the diversity of America's workforce require that we maintain an employment-based retirement system that is flexible in meeting the unique needs of specific segments of the workforce and that can adapt over time to reflect the changing needs of workers at different points in their lives. For this reason, there is no single "magic" solution to helping Americans toward a more secure retirement. Rather a comprehensive series of responsible and well-developed proposals—such as those found in H.R. 1102—is the best way to make substantial progress in strengthening our already successful private retirement system and we urge their inclusion in your upcoming tax bill.

Mr. Chairman, thank you again for the opportunity to appear today to share APPWP's views on ways to improve the retirement security of American families. We commend your commitment to this goal and salute Representatives Portman and Cardin, and those with whom they have worked, for crafting and cosponsoring a bill that will make this goal a reality. We look forward to working with you in the weeks ahead to enact these pension and savings reforms as part of your broader effort to make our nation's tax system simpler and less burdensome.

June 16, 1999

The Honorable Bill Archer Chairman,
Committee on Ways & Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

The undersigned group of organizations dedicated to promoting long-term savings for retirement would like to express our strong support for H.R. 1102, *The Comprehensive Retirement Security and Pension Reform Act of 1999,* which has been introduced by Representatives Rob Portman and Ben Cardin.

Thanks in large part to your efforts and leadership, Congress has taken important steps in recent years to strengthen the employer-sponsored retirement system and to aid American families in saving for retirement. Yet we share your conviction that much more can and should be done in this area. *We believe that The Comprehensive Retirement Security and Pension Reform Act of 1999* will substantially advance the goals of expanded pension coverage and increased retirement savings.

Offering a comprehensive retirement reform agenda, H.R. 1102 would encourage employers, particularly small employers, to establish and maintain workplace retirement plans and would provide enhanced opportunities for Americans to save by increasing contribution and benefit limits in these plans. It would facilitate the portability and preservation of retirement benefits—for both private and public retirement systems—and would allow for stronger funding of pension plans. H.R. 1102 would also simplify many of the overly complex rules governing retirement plans, reducing the administrative and cost barriers that have made it difficult for many employers to offer retirement benefits and ensuring that today's business transactions are not inhibited by outdated and unnecessary pension regulation. We believe the reforms contained in H.R. 1102 would mark an important step forward for our nation's retirement policy and would extend the benefits of pension coverage and retirement savings to many more American families.

We look forward to working in close partnership with you to see *The Comprehensive Retirement Security and Pension Reform Act of 1999* enacted this year. Thank you again for your efforts on this critical policy issue.

Sincerely,

American Council of Life Insurance
American Society of Pension Actuaries
Association for Advanced Life Underwriting
Association of Private Pension and Welfare Plans
College and University Personnel Association
Employers Council on Flexible Compensation
ERISA Industry Committee
Government Finance Officers Association
International Personnel Management Association
Investment Company Institute
National Association of Life Underwriters
National Association of Manufacturers
National Association of State Retirement Administrators
National Conference on Public Employee Retirement Systems
National Council on Teacher Retirement
National Defined Contribution Council
National Employee Benefits Institute
National Rural Electric Cooperative Association
National Telephone Cooperative Association
Profit Sharing/401(k) Council of America
Securities Industry Association
Small Business Council of America
U.S. Chamber of Commerce

Mr. ENGLISH. Thank you, Mr. Stewart.

Ms. Calimafde, we look forward to your testimony.

STATEMENT OF PAULA A. CALIMAFDE, CHAIR, SMALL BUSINESS COUNCIL OF AMERICA, BETHESDA, MARYLAND; AND MEMBER, AND DIRECTOR, SMALL BUSINESS LEGISLATIVE COUNCIL; ON BEHALF OF AMERICAN SOCIETY OF PENSION ACTUARIES, AND PROFIT SHARING/401(K) COUNCIL OF AMERICA

Ms. CALIMAFDE. I am Paula Calimafde. I am a practicing tax lawyer for more than 23 years in the qualified retirement plans and estate planning area. I am the chair of the Small Business Council of America. I am a director of the Small Business Legislative Council. I was a delegate appointed by Majority Leader Trent Lott to the National Summit on Retirement Savings. I was appointed by the President to the 1995 White House Conference on Small Business and served as the Commissioner of Payroll Costs at the 1986 White House Conference on Small Business where that section covered Social Security and retirement policy.

Today I am also representing the American Society of Pension Actuaries whose members provide actuarial consulting administrative services to approximately one-third of all the retirement plans in the country, many of which are small business plans. I am also representing the Profit Sharing/401(K) Council of America whose members represent about 3 million plan participants.

I want to discuss the reasons why a small business chooses not to sponsor a qualified retirement plan. We know that the coverage in the small business area is lagging and lagging seriously. The best of the statistics show small businesses cover somewhere in the 35 percent to 40 percent area, and those are the optimistic numbers. So why don't owners of small businesses want to sponsor retirement plans? They use a cost-benefit analysis.

Imagine a company that has three owners, four employees, and at the end of the year has $100,000 of profit. The owners can choose to put that money back into the company. They can also choose to establish a retirement plan and contribute some or all of that 100,000 for all of the employees, including themselves, or they can each take out $33,000 in compensation.

And that is the key to understanding why a lot of small businesses don't sponsor retirement plans. In order to induce that company to establish a retirement plan and make the contribution, the owners must perceive that they will be better off with a retirement plan than they would be putting the money back into the company or taking it out as compensation. If the plan is perceived by owners to be a headache, to require extra paperwork, require extra costs to administer the plan both inside and outside of the company, as not allowing the owners to get enough benefits out of the plan, to subjecting the company to audits from IRS on complex and technical rules and not being appreciated by employees, then they are not going to join the system.

If the owners do not think there is sufficient benefit in the plan for them, they will not join the system. This has been the situation we have been facing in the late seventies, all of the eighties and the early nineties. It is only recently that Congress has begun to realize that extra rules, extra burdens, and extra costs do not incentivize small businesses to join the qualified retirement plan system.

H.R. 1102 is the first major piece of legislation to reach out in a reasonable manner for small businesses to bring them into the system. We now know because the April 6, 1999 CRS report for Congress entitled Pension Coverage, Recent Trends and Current Policy Issues, that once a small business establishes a retirement plan, that coverage or participation in that plan is at roughly the same high levels as found in the larger businesses. This is a key statistic to understand.

What it means is that if a small business will join the system, and will sponsor a retirement plan, participation is at the same high level that you would have in a bigger plan. It is roughly 85 percent—85% of all the employees of the company participate in that plan. In other words, excellent coverage results.

I want to take a minute and look at the top-heavy rules. This is probably not the most important part of this bill. The limits—returning the limits to where they stood 17 years ago is more important. Increasing the 404 deduction limit is more important but make no mistake, the changes to the top-heavy rules that are in H.R. 1102 will help small businesses sponsor plans by rolling back some of these unnecessary burdens in the top heavy area. You know this is a well-grounded piece of legislation when it is criticized by both ends of the spectrum.

Some criticize this bill because they say it does not go far enough. These individuals maintain that the top-heavy rules are an abomination, that they are obsolete, and that they are the number one reason cited by small businesses why small business will not sponsor a retirement plan.

On the other hand, some criticize this bill because they believe in effect by trying to roll back some of the extra burdens, it is akin to allowing the proverbial camel's nose under the tent and that repeal will result in a future bill. Just because you have helped out a little bit in this bill, it is inevitable that repeal will follow.

Actually H.R. 1102 is a middle-ground approach. It keeps the meat of the top-heavy rules. It keeps the required minimum benefits and it keeps the somewhat accelerated minimum vesting—accelerated vesting, but it rids the system of some of the onerous burdens. In my opinion and in the opinion of those I am representing today, ASPA, Profit Sharing Council of America, Small Business Legislative Council, and the SBCA, this bill would do a tremendous amount to help small businesses and let them sponsor retirement plans which would give increased security to literally millions of Americans.

[The prepared statement follows:]

Statement of Paula A. Calimafde, Chair, Small Business Council of America, Bethesda, Maryland; and Member, and Director, Small Business Legislative Council; on behalf of American Society of Pension Actuaries, and Profit Sharing/401(k) Council of America

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which sponsor retirement plans or advise small businesses which sponsor private retirement plans. These enterprises represent or sponsor well over two hundred thousand qualified retirement plans and welfare plans, and employ over 1,500,000 employees.

The Small Business Legislative Council (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. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, tourism, and agriculture. Because SBLC is comprised of associations which are so diverse, it always presents a reasoned and fair position which benefits all small businesses.

The American Society of Pension Actuaries (ASPA) is an organization of over 4,000 professionals who provide actuarial, consulting, and administrative services to approximately one-third of the qualified retirement plans in the United States. The vast majority of these retirement plans are plans maintained by small businesses.

The Profit Sharing/401(k) Council of America (PSCA) is a non-profit association that for the past fifty years has represented companies that sponsor profit sharing and 401(k) plans for their employees. It has approximately 1200 company members who employ approximately 3 million plan participants. Its members range in size from a six-employee parts distributor to firms with hundreds of thousands of employees.

I am Paula A. Calimafde, Chair of the Small Business Council of America and a member of the Board of Directors of the Small Business Legislative Council. I am also a practicing tax attorney (over 20 years) who specializes in qualified retirement plans and estate planning. I can also speak on behalf of the Small Business Delegates to the 1995 White House Conference on Small Business at which I served as a Presidential Delegate. At this conference out of 60 final recommendations to emerge, the Pension Simplification and Revitalization Recommendation received the seventh highest ranking in terms of votes. H.R. 1102, the Comprehensive Retirement Security and Pension Reform Act, introduced on March 11, incorporates many of the most important recommendations made by the delegates to the 1995 White House Conference on Small Business.

Why did the delegates consider this recommendation to be so important as to vote it as the seventh out of the final sixty recommendations? The reason is simple—small business wants to be able to join the qualified retirement system. For small business, the qualified retirement plan is the best way to save for its employees' retirement. Based in part on the current tax law, many small businesses do not provide nonqualified pension benefits, stock options and other perks. Unfortunately, many, if not most, small businesses perceive the qualified retirement plan area to be a quagmire of complex rules and burdens. It is perceived as a system which discriminates against small business owners and key employees. The Conference Delegates understood that if the retirement system became more user friendly and provided sufficient benefits that they would want to join it. By doing so, they could provide for their own retirement security, while at the same time providing valuable retirement benefits for their other employees.

As a delegate appointed by Senator Trent Lott to the National Summit on Retirement Savings, I was able to share information and concerns with fellow delegates in break out sessions. Even though small business retirement plan experts, administrators and owners were not well represented, their ideas came through loud and clear in the break out sessions. Calls for repeal of the top heavy rules, increases in contribution limits, particularly the 401(k) limit, elimination of costly discrimination testing in the 401(k) area, and a return to the old compensation limits, were repeated across the break out sessions. There were even individuals calling for support of a particular piece of legislation—the Portman-Cardin retirement plan bill (this was last year's bill). Of course, many ideas were discussed particularly in the educational area, but an impartial observer would have noticed that the small business representatives were very united in their message—increase benefits, decrease costs. In other words, when undertaking a cost/benefit analysis, small business currently perceives the costs too high as compared to the benefits to be gained.

At the Summit, the following problems facing small businesses in the retirement plan area were brought up: staff employees' preference for cash or health care coverage, the revenue of the business beings too uncertain, the costs of setting up the plan and administering it being too high, required company contributions (i.e., the top heavy rules) being too high, required vesting giving too much to short term employees, too many governmental regulations, and benefits for owners and key employees being too small. When asked what could break down these barriers, the following answers were given: reduce the cost by giving small businesses tax credits for starting up a plan; repeal the top-heavy rules; reduce administration; allow owners and key employees to have more benefits; and change lack of employee demand by educating employees about the need to save for their retirement now. Some micro small businesses believed that until they were more profitable nothing would induce them to join the system.

Today we are here to focus on employer coverage and employee participation issues, explore ways to remove burdensome regulatory requirements, improve the level of benefits that workers may accrue towards their retirement and overall how to strengthen retirement plans. SBCA, SBLC, ASPA and PSCA all strongly support the landmark legislation, H.R. 1102. This legislation if enacted, will promote the formation of new small business retirement plans, significantly reduce overly complex and unnecessary regulatory requirements, increase portability and overall provide more retirement security for all of the Americans who work for small business.

I want to share with you two real life examples. A visiting nurses association in Vermont just established a 401(k) plan. The average salary of the roughly 150 participants is $17,000. 90% of the employees decided to participate in the plan by saving some of their current salary for future retirement security. The *average* amount saved from their salaries and put into the 401(k) plan was 8%. Many were at the 10% to 15% levels. Some of the employees would have gone beyond 15% if they had been allowed to do so. Many of these employees live in very rural areas of Vermont, but they understood the message—it is imperative to save now for your retirement security later. They understood it's primarily their responsibility to provide for their retirement income not the federal government's responsibility.

A criticism sometimes aimed at the retirement plan system is that it is used disproportionately by the so-called "rich" or the "wealthy." Practitioners who work in the trenches know better. The rules governing the qualified retirement system force significant company contributions for all non-highly compensated employees if the highly compensated are to receive benefits. The 401(k) plan, in particular, is a tremendous success story. Employees of all income levels participate, even more so when there is a company match. The real example set forth above is not unusual (though perhaps the level of savings is higher than normal).

Here's another example. This is a local company specializing in testing new drugs, particularly those designed to prevent or slow down AIDS. The company started off about 20 years ago with roughly 20 employees. For each of the last 20 years, this company has made contributions to its profit sharing plan in the amount of 8% to 10%. The company has now grown to about 220 employees. Their long-timers now have very impressive retirement nest eggs. The company believes this money has been well spent. It enjoys the well-deserved reputation of being generous with benefits and employee turn-over is way below the norm for this industry.

This is a retirement plan success story—a win-win situation. The company has a more stable and loyal workforce of skilled employees. The employees in turn will have retirement security. This plan benefits all eligible employees regardless of income level. Every eligible employee in the company has received in effect an 8% to 10% bonus every year which was contributed on their behalf into a qualified retirement trust where it earned tax free growth.

SOME SURPRISING GOOD NEWS—PARTICIPATION IS HIGH IN RETIREMENT PLANS SPONSORED BY COMPANIES WITH FEWER THAN 100 EMPLOYEES AND EVEN WITH FEWER THAN 25 EMPLOYEES

Recently, the Congressional Research Service issued a Report for Congress, entitled "Pension Coverage: Recent Trends and Current Policy Issues," authored by Patrick J. Purcell, Analyst in Social Legislation. This report gives an excellent overview of the current coverage trends for retirement plans, though it is relying on data through 1997. Thus, in the small business area, it is not picking up any additional plan sponsorship and thus, coverage, due to the new SIMPLE and some of the real simplications that have been accomplished in the last several retirement plan bills. (Put down the bills) of the last several Congresses. A quick perusal of the many tables shows small business lagging in many areas of coverage. For example, Table 3. Participation in Pension or Retirement Savings Plans by Size of Firm shows in Panel A, that in 1997, 83.3% of employees in firms with 100 or more employees had employers who sponsor a pension or retirement savings plan. This is contrasted to 58.1% of employees in companies with 25 to 99 employees have employers who sponsor such a plan. Worse, only 30.3%of employees in firms with under 25 employees have employers who sponsor such a plan. It is clear that the size of the company impacts retirement plan sponsorship, but in the very next table a very interesting pattern emerges.

Panel B: Percentage of employees in firms that sponsored a plan who participated in the plan shows that in 1997, 88.2% of employees in firms with 100 or more employees that sponsor a pension or retirement savings plan participated in the plan. However, 85.5% of employees in companies with 25 to 99 employees which sponsor such a plan participated. And again, the trend holds—84.8% of employees in firms with under 25 employees whose employers sponsor such a plan participate. In short, when small businesses sponsor retirement plans, the employees participate at just about the same levels as in larger companies. This is a very meaningful statistic and can be interpreted to mean that the key is to incentivize small business to sponsor retirement plans—once this occurs, meaningful participation results. Another way of saying this is it is critical to make the system attractive to small business. H.R. 1102 does just this—it strips away unnecessary burdens and increases incentives to attract small businesses to the qualified retirement plan system.

THREE MAJOR REASONS WHY SMALL BUSINESSES CHOOSE NOT TO SPONSOR A PLAN

There are three major reasons why a small business chooses not to adopt a retirement plan and H.R. 1102 addresses all three.

First, lack of profitability. H.R. 1102 addresses this problem by adding a new salary reduction only SIMPLE plan. This is a plan that a small business will adopt regardless of its lack of profits because it costs the company almost nothing to sponsor. This plan rests on an IRA framework so the company has no reporting requirements or fiduciary responsibilities. Also the company is not required to make any contributions to the plan—so profitability is irrelevant. The plan will give every eligible employee of the company a chance to contribute $5,000 for his or her own retirement security each year.

The second major reason why small businesses do not sponsor retirement plans is because the system is perceived (and deservedly so) as too complex and costly. The devastating legislation of the 80's and early 90's layered additional requirements on small business with overlapping and unnecessarily complex rules aimed at preventing abuse in the system or discrimination against the non-highly compensated and non-key employees. In fact, it often comes as a shock to those trying to strengthen the retirement plan system for small business that the system has harsher rules designed specifically for small business. Probably the most offensive of these rules are the so-called "top heavy rules." Because of the mechanical tests associated with the top-heavy rules, almost all small business plans are top-heavy. When a plan is top-heavy, the small business must make special required contributions which increase the cost of the small business plan and vesting is slightly accelerated. In addition to extra rules being placed on small business plans, all plans were being subjected to constant changes. These annual changes in the law and the regulations combined with reduced benefits, first brought the system stagnation and then decline. This legislation was prompted by the need to get short term revenue and where better to look then the pension system that no one understood and few were watching. It was also prompted by a need to rid the system of some real abuse (for instance back about 20 years ago, it was possible for a retirement plan to only make contributions for employees who earned over the social security wage base, this rule was eliminated and for good reason). Unfortunately, rather than using a fly swatter, a nuclear bomb was detonated and we ended up with a system in real disrepair. H.R. 1102 preserves the safeguards for non-highly compensated employees so that they are fully protected, while stripping away the unnecessary and overlapping rules so that true simplification is achieved.

H.R. 1102 provides reasoned answers. By stripping away needless complexity and government over regulation in the form of micro management, the system will have a chance to revive. This bill would go a long way towards removing the significant burdens imposed on small business by the top heavy rules. It would simplify portability. It would repeal the absurdly complex and unnecessary multiple use test. It would truly simplify the system without harming any of the underlying safeguards.

Some have criticized H.R. 1102 for not repealing the top-heavy rules because they are obsolete, discriminatory and serve as a real road block for small businesses to enter the qualified retirement plan system. Others have criticized H.R. 1102 as the first step towards repeal of the top-heavy rules—this is the camel's nose under the tent theory—if you try to remove any burdens, it's just a matter of time before all the rules are repealed. Interestingly, H.R. 1102 by stripping away the absurd burdens in the top heavy rules (for instance, requiring companies to look back only 1 year instead of 5 to determine who is a key employee to reduce extensive recordkeeping) while keeping the two meaningful provisions of the top-heavy rules—extra contributions required and accelerated vesting has tried to reach a middle ground on this difficult issue.

Costs would be reduced by eliminating user fees and providing a credit for small business to establish a retirement plan. This credit would go a long way towards reducing the initial costs of establishing a plan.

The third reason why small businesses stay away from the retirement system is that the benefits that can be obtained by the owners and the key employees are perceived as too low. It is no secret that small business owners believe that the retirement plan system discriminates against them. Short vesting periods and quick eligibility have provided more benefits for the transient employees at the expense of the loyal employees. Cutback in contribution levels hurt key employees and owners, (of course they hurt the non-highly compensated also, but it took a long time to understand there was a very real correlation between what the small business owners could put away for themselves and their key employees and what would be put in for the non-highly compensated employees).

H.R. 1102 solves this problem also. This legislation understands there are two pieces to the puzzle—a reduction in complexity and costs is essential but is not sufficient by itself. A second piece is required. Increasing the contribution limits (in reality reversing the limits) to where they stood in 1982 is equally important.

It is interesting to examine where these limits would be today if the law in 1982 had not been enacted. *The defined contribution limit which was $45,475 in 1982, assuming a constant 3% COLA would have been $75,163 in 1999. This is where 401(k) limit would have been also.* Only in 1987, was the amount an employee could save by 401(k) contributions on an annual basis limited to $7,000 and the "ADP" tests could further limit the amount (below $7,000) for the highly compensated employees. *The defined benefit limit which was at $136,425 in 1982, assuming a constant 3% COLA would be at $225,490 today. These numbers assume a constant COLA of 3%. The true number during those years would be closer to an average of 4%–5%.*

Given how critical it is for people to start saving for their own retirement today, it seems most peculiar to have limits harsher than what they were 17 years ago. Some people say that these limits will not operate as an incentive to small businesses to sponsor the plan and will only be used by the so-called "rich." Not only will the increased limits serve as an incentive to small businesses to sponsor a retirement plan, but the higher limits will be enjoyed by employees who are not "rich". For instance, it is very common today for both spouses to be employed. Quite often, these couples decide that one of the spouse's income will be used as much as possible to make contributions to a 401(k) plan. Today, the most the couple can save is $10,000 (and if the participant spouse makes more than $80,000 or makes less but is a 5% owner of a small business, then the couple might not even be able to put in $10,000). Often, the couple would have been willing to save more. These couples might make $40,000, $50,000 or more, but they are not "rich." It is only because both spouses are working, that they are making decent income levels—we should provide the means by which they can save in a tax advantaged fashion *while* they can.

This same principle applies particularly to women who enter and leave the work force intermittently as the second family wage earner. They and their families stand to benefit the most from increased retirement plan limits because the increased limits will provide the flexibility that families require as their earnings vary over time and demands such as child rearing, housing costs and education affect their ability to save for retirement.

Many mid-size employers rely less on their existing defined benefit plan to provide benefits for their key employees and more on non-qualified deferred compensation plans. This is a direct result of the reduction in the defined benefit plan limit. In 1974, the maximum defined benefit pension at age 65 was $75,000 a year. Today the maximum benefit is $130,000, even though average wages have more than quadrupled since 1974. Thus, pensions replace much less pre-retirement income now than they did in the past. In order for these ratios to return to prior levels, the maximum would have to be over $300,000 now. The lower limits have caused a dramatic increase in non-qualified pension plans, which provide benefits over the limits. They help only the top-paid employees. This has caused a lack of interest in the defined benefit plan since there is no incentive to increase benefits since the increases cannot benefit the highly compensated employees or key employees. This is unfortunate since increases affect all participants. The importance of bringing these limits back to the 1982 levels cannot be underestimated. They are crucial if small business is to be persuaded to join the system.

Prior to the last several Congresses which worked hard to improve the system, the thrust of the laws was how to prevent any conceivable abuse and how to limit what the upper middle income and upper income employees could receive from a retirement plan. Interestingly, it is often obvious for a member of Congress to understand that if the upper 2 to 3 quintiles of income earners are removed from the social security system that it could prove the death knell for the system because the top earners would be disenfranchised and would no longer have any interest in the system. Interestingly, this is exactly what has happened during the mid–70's through the early 90's in the retirement plan system, but even though the same concept applied, it was not apparent. By now it should be apparent to all that we have disenfranchised large numbers of employees from the qualified retirement system and that this has brought about its stagnation and decline.

Rumors have been circulating to the effect that 20% of all retirement plan benefits generated by both the private retirement plan system and the governmental retirement system go to the top 1% of taxpayers, 75% go to the top 20% of taxpayers and less than 10% go to the bottom 60% of taxpayers. These rumors appear to be attributable to a talking points sheet entitled "Distribution of Pensions Benefits under Current Law" prepared by the Office of Tax Analysis, Department of the Treasury, 1/29/99. Even though it is entitled "Distribution of Pension Benefits," it seems clear that all of the statistics are based on how projected tax expenditures for pension contributions and earnings are "received." Half of the total projected "tax expenditure" is allocated to government plans. Even taking into account that 30% of the taxpayers pay no tax (so would receive no tax expenditure), the numbers still appear to be out of line. It appears that couples where both spouses work have been treated as one individual and income has been imputed to the couple from a variety of sources. The concept of "tax expenditure" itself is controversial. The theory is based on the premise that all sources of money should be taxed and "belong" to the government. When the government foregoes its collection of this money it becomes a "tax expenditure." This is in contrast to the theory which states that the government is only entitled to tax certain enumerated items and no others. However, these rumors have started they are not based on fact and they do a real disservice to the people who are trying to revitalize the retirement plan system at a time when it is critical to do so.

Interestingly, the American Council of Life Insurance has concluded a research project authored by Janemarie Mulvey, Ph.D, Director of Economic Research, May 19, 1999. This study defines pension benefits as benefits coming from employer-sponsored plans, federal, state and local and military, but does not include lump sum payments. This study shows that the system provides meaningful benefits for many individuals who are in the low to middle income ranges. For example, the report found that:

Among Married Couples Receiving Pensions: ⅓ had incomes below $30,000 (median income); 57% had incomes below $40,000 (average income).

Nearly 70% of those receiving pensions had income below $50,000

These types of statistics are based on real data and show that meaningful benefits are being received by employees who have average income.

Another major "fix up" in this bill deals with Section 404. This section limits a company's deductible contribution to a profit sharing plan to 15% of all participant's compensation. This limit presently includes employee 401(k) contributions. This means that if an employer chose to make a 15% contribution to a profit sharing plan, then no employee would be allowed to make a 401(k) contribution. Realizing the absurdity of this rule, H.R. 1102 would no longer count employee contributions (401(k)) towards the 15% overall deduction level.

Even more importantly, the 15% level would be raised to 25%. This change would allow small businesses to sponsor one plan in place of two plans that are now required to accommodate a contribution greater than 15%. This would generate real savings to the small business since only one plan document, one summary plan description, one annual 5500, etc. would be required instead of two.

This bill is indeed comprehensive legislation which will inject needed reforms into the pension system and by doing so will truly provide retirement security for countless Americans. It will increase small business coverage and it is important that we all work hard to see this entire bill enacted into law.

The Department of Labor's ERISA Advisory Council on Employee Welfare and Benefit Plans recently released its Report of the Working Group on Small Business: How to Enhance and Encourage The Establishment of Pension Plans dated November 13, 1998. This report provides eight recommendations for solving the problems facing small businesses today in the retirement plan area. Interestingly, these recommendations mirror many of those that came out of the National Summit on Retirement Savings.

The Advisory Council report calls for a Repeal of Top-Heavy Rules, Elimination of IRS User Fees, an Increase in the Limits on Benefits and Contributions, an Increase in the Limits on Includable Compensation, the Development of a National Retirement Policy, Consider the development of Coalitions, Tax Incentives and the Development of a Simplified Defined Benefit Plan.

The Report explains the legislative development of the top-heavy rules and then summarizes the layers of legislation that occurred subsequent to their passage which made them obsolete. The Report states, “The top-heavy rules under Internal Revenue Code Section 416 should be repealed....Their effect is largely duplicated by other rules enacted subsequently....They also create a perception within the small business community that pension laws target small businesses for potential abuses. This too discourages small business from establishing qualified retirement plans for their employees.”

It is important to note that the Portman-Cardin legislation dramatically improves the top-heavy rules and significantly reduces administration expenses associated with them.

The Report calls for the elimination of User Fees imposed by IRS. The Report in part states, “The imposition of user fees adds another financial obstacle to the adoption of qualified retirement plans by small business. Although user fees apply to all employers—large and small—the cost of establishing a plan is more acutely felt among small employers. User fees do not vary by size of employer....Now that the budget deficit has become a budget surplus, the economic justification for user fees is much diminished. User fees should be repealed.”

H.R. 1102 addresses the user fee issue to assist small businesses in sponsoring retirement plans.

The Advisory Council Report calls for increasing the limits on benefits and contributions:

“The defined benefit and defined contribution plan dollar limit were indexed by ERISA and were originally established in 1974 at $75,000 and $25,000 respectively. From 1976 to 1982, the indexing feature was allowed to operate as intended and the dollar amounts grew to $136,425 and $45,475. Under the Tax Equity and Fiscal Responsibility Act of 1982, the dollar limit on defined benefit plans was reduced to $90,000 and the dollar limit on defined contribution plans was reduced to $30,000. ...

“These reductions in the dollar amounts are widely believed to have been revenue driven. These reductions had the net effect of adjusting downward the maximum amount of benefits and contributions that highly-paid employees can receive in relationship to the contributions and benefits of rank and file employees. ...

“In order to give key employees the incentive needed to establish qualified retirement plans and expand coverage, we recommend that the $30,000 dollar limit on defined contribution plans be increased to $50,000 which will help partially restore the dollar amount to the level it would have grown to had the indexing continued without alteration since the dollar limit was first established in 1974.

“Second, we recommend that the $90,000 dollar limit on defined benefit plans be increased to $200,000 which will restore the dollar amounts lost through alterations in the dollar amount since 1974, while maintaining the 1:4 ratio established in 1982 as part of TEFRA.

“Third, we recommend, that in the future, indexing occur in $1,000, not $5,000 increments which has had the effect of retarding recognition of the effect of inflation.”

And finally the report concludes, “we recommend, that actuarial reductions of the defined benefit plans dollar limit should be required only for benefits commencing prior to age 62. This was the rule originally enacted in 1974 as part of ERISA.”

THE PORTMAN-CARDIN LEGISLATION INCREASES THE CONTRIBUTION LIMITS WITH RESPECT TO ALL OF THE RETIREMENT PLANS. AS DISCUSSED IN MORE DETAIL BELOW, THIS IS PERHAPS ONE OF THE MOST IMPORTANT CHANGES THAT CAN BE MADE TO THE SYSTEM TO INCREASE SMALL BUSINESS ACCESS.

The Report also calls for a corresponding increase in the limit on includable compensation for similar reasons. “Under ERISA, there was no dollar limit on the amount of annual compensation taken into account for purposes of determining plan benefits and contributions. However, as part of the Tax Reform Act of 1986, a qualified retirement plan was required to limit the annual compensation taken into account to $200,000 indexed. The $200,000 limit was adjusted upward through indexing to $235,843 for 1993. As part of the Omnibus Budget Reconciliation Act of 1993, the limit on includable compensation was further reduced down to $150,000 for years after 1994. Although indexed, adjustments are now made in increments of $10,000, adjusted downward. In 1998, the indexed amount is $160,000.” “We recommend that the limit on includable compensation be restored to its 1988 level of $235,000 be indexed in $1,000 increments in the future.”

THE PORTMAN-CARDIN LEGISLATION WILL RETURN THE COMPENSATION LIMIT BACK TO WHERE IT STOOD IN 1988. THE SYSTEM IS PERCEIVED BY MANY SMALL BUSINESS OWNERS AS DISCRIMINATORY AGAINST KEY EMPLOYEES; THIS TYPE OF CHANGE WILL ALLOW IT TO BE PERCEIVED AS MORE FAIR TO ALL EMPLOYEES.

The Report develops a number of recommendations in the area of education, including using public service spots on television, radio and in the printed media to educate the public and raise the awareness of the need to prepare and save for retirement. Virtually all of the Report's recommendations in this area also were made at the National Summit on Retirement Savings. This is a critical area for small business. Clearly, more small businesses will want to sponsor retirement plans if retirement benefits are perceived as a valuable benefit by their employees.

ONE OF THE DIRECT BENEFITS TO COME OUT OF THE NATIONAL RETIREMENT SUMMIT IS THE EDUCATIONAL SPOTS BEING PUT ON THE AIR BY ASEC AND EBRI. IT IS CRITICAL FOR THE PUBLIC TO BECOME EDUCATED ABOUT THE NEED TO START SAVING FOR THEIR RETIREMENT AND THE BENEFITS OF STARTING EARLY.

The Report calls for tax credits that could be used as an incentive for a small business to adopt a qualified retirement plan or to offset administration costs or even retirement education costs.

H.R. 1102 PROVIDES TAX CREDITS AS AN INCENTIVE FOR SMALL BUSINESSES TO ADOPT RETIREMENT PLANS.

Finally the Advisory Council calls for a Simplified Defined Benefit Plan.

The graying of America, and the burden that it will place on future generations, should not be ignored. The American Council of Life Insurance reports that from 1990 to 2025, the percentage of Americans over 65 years of age will increase by 49%. This jump in our elderly population signals potentially critical problems for Social Security, Medicare and our nation's programs designed to serve the aged.

While we must shore up Social Security and Medicare, it is clear that the private retirement system and private sources for retiree health care will have to play a more significant role for tomorrow's retirees. The savings that will accumulate for meeting this need will contribute to the pool of capital for investments that will provide the economic growth needed to finance the growing burdens of Social Security and Medicare. The policy direction reflected by H.R. 1102 will ensure that sufficient savings will flow into the retirement plan system so as to provide a secure retirement for as many Americans as possible.

The last two bills passed by this Congress to enhance the retirement system and retirement savings began the process of simplifying the technical compliance burdens so that small businesses are able to sponsor qualified retirement plans. *H.R. 1102 represents another huge step forward.* Indeed, if this legislation becomes the law, only a few changes remain to fully restore the system to its former health prior to the onslaught of negative and complex changes of the 1980's while retaining the needed reforms introduced during that period.

SBCA, SBLC, ASPA and PSCA strongly support the following items in H.R. 1102 which will greatly assist businesses, and particularly small businesses, in sponsoring retirement plans:

401(k) Changes

The 401(k) Plan is a tremendous success story. The excitement generated by this plan is amazing. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much does the employer contribute. Employees meet with investment advisors to be guided as to which investments to select, employees have 800 numbers to call to see how their investments are doing and to determine whether they want to change investments. Employees discuss among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown.

The forced savings feature of the 401(k) plan cannot be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Savings can be removed by written plan loan which cannot exceed 50% of the account balance or $50,000 whichever is less. Savings can be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency. This is in contrast to funds inside an IRA or a SIMPLE (which is an employer sponsored IRA program) where the funds can be accessed at any time for any reason. True, funds removed will be subject to a 10% penalty (which is also the case for a hardship distribution from a 401(k) plan), but preliminary and totally unofficial data suggests that individuals freely access IRAs and SEPs (also an employer sponsored IRA program) and that the 10% penalty does not seem to represent a significant barrier. In fact, this is why the SIMPLE IRA starts off with a 25% penalty for the first two years an individual participates in SIMPLE in hopes that if a participant can accumulate a little bit he or she will be tempted to leave it alone and watch it grow. Nevertheless, there is a distinct difference between asking the employer for a loan or a hardship distribution and having to jump through some statutorily and well placed hoops versus simply removing money at whim from your own IRA.

- Increasing 401(k) contributions from $10,000 to $15,000 is a significant, beneficial change which will assist many employees, particularly those who are getting closer to retirement age.
- Opening up the second 401(k) Safe Harbor, the "Match Safe Harbor" to small businesses by exempting it from the Top-Heavy Rules is a valuable change which places small businesses on a level playing field with larger entities.
- We believe that the voluntary safe harbors will prove to be the easiest and most cost effective way to make the 401(k) plan user friendly for small businesses. If a small business makes a 3% contribution for all non-highly compensated employees, or makes the required matching contributions, then the company no longer has to pay for the complex 401(k) antidiscrimination testing (nor does it have to keep the records necessary in order to do the testing). We recognize that many companies will choose to stay outside the safe harbor because the 3% employer contribution or required match "cost of admission" is too high and because it is more cost-effective to stay with their current system (including software and written communication material to employees). *Many believed that small business would embrace the voluntary safe harbors that do away with costly complex testing. Unfortunately, because of some serious roadblocks placed in the path of the voluntary safe harbors by the Internal Revenue Service, it is not clear what the future of the safe harbors will be.*
- Unfortunately, IRS is imposing a Notice Requirement which is very restrictive and will probably cause most small businesses not to be able to use the safe harbor this year. IRS Notice 98–52, which was published November 16, 1998, requires that a business adopting either safe harbor give written notice (in the case of a calendar year plan) by March 1st. Now let's examine the rationale behind the notice requirement and see whether this type of restriction is justified. Remember there are two safe harbors—one is a prescribed company match to employee 401(k) contributions, the other is a non-elective 3% contribution. A non-elective 3% contribution means that every eligible employee receives this contribution whether or not he or she makes 401(k) contributions. The rationale for notice in the context of the match safe harbor is self evident. An employee may very well change his or her behavior and contribute more 401(k) contributions knowing that a match is going to be made.

There appears to be no rationale for notice in the context of the non-elective 3% contribution—no employee is going to change any behavior on knowing that a contribution will be made for them at the end of the year.T1 The problem of course is compounded when dealing in the small business world. Unless an outside advisor has informed a small business that it must give a fairly extensive written notice by March 1st and the company complies, it will not be able to take advantage of the safe harbor for this entire year. My guess is that there will be many, many small businesses this year who would have taken advantage of the 3% non-elective safe harbor but will not be able to do so because they had not been informed of the requirements of this overly restrictive notice requirement. Thus, they will not be able to rid themselves of the complex and costly 401(k) anti-discrimination testing this year.

IRS also has stated that the 3% non-elective contribution must be paid to every non-highly compensated employee regardless of whether they have completed 1000 hours and whether he or she is employed on the last day of the plan year. This is more restrictive than either the rule for normal plan contributions or the rule for the top-heavy minimum contributions. Again, there seems to be no rationale for a safe harbor which is designed to help small business avoid complicated testing to be made so restrictive.

IRS has also stated publicly that if the notice has not been given correctly or the plan otherwise failed to satisfy the safe harbor after electing it (and remember the company is required to elect basically a month before the beginning of the plan year), then the plan is disqualified. This type of severe penalty will certainly be the death knell of the safe harbors for if a small business has to worry about disqualification, it will simply stay away from them. A cynic might observe that the IRS is doing everything it can to make sure it does not carry out Congressional intent.

Even statutorily, the Services' position cannot be sustained, since the safe harbor is entitled as an alternative means to satisfy the non-discrimination tests.

SBCA, SBLC, ASPA and PSCA suggest that the notice requirement be changed to within 30 days of the close of the plan year for those companies selecting the 3% non-elective contribution safe harbor. This change will allow word to get out to small business about this option and give them time to comply with the notice requirement. We also suggest that the 3% non-elective contribution be made to either all non-highly compensated employees who have worked 1,000 hours or to those employees who are employed on the last day of the plan year, but not both. We also suggest that it be made clear in writing that if a small business does not comply with the safe harbor election, that the plan falls back to the regular 401(k) discrimination rules not be disqualified.

- Increasing the IRC Section 404 15% deduction limit to 25% is a major change which will appreciably assist small businesses. Section 404 limits a company's deduction for profit sharing contributions to 15% of eligible participants' compensation. Because of this rule, today many companies, including small businesses, sponsor two plans because the 15% limit is too low for the contributions they are putting in for their employees. Most often a money purchase pension plan is coupled with a profit sharing plan to allow the company to get up to a 25% deduction level. By requiring companies to sponsor two plans where one would do, administration expenses and user fees are doubled. Each year the company is required to file two IRS 5500 forms instead of one. The company is required to have two summary plan descriptions instead of one. This change would truly simplify and reduce administration expenses and exemplifies the outside of the box thinking found in H.R. 1102. In fact, it is interesting to contemplate whether Section 404 serves any meaningful function today.
- The Qualified Plus Contribution is an exciting concept which may prove to be sought after by employees contributing 401(k) contributions.
- Excluding 401(k) contributions made by the employees from the IRC Section 404 15% deduction limit will make these plans better for all employees. Today, employee 401(k) contributions are included in the Section 404 limit. Section 404 limits a company's deduction for profit sharing contributions to 15% of eligible participants' compensation. This limit covers both employer and employee 401(k) contributions. This limitation now operates against public policy; either employer contributions are cut back which works to the detriment of the employees' retirement security *or* employee pre-tax salary deferred contributions must be returned to the employee. Thus, employees lose an opportunity to save for their retirement in a tax-free environment. This is particularly inappropriate since the employee has taken the initiative to save for his or her retirement, exactly the behavior Congress wants to encourage, not discourage.
- Repeal of the complicated "Multiple Use Test" is a very welcome change and will benefit the entire retirement plan system. This test was nearly incomprehensible and forced small businesses (really their accountants or plan administrators) to apply different anti-discrimination tests to employer matching contributions than what may have been used for the regular 401(k) anti-discrimination tests.
- Allowing employee-pay all 401(k) plans for small business is fair. Portman-Cardin would allow a key employee to make a contribution to a 401(k) plan sponsored by a small business without triggering the top-heavy rules were triggered so that the small business was required to make a 3% contribution for all non-key employees. Not only is this a trap for the unwary since many small businesses, including their advisors, are unaware of this strange rule, but it is also unfair since a larger company would be able to sponsor an employee-pay-all 401(k) plan and not have to make any employer contributions to the plan. The regular 401(k) anti-discrimination tests are more than sufficient to ensure that the non-highly compensated employees are treated fairly vis a vis the highly compensated employees.
- The so-called "Catch-Up Contributions" for people approaching retirement may be helpful for small business employees, particularly those who were not able to save while they were younger.

Changes to Plan Contribution Limits

Perhaps the most important change in the retirement legislation is increasing the dollar limits on retirement plan contributions, removing the 25% of compensation limitation and increasing the compensation limitation.

- Increasing the $150,000 compensation limit to $235,000 is an important change which will bring the plan contributions back into line with 1998 dollars. The $150,000 limit in 1974 (ERISA) dollars is about $46,500 (assuming 5 percent average inflation). This is far below the $75,000 that represented the highest amount upon which a pension could be paid under then-new Code Section 415 (back in

1974). This cutback has hurt several groups of employees—owners and other key employees of all size businesses who make more than $150,000 and mid-range employees and managers (people in the $50,000 to $70,000 range) who are in 401(k) plans and in defined benefit plans. This cutback was perceived by owners and other key employees of small businesses as reverse discrimination and as a disincentive in establishing a retirement plan.

• Increasing the defined contribution limit from $30,000 to $45,000 and the defined benefit limit from $130,000 to $180,000 are strong changes which will increase retirement security for many Americans. These numbers are in line with actual inflation.

Top Heavy Rules

These rules are now largely duplicative of many other qualification requirements which have become law subsequent to the passage of the top-heavy rules. They often operate as a "trap for the unwary" particularly for mid-size businesses which never check for top-heavy status and for micro small businesses which often do not have sophisticated pension advisors to help them. These rules have always been an unfair burden singling out only small to mid-size businesses. *The changes made in H.R. 1102 will significantly simplify the retirement system with little to no detriment to any policy adopted by Congress during the last decade.* The top-heavy rules have required extensive record keeping by small businesses on an ongoing 5 year basis. They also have represented a significant hassle factor for small business—constant interpretative questions are raised on a number of top-heavy issues and additional work is required to be done by a pension administrator when dealing with a top-heavy plan, particularly a top-heavy 401(k) plan.

SBCA, SBLC, ASPA and PSCA support the repeal of the family attribution for key employees in a top-heavy plan, as well as finally doing away with family aggregation for highly compensated employees. These rules require a husband and wife and children under the age of 19 who work in a family or small business together to be treated as one person for certain plan purposes. They discriminate unfairly against spouses and children employed in the same family or small business.

We also support the simplified definition of a key employee as well as only requiring the company to keep data for running top heavy tests for the current year rather than having to keep it for the past four years in addition to the current year.

SIMPLE Plans

It is exciting to see that the SIMPLE is attracting so many small businesses. We believe, though, that the SIMPLE plan should be viewed as a starter plan and that all businesses, including the very small, should be given incentives to enter the qualified retirement plan system as quickly as possible. The SIMPLE is an IRA program, as is the old SEP plan and in the long run true retirement security for employees is better served by strengthening qualified retirement plans rather than SIMPLES and SEPs. This is simply because employees have a far greater opportunity to remove the money from IRAs and SEPs and spend it—the forced savings feature of a qualified retirement plan is not present. While we appreciate that for start-up companies or micro businesses, a SIMPLE or the proposed salary reduction SIMPLE is the best first step into the retirement plan system, the company should be encouraged to enter the qualified retirement system as soon as possible. By making the SIMPLE rules "better" than the qualified retirement system, the reverse is achieved. Thus, we hope that the "gap" between the 401(k) limit ($15,000) and the SIMPLE limit ($10,000) and the salary reduction SIMPLE limit ($5,000) is carefully preserved so that the system does not tilt in the wrong direction.

We do not believe that any other new plans than those set forth in H.R. 1102 are needed. We now have a very good mix of plans—from those which provide flexibility and choice to very simple plans for the companies who do not want administration costs.

Required Minimum Distribution Rules

We support exempting a minimum amount from the required minimum distribution rules. We would encourage the Committee to also consider whether the rule which delays receiving distributions for all employees, other than 5% owners, until actual retirement, if later, should be extended to 5% owners. There seems to be no policy rationale for forcing 5% owners to receive retirement distributions while they are still working.

We also respectfully suggest the following:

1. Allow direct lineal descendants of the participant, in addition to a spouse, to be able to roll-over a plan contribution to an IRA. Today, if a participant dies and names the spouse as beneficiary, the spouse can "roll-over" the retirement plan as-

sets into an IRA, rather than receiving payments from the retirement plan. On the other hand, if a participant dies and names his or her children as the beneficiaries, the children cannot roll-over the assets into an IRA and will in most cases be forced to take the distribution in one lump sum. This triggers the problem set forth in 2 below.

2. Provide an exemption of retirement plan benefits from estate taxes. As mentioned above, if the children are forced to take a lump sum distribution (and assuming they have no surviving parent), the entire retirement plan contribution is brought into the estate of their parent who was a plan participant and is subject to immediate income tax. This is the fact pattern where the plan distribution is reduced by up to 85% due to taxes—federal and state income taxes and federal and state estate taxes. This is why people often say they don't want to save in a retirement plan because if they die the government takes it all and the children and grandchildren receive way too little.

3. Section 404(a)(7) should be eliminated. Section 404(a)(7) is an additional deduction limitation imposed on companies that sponsor any combination of a defined benefit plan and a defined contribution plan. When a company chooses to sponsor both types of plans, then it is limited to a 25% of compensation limit. The defined benefit plan is subject to a myriad of limitations on deductions and contributions. The defined contribution plan is likewise subject to its own limitations on deductions and contributions. This extra limitation often hurts the older employees who would otherwise receive a higher contribution in the defined benefit plans. Often companies simply choose not to sponsor both types of plan because of this limitation.

Plan Loans for Sub-S Owners, Partners and Sole Proprietors

This is a long overdue change to place all small business entities on a level playing field. We support this change.

Repeal of 150% of Current Liability Funding Limit

This is a very technical issue, but basically defined benefit plans are not allowed to fund in a level fashion. Code Section 412(c)(7) was amended to prohibit funding of a defined benefit plan above 150 percent of current "termination liability." This is misleading because termination liability is often less that the actual liability required to close out a plan at termination, and the limit is applied to ongoing plans which are not terminating. *This provision is particularly detrimental to small businesses who simply cannot adopt a plan which does not allow funding to be made in a level fashion.* The changes made to this law by H.R. 1102 are critical for small businesses to be able to sponsor defined benefit plans.

We also applaud the change in the variable rate premium which will assist small businesses which are not allowed to fund in a proper fashion because of this limitation.

A small business will go through a cost-benefit analysis to determine whether to sponsor a qualified retirement plan. A number of factors are analyzed including the profitability and stability of the business, the cost of sponsoring the plan both administratively as well as required company contributions, whether the benefit will be appreciated by staff and by key employees and whether the benefits to the key employees and owners are significant enough to offset the additional costs and burdens. The legislation being contemplated by this Committee will dramatically improve the qualified retirement plan system. By making the system more user friendly and increasing benefits, more small businesses will sponsor retirement plans. Easing administrative burdens will reduce the costs of maintaining retirement plans. The changes would revitalize the retirement plan system for small business as it is perceived by small businesses as more fair to them. Finally, the positive changes made by Congress in the 1980's would be retained and the time tested ERISA system would stay in place. Ultimately, it is essential for this country to do everything possible to encourage retirement plan savings so that individuals are not dependent upon the government for their retirement well-being.

Mr. ENGLISH. Thank you, Ms. Calimafde.

Mr. MacDonald, we look forward to your testimony.

STATEMENT OF J. RANDALL MACDONALD, EXECUTIVE VICE PRESIDENT, HUMAN RESOURCES AND ADMINISTRATION, GTE CORP., IRVING, TEXAS; ON BEHALF OF ERISA INDUSTRY COMMITTEE

Mr. MACDONALD. Good afternoon. My name is Randall MacDonald. I am executive vice president of human resources and administration of GTE, and a member of the board of directors of the ERISA Industry Committee on behalf of whom I appear today.

I am here today to urge that the Full Committee enhance retirement security by, first, approving H.R. 1102; second, by extending the current authority of section 420 of the Internal Revenue Code that permits the use of excess pension assets to fund current retiree health obligations; third, by permitting ESOP dividends to be reinvested without loss of dividend reduction for employers; and finally, by resisting the efforts to prevent employers from establishing cash balance and other innovative and creative defined benefit plan designs.

H.R. 1102 corrects many of the problems that are a product of the multiplication of the many changes during the past 12 years. The law did not always impose the current dizzying array of limits on the benefits that can be paid from and contributions that can be made to tax-qualified plans.

Between 1982 and 1994, however, scores of laws were enacted that repeatedly allowed the ERISA limits on benefit funding. H.R. 1102 reverses this trend, and none too soon. This Committee does not need to be reminded that the baby-boom cohort rapidly is nearing retirement. If we delay action, many employers will not have the cash available to pay for rapid increases in pension liabilities, and workers will not have time to accumulate their savings. H.R. 1102 thus provides an opportunity that we cannot afford to pass up.

Consider this. While retirement savings are accumulating in tax qualified plans, they fuel the engine of America's economic growth. According to the most recently available statistics, pension funds held 28.2 percent of our Nation's equity market, 15.6 percent of the taxable bonds, and 7.4 percent of cash securities.

Many of today's workers' savings and benefit opportunities are significantly restricted by current limits. Limits imposed on defined benefit plans imprudently delay funding.

Pensions are not a benefit for the rich. Most plan participants, by the way, are compensated at less than $30,000.

Finally current law has created a world in which an increasing number of people who make decisions about compensation and retirement security depend instead on unfunded qualified plans for the bulk of their retirement savings.

ERIC, the ERISA Industry Committee, believes the restored limits regarding compensation and regarding the benefits that a defined benefit plan may provide will be particularly beneficial in increasing the retirement security available to American workers.

H.R. 1102 also promotes pension portability by eliminating a significant number of stumbling blocks created by the current law. For example, ERIC is especially appreciative that the bill repeals the same desk rule. ERIC also supports the bill's provisions that facilitate plan-to-plan transfers by providing that receiving plan need not maintain all of the optional forms benefits under the sending plans.

ERIC would expand the bill's provisions to allow rollovers of after tax contributions. Current rules not only are confusing to employees but force them to strip a portion of their savings from their accounts just because the savings were made with after tax dollars.

Current law relating to ESOP discourages reinvestment of retirement savings and increases leakage. H.R. 1102 remedies the law by permitting employers to deduct dividends paid to the ESOP when the employees are allowed to take the dividends in cash or to leave them in the plan as a reinvestment vehicle for retirement security.

The Committee will also consider this year the extension of 420 which permits the use of excess pension assets in support of companies' retiree health benefits. This has been a highly successful effort over the past several years and should be continued.

Finally, we are concerned with the unbalanced, inaccurate, and inflammatory publicity surrounding the so-called cash balance and other hybrid defined benefit plan designs. Certain cash balance and similar plans meet employee demands, especially our new generation in the work force, by providing an understandable, portable, and secure benefit where employers, nonemployees, bear the investment risk and the participants benefit is guaranteed by the PBGC, Pension Benefit Guaranty Corporation.

A significant number of large- and medium-size employers have adopted the new plan design breaking the "golden handcuffs" and letting their workers out of "pension jail," if you will. The plans have become very popular among the increasing number of workers, particularly women, who expect to move in and out of the work force and who do not believe that they will remain with one employer for their entire career. That completes my prepared statement.

[The prepared statement and attachments follow:]

Statement of J. Randall MacDonald, Executive Vice President, Human Resources and Administration, GTE Corp., Irving, Texas; on behalf of ERISA Industry Committee

My name is Randall MacDonald. I am Executive Vice President Human Resources and Administration for GTE Corp. I also serve on the Board of Directors of The ERISA Industry Committee, commonly known as "ERIC," and I am appearing before the Committee this afternoon on ERIC's behalf.

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and effectiveness, and the role of those benefits in the American economy.

ERIC has played a leadership role in advocating responsible solutions to the critical retirement and health care coverage issue that face our nation. In addition, ERIC recently published policy papers and studies that have received wide acclaim. These include:

—*The Vital Connection: An Analysis of the Impact of Social Security Reform on Employer-Sponsored Retirement Plans,*

—*Getting the Job Done: A White Paper on Emerging Pension Issues, and*

—*Policy Statement on Health Care Quality and Consumer Protection.*

ERIC also has proposed numerous amendments to current law designed to facilitate the provision of employee benefits by employers and to promote national savings. The organization and its members have worked closely with the Ways and

Means Committee for over twenty-five years to resolve important policy questions and to devise practical solutions to the often vexing problems facing the Committee and the country.

ERIC is gratified that, in holding this hearing, the Committee and its Chair have displayed a strong interest in affirmatively addressing long-term retirement security issues. ERIC believes strongly in the importance of addressing these security issues now. The need to do so is reflected in legislation before the Committee. At least five comprehensive pension reform bills have been introduced in the House of Representatives in this Congress. They include:

—H.R.739, The Retirement Account Portability Act, by Reps Earl Pomeroy (D–ND) and Jim Kolbe (R–AZ), *et al.,*

—H.R.1102, The Comprehensive Retirement Security and Pension Reform Act, by Reps. Rob Portman (R–OH) and Ben Cardin (D–MD), *et al.,*

—H.R. 1213, Employee Pension Portability and Accountability Act of 1999, by Rep. Richard Neal (D–MA), *et al.,*

—H.R.1546, Retirement Savings Opportunity Act of 1999, by Rep. Bill Thomas (R–CA), and

—H.R.1590, Retirement Security Act of 1999, by Representative Sam Gejdenson (D–CT), *et al.*

In addition, H.R.1176, The Pension Right to Know Act, by Rep. Jerry Weller (R–IL), *et al.,* would have a significant impact on defined benefit plans sponsored by major employers such as the members of ERIC. Several of these bills have companion measures that have been introduced in the U.S. Senate.

ERIC will be pleased to provide the Committee with detailed comments on any of these bills. Our testimony today, however, will focus on H.R. 1102 and H.R. 1176 and comment on the use of excess pension assets to pay for other critical employee benefits such as medical benefits for retirees.

H.R. 1102—Effective Pension Reform

ERIC would like to focus the Committee's attention on H.R.1102, The Comprehensive Retirement Security and Pension Reform Act, sponsored by Committee members Rep. Rob Portman and Ben Cardin and cosponsored by many Members of this Committee and of the House. ERIC thanks Congressmen Portman and Cardin and their staffs for the vision, wisdom, and commitment that they have displayed in crafting and introducing ground-breaking retirement security legislation. H.R.1102 makes significant reforms that will strengthen the retirement plans that employers voluntarily provide for their employees and improve the ability of workers to provide for their retirement.

ERIC advocates the speedy enactment of major provisions in H.R. 1102 that will (1) increase benefit security and enhance retirement savings, (2) increase pension portability, and (3) rationalize rules affecting plan administration.

Increased Benefit Security and Enhanced Retirement Savings

The Internal Revenue Code imposes a dizzying array of limits on the benefits that can be paid from, and the contributions that can be made to, tax-qualified plans. It was not always that way.

The limits originally imposed by ERISA in 1974 allowed nearly all workers participating in employer-sponsored plans to accumulate all of their retirement income under funded, tax-qualified plans. Between 1982 and 1994, however, Congress enacted laws that repeatedly lowered the ERISA limits and imposed wholly new limits. [See Attachment A].The cumulative impact of constricted limits has been to reduce significantly retirement savings and imperil the retirement security of many workers.

H.R.1102 turns this tide at a critical time. This Committee does not need to be reminded that the baby boom cohort is rapidly nearing retirement, and that it is critical for them and for our nation that baby boomers have all the incentives and resources they need to prepare for their own retirement. Retirement planning is a long-term commitment. If we wait until this group has begun to retire, it will be too late. Many employers will not have cash available to pay for rapid increases in pension liabilities, and employees will not have time to accumulate sufficient savings. We must act now. The provisions of H.R.1102 open the door. It is an opportunity we cannot afford to pass up.

Just as many of the laws restricting retirement savings were enacted to increase federal revenues, restoring benefit and contribution limits to the more reasonable levels necessary to help employees prepare for retirement will reduce federal revenues over the short term. ERIC recognizes that the Committee has many needs to consider, but ERIC strongly urges the Committee to work with us to ensure that the laws enacted today clearly provide for increased retirement savings opportunities in the future. In reviewing these provisions, Congress should consider the following:

- Deferred taxes are repaid to the government. Savings accumulated in tax-qualified retirement plans are not a permanent revenue loss to the federal government. Taxes are paid on almost all savings accumulated in tax-qualified plans when those savings are distributed to plan participants and beneficiaries. Workers who save now under most types of plans will pay taxes on those savings when they retire in the future. In 1997, tax-qualified employer-sponsored retirement plans paid over $379 billion in benefits, exceeding by almost $63 billion the benefits paid in that year by the Social Security Old Age and Survivors Insurance (OASI) program. In future years, benefits paid from qualified plans will increase dramatically. For example, the 1991 Social Security Advisory Council predicts the percent of elderly receiving a pension will increase from 43 percent in the early 1990s to 76 percent by 2018.
- Tax-qualified retirement plans help all workers. Budgetary figures analyzing the distributional impact of estimated tax expenditures for retirement savings in a way that indicates that a "disproportionate" share of the tax expenditure inures to higher-income taxpayers can be extremely misleading in this regard. Such analysis ignores both the fact that the top few percent of taxpayers pay most of the income taxes collected and the fact that older workers, who are nearing retirement often have larger accruals than younger workers who are just starting out. Such analysis also is misleading because it obscures the importance of tax deferral in making it economically possible for lower-income workers to save for retirement. According to calculations by the American Council of Life Insurance based on data contained in the March 1998 Current Population Survey, over 50 percent of the pension benefits paid go to elderly with adjusted gross incomes below $30,000. Such analysis also overlooks the fact that the vast majority of participants in employer-sponsored plans are not highly compensated individuals. The same ACLI study shows that over 77 percent of individuals accumulating retirement savings in pension plans in 1997 had earnings below $50,000 and nearly 45 percent had earnings below $30,000. In addition, among married couples receiving a pension today, 70 percent had incomes below $50,000 and 57 percent had incomes below $40,000. Among widows receiving a pension, nearly 85 percent had incomes below $50,000 and 55 percent had incomes below $25,000.
- Retirement savings fuel economic growth. While retirement savings are accumulating in tax-qualified plans, they serve as an engine for economic growth and thereby indirectly produce additional revenue for the federal government and directly enhance the ability of the nation to absorb an aging population. In 1994, pension funds held 28.2% of our Nation's equity market, 15.6% of its taxable bonds, and 7.4% of its cash securities. In a time of increased concern about national savings rates, retirement plans have been a major source of national savings and capital investment.
- Today's limits restrict workers' savings. Many of today's workers' savings and benefits opportunities are significantly restricted by current limits. Recently, in one typical ERIC company, workers who were leaving under an early retirement program and who had career-end earnings of less than $50,000 had the benefits payable to them under their tax-qualified defined benefit plan reduced by the Internal Revenue Code limits. Recent studies by the Employee Benefit Research Institute of contribution patterns in 401(k) plans indicate that many older workers are constrained by the dollar limits on contributions to 401(k) plans. The qualified plan limits also curtail the efforts of women and other individuals who have gaps in their workforce participation or in their pension coverage to make significant savings in a timely manner.
- Today's limits delay retirement funding. Limits imposed on defined benefit plans imprudently delay current funding for benefits that workers are accruing today. Funding is restricted because tax-law limits arbitrarily truncate projections of the future salaries on which benefits will be calculated. As a result, in some cases, the employer is still funding an employee's benefits after the employee has retired. This situation will become more burdensome for plan sponsors as the large baby-boom cohort moves to retirement. One of the major purposes of ERISA was to avert precisely this kind of benefit insecurity.
- Today's limits divide the workforce. The retirement security of all workers is best served when all workers participate together in a common retirement plan, as was the case until recent years. The current system has created a bifurcated world in which business decision-makers (as well as more and more of those who work for them) depend increasingly on unfunded nonqualified plans for the bulk of their

retirement savings. Not only does this cause unnecessary complexity in business administration, it diverts energy and resources away from the qualified plans.

H.R. 1102 does not fully restore all limits to their ERISA levels. It merely begins that process. Restoring limits to more rational levels will be critical to providing retirement security to working Americans in the coming decades. Let me briefly highlight some of the specific provisions that are of particular concern to ERIC members:

H.R. 1102 (§ 101) restores the limits on early retirement benefits to more appropriate levels. Under ERISA, benefits payable from a tax-qualified plan before age 55 were actuarially reduced from a $75,000 dollar limit. In 1999, the limit at age 55 is approximately $52,037—more than $20,000 less than the limit set in 1974. The reduction in limits for early retirement—which already results in reduced benefits for early retirees and disabled workers earning $50,000 and less—will become even more severe as the Social Security retirement age increases to age 67. H.R.1102 eliminates the requirement for actuarial reductions in benefits that commence between age 62 and the Social Security retirement age.

Currently scheduled increases in the Social Security retirement age, as well as rapidly changing work arrangements, mean that early retirement programs will continue to be attractive and significant components of many employers' benefit plans. Where an employer maintains only tax-qualified plans, employees whose benefits are restricted suffer a long-term loss of retirement benefits. Where the employer also maintains a nonqualified plan that supplements its qualified plan, employees might accrue full benefits, but the security and dependability of those benefits are substantially reduced. Since benefits under nonqualified plans are generally not funded, and are subject to the risk of the employer's bankruptcy, nonqualified plans receive virtually none of the protection that ERISA provides.

H.R. 1102 (§ 101) restores the compensation limit to the 1993 indexed amount. ERISA had no limit on an employee's compensation that could be taken into account under a tax-qualified retirement plan. The Tax Reform Act of 1986 imposed a limit of $200,000 (indexed) per year. The Omnibus Budget Reconciliation Act of 1993 reduced the limit, and the Retirement Protection Act of 1994 slowed down future indexing. The 1999 compensation limit is $160,000. If the Tax Reform Act limit had remained in effect, the limit today would be $272,520. H.R. 1102 would increase the limit to $235,000.

Although this limit might appear to be aimed at the most highly paid employees, it has a substantial effect on employees much farther down the salary scale. In a defined benefit plan, the principal consequence of the reduced limit is to delay the funding of the plan. In plans where benefits are determined as a percentage of pay, projected pay increases are taken into account in funding the plan. This protects the plan and the employer from rapidly increasing funding requirements late in an employee's career. However, projected salary increases today are truncated at the compensation limit, or $160,000. The result is that funding of the plan is delayed—not just for the highly paid but for workers earning as little as $40,000.

This restriction is particularly troublesome today since it delays funding for a very large cohort of workers: the baby boomers. The limit will result in higher contribution requirements for employers in the future. Some employers will not be able to make these additional contributions, and they may have to curtail the benefits under their plans.

H.R. 1102 (§ 112) permits employer-sponsored defined contribution plans to allow employees to treat certain elective deferrals as after-tax contributions. In 1997, Congress created a new savings vehicle, commonly known as the Roth IRA. Under this savings option, individuals may make after-tax contributions to a special account. The earnings on those contributions accumulate on a tax-free basis, and no tax is assessed on distributions if certain conditions are met. H.R. 1102 and H.R. 1546 permit employers to offer a similar option within the employer's 401(k) plan.

Employer plans offer several advantages to individual savers. Payroll deduction programs make decisions to save less painful and regular savings more likely to occur. Where available, employer matching contributions provide an immediate enhancement of savings. Because plans generally allow each participant to allocate his or her account balance among designated professionally-managed investment funds and index funds, participants enjoy the benefits of professional benefit management. Participants in employer-sponsored plans also are more likely to have free access to information and assistance (e.g., decision guides or benefits forecasting software) that enable them to make better informed investment decisions.

Employees who find the tax treatment of these new accounts attractive will, under the bill's provision, be able to enhance their savings while not losing the benefits of participating in an employer plan. To the extent that individuals who find these accounts attractive are concentrated among the lower-paid, offering such accounts within the employer's 401(k) plan also will help to prevent erosion of the plan's ability to comply with nondiscrimination tests and will preserve the plan and its savings potential for all employees.

H.R. 1102 (§ 202) repeals the 25% of compensation limit on annual additions to a defined contribution plan. Under current law, the maximum amount that can be added to an employee's account in a defined contribution plan in any year is the lesser of $30,000 or 25% of the employee's compensation. H.R.1102 and H.R. 1546 repeal the 25% limit.

The 25% limit does not have a practical impact on a company's upper echelon employees. For example, for an employee earning $200,000 per year, the dollar limit is lower than the 25% limit. Because of the 25% limit, employers are often forced by the law to limit the contributions on behalf of lower-paid employees, especially employees who take advantage of the savings feature in a § 401(k) plan. Repealing the 25% limit will eliminate this problem.

Repealing the 25% limit also will benefit the significant number of employees who want to increase their retirement savings at opportune times in their careers, including women who have reentered the work force after periods of child-rearing and others who need to catch up on their retirement savings after periods during which other financial obligations restricted their ability to save.

INCREASED PENSION PORTABILITY

Employers and employees are increasingly involved in mergers, business sales, the creation of joint ventures, and other changes in business structure.[1] H.R. 1102 promotes pension portability by eliminating a number of significant stumbling blocks to portability created by current law. The bill will substantially improve employees' ability to transfer their retirement savings from one plan to another and to consolidate their retirement savings in a single plan where they can oversee it and manage it more effectively and efficiently.

H.R. 1102 (§ 303), which allows an employee's after-tax contributions to be included in certain rollovers, should be expanded. Under current law, any portion of a distribution that is attributable to after-tax employee contributions cannot be included in a rollover to another employer's plan or to an IRA. The rule unnecessarily and unwisely reduces the employee's retirement savings, and is inconsistent with the Congressional policy of encouraging employees to *preserve* their retirement savings. H.R.1102 allows after-tax money to be included in a rollover to an IRA.

While we applaud the direction set by this provision of H.R. 1102, ERIC proposes that the provision be expanded to allow after-tax rollovers to qualified employer plans that accept them. Both H.R. 1213 (by Rep. Neal) and S.741 (by Sens. Graham and Grassley) provide for rollovers either to an employer plan or to an IRA.

H.R. 1102 (§ 304) facilitates plan-to-plan transfers. Current Treasury regulations unnecessarily impair an employee's ability to transfer his or her benefits from one plan to another in a direct plan-to-plan transfer. The regulations provide that when a participant's benefits are transferred from one plan to another, the plan receiving the assets must preserve the employee's accrued benefit under the plan transferring the assets, including all optional forms of distribution that were available under the plan transferring the assets. The requirement to preserve the optional forms of benefit inhibits the portability of benefits because it creates significant administrative impediments for plan sponsors that might otherwise allow their plans to accept direct transfers from other plans.

H.R. 1102 resolves this problem by providing that the plan receiving the assets does not have to preserve the optional forms of benefit previously available under the plan transferring the assets if certain requirements are met. The provision will encourage employers to permit plan-to-plan transfers and will allow employees to consolidate their benefits in a single plan where they can oversee and manage their retirement savings effectively and efficiently.

H.R. 1102 (§ 305) repeals the § 401(k) "same desk" rule. As a result of the sale of a business, an employee may transfer from the seller to the buyer but continue to perform the same duties as those that he or she performed before the sale. In these circumstances, under the § 401(k) "same desk" rule, the employee is not deemed to have "separated from service" and the employee's § 401(k) account under the seller's plan must remain in the seller's plan until the employee terminates employment with the buyer. This prevents the employee from rolling over his § 401(k) account to an IRA or consolidating it with his or her account under the buyer's plan.

Although current law (Internal Revenue Code § 401(k)(10)) provides some relief where the seller sells "substantially all of the assets of a trade or business" to a

[1] One large pension manager (T. Rowe Price) reported that 40% of the new plans that it set up in 1995 resulted from mergers, acquisitions, and divestitures.

corporation or disposes of its interest in a subsidiary, the relief provided by current law is deficient in many respects. For example, in the case of an asset sale, the sale must cover "substantially all" the assets of the trade or business and the buyer must be a corporation. In some cases, it is not clear whether the "substantially all" standard has been met; in others, the transaction does not qualify as a sale; and in still other cases, the buyer is not a corporation.

More importantly, § 401(k) plans are the only tax-qualified plans that are subject to the "same desk" rule. [*See Attachment B*]

As employees continue to change jobs over the course of their careers, it often is difficult for them to keep track of their accounts with former employers and difficult for former employers to keep track of former employees who may or may not remember to send in changes of address or otherwise keep in touch with their former employers' plans.

There is no justification for singling out § 401(k) plans for special restrictions on distributions in this way, and ERIC strongly supports repeal of the § 401(k) "same desk" rule, included in H.R. 1102, as well as in H.R. 739 and H.R. 1590.

H.R. 1102 (§ 510) allows ESOP dividends to be reinvested without the loss of the dividend deduction for the employer. Under current law, an employer may deduct the dividends that it pays on company stock held by an unleveraged employee stock ownership plan ("ESOP") only if the dividends are paid out in cash to plan participants. By favoring early distributions, this rule discourages retirement savings and increases "leakage" from the retirement system, much like the prohibition on including after-tax savings in a rollover (see comments on section 303 of H.R. 1102, above).

Some employers attempt to cope with the restrictions imposed by current law by allowing participants to increase their § 401(k) deferrals by the amount of the dividends distributed to them. However, this arrangement is convoluted, confusing to employees, and effective only up to the legal restrictions on § 401(k) deferrals.

H.R. 1102 remedies this unsatisfactory situation by allowing an employer with an ESOP to deduct dividends paid on employer securities held by the ESOP whether paid out in cash or, at the employee's election, left in the plan for reinvestment.

Rational Rules for Plan Administration

Superfluous, redundant, confusing and obsolete rules encumber the administration of tax-qualified retirement plans. These rules unnecessarily increase the cost of plan administration, discourage plan formation, and make retirement planning more difficult for employees. Many provisions before the Committee significantly advance the work Congress began in earlier bills to strip away these regulatory "barnacles." For example:

H.R. 1102 (§ 22) updates the definition of an ERISA "excess" plan. ERISA provided for "excess benefit plans," that is, nonqualified plans maintained exclusively to pay benefits that have been curtailed by the limits in the Internal Revenue Code. However, in 1974 the IRC included only the limits imposed by IRC § 415. Since that time, a limit has been imposed on compensation that can be taken into account under a qualified plan [IRC § 401(a)(17)], and several additional limits have been imposed on contributions to 401(k) plans. These new limits have never been reflected in ERISA's definition of "excess benefit plan."

Unless ERISA's definition of an "excess benefit plan" is updated to reflect the new IRC limits, a rapidly increasing numbers of employees will see their retirement benefits substantially diminished. The new limits are most damaging to older workers who are at the height of their earning capacity and ability to save for retirement. Many such workers have been unable to set aside sufficient retirement savings earlier in their careers because of family obligations such as housing and education.

H.R. 1102 (§ 523) allows employers to provide suspension of benefit notices through the summary plan description (SPD). One of the chief impediments to the creation and maintenance of defined benefit plans is their administrative cost and complexity. While some of that complexity is inherent in the design of these plans, much of it is due to excessive and wasteful regulation. The Department of Labor's regulation requiring individual "suspension of benefit" notices is a glaring example of such over-regulation.

Most defined benefit pension plans provide that, in general, benefits do not become payable until the employee terminates employment. Pursuant to Department of Labor Regulations, however, a plan may not withhold benefit payments after an employee has attained normal retirement age, unless during the first calendar month or payroll period after the employee attains normal retirement age, the plan notifies the employee that his or her benefits are suspended. The notice must meet complex and detailed specifications. The notice requirement should be changed for the following reasons:

- Employees who continue working past the plan's normal retirement age do not expect to begin receiving benefit payments until they actually retire. Thus, many employees who receive the notice view it as a waste of plan assets. For others, the notice is perceived as a subtle attempt by the employer to expedite their retirement.
- The notice requirement also creates substantial record-keeping and paperwork burdens for employers. Regardless of the number of employees affected, the employer must incur the cost of installing a system to identify and notify each employee who works beyond the plan's normal retirement age or who is re-employed after attaining normal retirement age.
- In spite of the most conscientious efforts by plan administrators to comply with the DOL requirement, errors inevitably occur. Unfortunately, a plan that fails to provide the required notice to even a single affected employee risks losing its tax-qualified status—exposing the plan, the employer, and all of the plan's participants and beneficiaries to enormous financial penalties.

The SPD is the primary vehicle for informing plan participants and beneficiaries about their rights under employee benefit plans. Plans are required by ERISA to supply copies of the SPD to participants and beneficiaries, and participants have been educated to consult their SPD's for information about their benefit plans. As such, the SPD is the most appropriate—and effective—mechanism for delivering information about the payment of benefits to participants.

Other provisions. H.R. 1102 makes other changes that remove significant regulatory burdens and will enable plan sponsors to design plans that meet the needs of their individual workforces. For example, section 504 contains modifications that will make the separate line of business rules of current law more workable. Today's separate line of business rules are so complex that many employers have given up trying to use them even though the companies involved have significantly diverse lines of business. The nature of today's business combinations and alliances differs significantly from just a decade ago, making it more important to have workable separate line of business rules. ERIC looks forward to working with the Committee on this and other similar provisions.

Congress should reject § 501 of H.R. 1102, which changes the way in which the qualification standards are enforced. Under current law, a plan may be disqualified for failing to meet the Internal Revenue Code's qualification requirements even if the failure was inadvertent and even if the employer has made a good faith effort to administer the plan in accordance with the qualification requirements. ERIC has long been concerned with this serious problem, and it is very appreciative of the interest that the sponsors of H.R.1102 have taken in this issue.

ERIC, however, advocates an enforcement policy that emphasizes correction over sanction; that encourages employers to administer their plans in accordance with the qualification standards; that encourages employers to remedy promptly any violations they detect; that reserves IRS involvement for serious violations; and that applies appropriate sanctions only where employers fail to remedy serious violations that they are aware of.

The Internal Revenue Service has incorporated these principles in its Employee Plans Compliance Resolution System ("EPCRS"). In formulating and improving EPCRS, the Treasury and the Service have been very responsive to the concerns expressed by ERIC and other groups. Although we believe that improvements can and should be made in EPCRS, we believe that improvements are best made at an administrative level, where changes can readily be made to respond to changing circumstances and to newly-identified issues. If the Committee believes that legislation is necessary, we suggest that the legislation encourage the Treasury and the Service to expand and improve their existing programs.

AVOIDING MISDIRECTED REGULATORY BURDENS SUCH THOSE IN H.R. 1176

As pension law evolves, ERIC urges that Congress avoid imposing *new regulatory burdens* on employer-sponsored plans. Several provisions before the Committee, contrary to the proposals highlighted above, would continue to heap new requirements on plans. Contrary to Congress's objective of increasing pension coverage, these requirements, added to those of existing law, will encourage plan terminations and discourage any employer not already in the pension system from entering. ERIC's concerns with H.R. 1176, developed in response to media analysis of plans that have been changed from traditional defined benefit plans to cash balance plans are explained in more detail below.

H.R. 1176 imposes new notice requirements when a change in plan design results in significant reductions in the rate of future benefit accruals. Under ERISA § 204(h), plans must notify participants in advance of any plan amendment that will result in a significant reduction in the rate of benefit accruals under the plan.

ERIC's members invest large sums of money and substantial resources in ensuring that employees have a full understanding of their benefit plans and any changes to those plans. ERIC is concerned that modifications currently proposed to legal disclosure requirements will add significantly to plan costs without enhancing employee understanding, impose requirements that are difficult if not impossible to satisfy, and hinder the ability of employers to adjust their plans to meet changing business circumstances or changing employee needs. Any of these results would defeat the purpose of the amendment by making it more difficult for employers to offer significant retirement savings opportunities for their employees.

Recently, legislation has been introduced in response to recent news articles and 90-second "in depth" TV reports concerning conversions of traditional defined benefit plans to cash balance plans. The media reports have failed to provide balanced background material for understanding the dynamics of change in retirement security plans. Attached to this testimony is a detailed briefing document to assist the Committee in understanding cash balance and other "hybrid" defined benefit plan designs as well as the recent media controversy and the impact of the proposed legislation. [*See* accompanying brief "Understanding Cash Balance and Other "Hybrid" Defined Benefit Plan Designs"]

ERIC is particularly concerned that H.R. 1176 requires the distribution of information that frequently will be misleading. In addition, the bill saddles employers with data collection and reporting requirements obligations that are oppressive and impractical.

Cash balance plans are defined benefit plans that express the benefit in the form of an individual account balance. As such, these plans are welcomed and understandable by employees, are easily portable, and accrue benefits more rapidly in an employee's career than a traditional defined benefit plan. At the same time, participants in a cash balance plan receive all the protections of a defined benefit plan that are not available to individual account plans such as 401(k) plans: employee participation is automatic, contributions are made by the employer, the risk of investment return is borne by the employer, and the benefit is guaranteed by the Pension Benefit Guaranty Corporation.

Unfortunately, H.R. 1176 requires employers to distribute information that often will effectively mislead employees. Under the Pension Right to Know Act, whenever a "large" defined benefit plan is amended in a way that results in a significant reduction in the rate of future benefit accrual for *any one* participant, the plan must provide an individually-tailored "statement of benefit change" to *every* plan participant and alternate payee. The "statement of benefit change" must be based on government-mandated assumptions and must project future benefits at several time intervals under both the old and new plan provisions.

The problem is—

- Projections of future benefits are inherently unreliable. Even minor changes between the interest rates required to be used under the bill and rates that in fact occur over time can have a dramatic impact on the value of benefits accrued by individual employees.
- Projections of an employee's possible future benefits required by the government and provided by the employer are easily misinterpreted by the employee as guarantees that benefits will accrue according to the projections provided.
- The benefit statements required by the bill will lead employees to believe that the plan offers a lump-sum option that it might not actually provide.
- The benefit statements required by the bill ignore other changes in the employer's "basket of benefits."
- By requiring projections of future benefit accruals under the old plan's provisions—which are no longer operative—the bill falsely implies that participants have the option to retain the old provisions.

H.R. 1176 also imposes burdens on employers that are intolerable and unjustified. For example,

- Under the bill, whenever a defined benefit plan is amended, the employer must analyze the effect of the amendment on every individual participant and alternate payee to determine whether the amendment significantly reduces the rate of future benefit accrual for any one of them.
- If the employer finds that the amendment significantly reduces the rate of future benefit accrual for any one participant or alternate payee, the bill requires the employer to prepare an individually-tailored statement of benefit change for every participant and alternate payee.
- Existing plans often include numerous features that apply only to certain individuals. For example, groups of employees often have been grandfathered under

prior plan provisions frequently attributable to their participation in a predecessor plan that merged into the existing plan following a merger or acquisition. Most of the calculations for these employees (which could easily run into the thousands in a large company) will have to be performed by hand.

• Many employees also are subject to individual circumstances that will affect their benefits—e.g. an employee's benefit might be subject to a Qualified Domestic Relations Order (QDRO) or the employee might have had a break in service or a personal or military leave. The calculations for many of these employees also will have to be performed by hand.

• The calculations required by the bill must be completed *before* the changes in the plan become effective. This can take several months. New calculations regarding the employees' actual accrued benefit values must then be calculated *after* the plan becomes effective, since only then will the applicable interest rate and other variables as of the effective date be known.

The bill also imposes disproportionate and oppressive tax penalties. At a time when Congress is properly focusing on expanding employer-sponsored retirement plans, the Pension Right to Know Act will have the opposite result. The bill will have a chilling effect on sponsorship of any form of defined benefit plan, pushing medium and large employers to turn to compensation and benefit forms that place employees more at risk for their own economic and retirement security.

FLEXIBLE FUNDING FOR EMPLOYEE BENEFITS

Retirement security relies not only on adequate cash resources. For many, the availability of employer-provided retiree medical coverage has materially enhanced their standard of living in retirement. Internal Revenue Code (IRC) § 401(h) allows a pension plan to provide medical benefits to retired employees and their spouses and dependents if the plan meets certain requirements.

These restrictions on 401(h) accounts indicate that only new contributions—not existing plan assets—can be used to fund a 401(h) account. If the plan is very well funded—so that the employer is no longer making *any* contributions to the plan—401(h) is not available. Recognizing that this arbitrary restriction unnecessarily imperiled the security of retiree medical benefits, Congress in 1990 enacted IRC § 420 to permit a pension plan to use part of its surplus assets to pay current retiree medical expenses. Although 420 was originally scheduled to expire at the end of 1995, Congress later extended the life of 420 until 2000.

Section 420 does not allow *advance funding* of future retiree health liabilities. But because it allows pension assets to be used for *current* retiree health care expenses, 420 permits excess pension assets to be used productively. In addition, because 420 relieves employers of the need to make tax-deductible payments for retiree health benefits, 420 raises federal tax revenues.

In order to make a 420 transfer, the employer must meet a number of requirements, including the following:

• The transferred amount may not exceed the excess of the value of the plan's assets over the greater of the plan's termination liability or 125% of the plan's current liability. This is designed to assure that the plan retains sufficient assets to cover the plan's pension obligations.

• The transferred amount also may not exceed the amount reasonably estimated to be what the 401(h) account will pay out during the year to provide current health benefits on behalf of retired employees who are also entitled to pension benefits under the plan. Key employees are not included.

• The pension plan must provide that the accrued pension benefits must become nonforfeitable for any participant or beneficiary under the plan as well as for any participant who separated from service during the year preceding the transfer.

• Section 420 also includes a five-year maintenance of effort requirement. When 420 was originally enacted, the employer was required to maintain the same retiree health costs for the five years following the 420 transfer.

• In 1994, Congress changed this cost-maintenance requirement to a benefit-maintenance requirement. Under the benefit-maintenance requirement, the employer must maintain substantially the same level of retiree health benefits during the five years following the transfer.

• In addition, ERISA requires the plan administrator to notify each participant and beneficiary of the amount to be transferred and the amount of the pension benefits that will be nonforfeitable immediately after the transfer. Notice must also be provided to the Labor Department and any union representing plan participants.

The Senate Finance Committee recently voted to extend § 420 through September 30, 2009. The Committee also voted to replace the benefit-maintenance requirement with the pre–1994 cost-maintenance requirement. We encourage this Committee to consider the Finance Committee's action.

That completes my prepared statement. I would like to thank the Chair and the Committee for giving ERIC the opportunity to testify. I will be happy to respond to any questions that the members of the Committee might have.

ATTACHMENT A

A HISTORICAL SUMMARY OF LIMITS IMPOSED ON QUALIFIED PLANS

- IRC § 415(b) limit of $120,000 on benefits that may be paid from or funded in defined benefit (DB) plans. Prior to ERISA, annual benefits were limited by IRS rules to 100% of pay. ERISA set a $75,000 (indexed) limit on benefits and on future pay levels that could be assumed in pre-funding benefits. After increasing to $136,425, the limit was reduced to $90,000 in TEFRA (1982). It was not indexed again until 1988; and it was subjected to delayed indexing, i.e., in $5000 increments only, after 1994 (RPA). RPA also modified the actuarial assumptions used to adjust benefits and limits under § 415(b). The limit for 1999 is $130,000. If indexing had been left unrestricted since 1974, the limit for 1999 would be approximately $238,000.
- IRC § 415(b) defined benefit limit phased in over first ten years of service. ERISA phased in the $75,000 limit over the first ten years of service. This was changed to years of participation in the plan (TRA '86).
- IRC § 415(b) early retirement limit. Under ERISA, the $75,000 limit was actuarially reduced for retirements before age 55. TEFRA imposed an actuarial reduction for those retiring before age 62 (subject to a $75,000 floor at age 55 or above); and TRA '86 imposed the actuarial reduction on any participant who retired before social security retirement age and eliminated the $75,000 floor. For an employee retiring at age 55 in 1999, the limit (based on a commonly-used plan discount rate) is approximately $52,037.*The early retirement reduction will become even greater when the social security retirement age increases to age 66 and age 67*.
- IRC § 415(c) limit of $30,000 on contributions to defined contribution (DC) plans. ERISA limited contributions to a participant's account under a DC plan to the lesser of 25% of pay or $25,000 (indexed). The $45,475 indexed level was reduced to $30,000 in TEFRA (1982); indexing also was delayed by TRA '86 until the DB limit reached $120,000. RPA restricted indexing to $5000 increments. The 1999 limit is still $30,000. If indexing had been left unrestricted since 1974, the 1999 limit would be approximately $79,600.

5. IRC § 415(c) limit of 25% of compensation on contributions to defined contribution plans. Prior to ERISA, the IRS had adopted a rule of thumb whereby contributions of up to 25% of annual compensation to a defined contribution plan generally were acceptable. ERISA limited contributions to a participant's account under a DC plan to the lesser of 25% of pay or $25,000 (indexed). Section 1434 of Public Law 104–188 alleviates the more egregious problems attributed to the 25% limit for non-highly compensated individuals by including an employee's elective deferrals in the definition of compensation used for § 415 purposes. Public Law 105–34 alleviates an additional problem by not imposing a 10% excise tax on contributions in excess of 25% of compensation where the employer maintains both a defined benefit and defined contribution plan and the limit is exceeded solely due to the employee's salary reduction deferrals plus the employer's matching contribution on those deferrals.

6. Contributions included in the IRC § 415(c)'s defined contribution plan limit. ERISA counted against the DC limit all pre-tax contributions and the lesser of one-half of the employee's after-tax contributions or all of the employee's after-tax contributions in excess of 6% of compensation. TRA '86 included all after-tax contributions.

7. IRC § 415(e) combined plan limit. Under ERISA, a combined limit of 140% of the individual limits applied to an employee participating in both a DB and a DC plan sponsored by the same employer. E.g., if an employee used up 80% of the DC limit, only 60% of the DB limit was available to him or her. TEFRA reduced the 140% to 125% for the dollar limits. Section 1452 of Public Law 104–188 repeals the combined plan limit beginning in the year 2000.

8. IRC § 401(a)(17) limit on the amount of compensation that may be counted in computing contributions and benefits. TRA '86 imposed a new limit of $200,000 (indexed) on compensation that may be taken into account under a plan. OBRA '93 reduced the $235,000 indexed level to $150,000. RPA restricted future indexing to

$10,000 increments. The 1999 limit is $160,000. If this limit had been indexed since 1986 without reduction the 1999 level would be $272,520.

9. IRC § 401(k)(3) percentage limits on 401(k) contributions by higher paid employees. Legislation enacted in 1978 that clarified the tax status of cash or deferred arrangements also imposed a limit on the rate at which contributions to such plans may be made by highly compensated employees. TRA '86 reduced this percentage limit. Section 1433 of Public Law 104–188 eliminates this requirement for plans that follow certain safe-harbor designs, beginning in the year 1999.

10. IRC § 401(m)(2) percentage limits on matching contributions and after-tax employee contributions. TRA '86 imposed a new limit on the rate at which contributions may be made on behalf of HCEs. Beginning in the year 1999, section 1433 of Public Law 104–188 eliminates this requirement for matching payments on pretax (but not after-tax) elective contributions of up to 6% of pay if those payments follow certain safe-harbor designs.

11. IRC § 402(g) dollar limit on contributions to 401(k) plans. TRA '86 imposed a limit of $7000 on the amount an employee may defer under a 401(k) plan. RPA restricted further indexing to increments of $500. The 1999 indexed limit is $10,000.

12. IRC § 4980A—15% excise tax on "excess distributions." TRA '86 imposed an excise tax (in addition to applicable income taxes) on distributions in a single year to any one person from all plans (including IRAs) that exceed the greater of $112,500 (indexed) or $150,000 (or 5 times this threshold for certain lump-sum distributions). RPA restricted indexing to $5000 increments. The limit was indexed to $160,000 in 1997. In addition, TRA '86 imposed a special 15% estate tax on the "excess retirement accumulations" of a plan participant who dies. Section 1452 of Public Law 104–188 provides a temporary suspension of the excise tax (but not of the special estate tax) for distributions received in 1997, 1998, and 1999. Public Law 105–34 permanently repeals both the excess distributions tax and the excess accumulations tax, for distributions or deaths after 12–31–96.

13. IRC § 412(c)(7) funding cap. ERISA limited deductible contributions to a defined benefit plan to the excess of the accrued liability of the plan over the fair market value of the assets held by the plan. OMBRA (1987) further limited deductible contributions to 150% of the plan's current liability over the fair market value of the plan's assets. Public Law 105–34 gradually increases this limit to 170%.

14. ERISA § 3(36) definition of "excess benefit plan." ERISA limited excess benefit plans to those that pay benefits in excess of the IRC § 415 limits. Other nonqualified benefits must be paid from "top hat" plans under which participation must be limited to a select group of management or highly compensated employees.

LEGEND:

ERISA—Employee Retirement Income Security Act of 1974

HCE—highly compensated employee

IRC—Internal Revenue Code

IRS—Internal Revenue Service

OBRA '93—Omnibus Budget Reconciliation Act of 1993 (P.L.103–66)

OMBRA—Omnibus Budget Reconciliation Act of 1987 (P.L.100–203)

P.L.104–188—The Small Business Job Protection Act of 1996

P.L.105–34—The Taxpayer Relief Act of 1997

RPA—The Retirement Protection Act of 1994 (included in the GATT Implementation Act, P.L.103–465)

TEFRA—The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97–248)

TRA '86—The Tax Reform Act of 1986 (P.L. 99–514)

ATTACHMENT B

APPLICATION OF SAME DESK RULE TO PAYMENTS FROM TAX-QUALIFIED PLANS

Type of Plan	Does Same Desk Rule Apply?
Conventional Defined Benefit Pension Plan	No
Cash Balance Pension Plan	No
Money Purchase Pension Plan	No
Profit-Sharing Plan	No
Stock Bonus Plan	No
Employee Stock Ownership Plan	No
Employer Matching Contributions	No
After-Tax Employee Contributions	No
§ 401(k) Contributions	Yes [1]

[1] The same desk rule also applies to § 403(b) and § 457(b) plans, which are nonqualified plans sponsored by governmental and tax-exempt employers.

I. Understanding Cash Balance and Other "Hybrid" Defined Benefit Plan Designs

The rapid emergence of new, dynamic technologies and obsolescence of many existing products and services, the need to respond to new domestic and global competitors, and the changing attitudes toward career and work by employees in many industries, requires that many employers change their incentives to attract and retain talented employees. For workers and employers in new and changing industries, and for those employees who do not anticipate a single career with one employer but who still value retirement security, the traditional defined benefit plan design has given way to cash balance and similar "hybrid" defined benefit pension plans.

The new plans are responsive to and popular with many employees: the benefits are understandable, secured by the federal Pension Benefit Guaranty Corporation (PBGC), and provide greater benefits to women and others who move in and out of the workforce. Moreover, the employer bears the risk of investment for benefits that are nevertheless portable, and employees under the new plans avoid "pension jail" and "golden handcuffs."

Recent news articles and 90-second "in depth" TV reports have failed to provide useful and balanced background material for understanding the dynamics of change in retirement security plans. Moreover, legislation based on media coverage in an effort to correct reported problems has been misdirected and overreaching.

In order to start fresh and balance the scales, The ERISA Industry Committee has prepared the accompanying materials that identify the issues in the present debate and describe why many employers have shifted from traditional defined benefit plan designs.

The ERISA Industry Committee (ERIC) is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers and is the only organization representing exclusively the employee benefits interests of major employers. ERIC's members provide comprehensive retirement, health care coverage and other economic security benefits directly to some 25 million active and retired workers and their families. The association has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

We hope that these materials will help in understanding the new direction many employers are taking to provide retirement security. We hope to be in touch with you directly in the coming weeks. In the meantime, please feel free to call on any of us for information or assistance.

Very truly yours,

MARK J. UGORETZ
President

JANICE M. GREGORY
Vice President

ROBERT B. DAVIS
Legislative Representative

[Additional attachments are being retained in the Committee files. Attachments may be accessed at www.eric.org]

Chairman ARCHER [presiding]. Thank you, Mr. MacDonald.

Mr. McCarthy, welcome to the Committee. We will be pleased to receive your testimony.

STATEMENT OF JIM MCCARTHY, VICE PRESIDENT AND PRODUCT DEVELOPMENT MANAGER, PRIVATE CLIENT GROUP, MERRILL LYNCH & CO., INC., PRINCETON, NEW JERSEY; ON BEHALF OF SAVINGS COALITION OF AMERICA

Mr. MCCARTHY. Thank you, Mr. Chairman. My name is Jim McCarthy. I am principally responsible for tax product development at Merrill Lynch. Today I am here representing the Savings Coalition. I am honored to be here and pleased that the Committee is taking such a proactive stance in this area.

The Savings Coalition is a broad-based group of parties representing 75 member organizations all of whom are interested in increasing the rate of personal savings in this country. We represent homebuilders, realtors, health care companies, financial services industries, a list of the Savings Coalition members is attached to my commentary.

As you all know, we have a looming savings crisis in this country and I would—to put it in a larger context, I would argue that success or failure in this area will cascade either positive or negative results into the rest of the personal financial health of Americans. The inadequacy of a retirement savings pool will have disastrous effects, for example, in things like the ability to fund education or health care costs. So, as a result, while the savings shortfall is of sufficient magnitude to gather everyone's attention, since it is the largest pot of assets that tends to be held by American workers, its spillover effect, if dealt with correctly and solved, is magnified by that preeminent position.

The members of the Savings Coalition ask you, Mr. Chairman and the Members of the Committee, to enact the provisions of H.R. 1546, Congressman Thomas' bill also entitled the Retirement Savings and Opportunity Act of 1999. Among other changes, that legislation would substantially expand personal savings by increasing the maximum permitted IRA contribution from $2,000 to $5,000. It would eliminate a number of interrelated and complex caps on eligibility, counterproductive income limits and allow additional catchup contributions to IRAs for those nearing retirement.

Before going into the provisions of 1546 in more detail, let me congratulate the Members of the Committee on their work in 1997 to, in essence, bring the IRA out of retirement. Our experience at Merrill Lynch indicates, for example, that the new Roth IRA, which originated in this Committee under the name of the American dream savings account, could well be the most effective new savings generator since the successful expansion of the 401K plans in the early eighties and nineties.

This has been a critical step in strengthening the private savings leg of the traditional three-legged stool. We think in large measure the Roth IRA has had the success because of its relative simplicity. For example, at Merrill Lynch, we have seen an increase of more than 80 percent in IRA contributions in the last year. That is an astounding number that I would like to put in historical context in just a moment, but given that it is the first year of a financial instrument or an account vehicle being in place, an 80-percent increase in contributions is just a staggering kind of launch of acceptance and internalization by the American public.

Also in our 401(k) business, for example, we have seen less leakage out of our system because of the heightened—In defining leakage, I refer to the number of distributions that are not rolled over to either an IRA or a subsequent employer plan, in part because we believe of the heightened public awareness of the need to both quantify and then attack through aggressive savings the challenge of saving adequately for retirement.

An interesting aspect of the Roth IRA expansion, for example, is that we have seen a tremendous increase in the amount of traditional IRA contributions. We have had almost a 60-percent increase in the number of traditional IRA contributions that we have had and what we think is that if people come to the door asking for ways to focus on retirement savings, they will leave with the solution that fits them best.

We know the personal savings rate in this country has dropped from roughly 8 percent during the sixties and seventies down to what many would argue is a very anemic one-half of 1 percent currently, and in certain months we have been negative.

While we believe that the nature of the statistic is not perfect, we believe that this is an area that needs to be addressed. Our own research, we have Douglas Bernheim, a Stanford economics professor, who prepares a baby-boom index for us. That index currently stands at 32 percent, which means there is 68 percent inadequacy of retirement savings.

Let me just get into some of the provisions of H.R. 1546.

First and foremost, we need to raise the contribution limit from $2,000 to $5,000. That limit has been in place since 1981. It is far short of the $5,000 that would be the limit in the event that a number had been originally indexed.

We also think that it is increasingly important to eliminate the complexity and the interrelation between eligibility and income deductions, especially in a married couple. Because, in effect, we have imposed a marriage penalty on savings, for people who want a simple and portable vehicle in which to make their retirement savings. We think that this is especially important in that the bulk of job creation is happening in the small employer market and, as a result, traditional plan coverage is not rising there as fast as it is in the larger employer market.

The last provision is catch-up provisions for those over 50, the ability to, in effect, fund a plan that has not been adequately funded before. We think that it is particularly important to women who have been out of the work force or who may be more transitory in the work force, and we urge with all emphasis and haste that the Committee enact H.R. 1546.

Thank you.

[The prepared statement follows:]

Statement of Jim McCarthy, Vice President and Product Development Manager, Private Client Group, Merrill Lynch & Co., Inc., Princeton, New Jersey; on behalf of Savings Coalition of America

Mr. Chairman, let me commend you and the other members of this Committee for holding this hearing today. Savings, and particularly retirement savings, is the key to America's long-term economic prosperity.

I am Jim McCarthy, Vice President and Product Development Manager, Private Client Group, for Merrill Lynch & Co., Inc. I am here today representing the Savings Coalition of America. The Savings Coalition is a broad-based group of parties interested in increasing personal savings in the United States. The 75 member organizations of the Savings Coalition represent a wide variety of private sector organizations including consumer, education and business groups; senior citizen groups; home builders and realtors; health care providers; engineering organizations; and trust companies, banks, insurance companies, securities firms, and other financial institutions. A list of the members of the Savings Coalition is attached.

With Americans saving less than at any time since World War II, we stand at a crossroads. For individuals (including especially the baby boom generation), inadequate savings today will lead to a retirement crisis in the next century. If Americans do not begin saving more for retirement soon, the pressures on the Social Security system that are caused by the aging of our population will be compounded. With Americans living longer, millions of Americans will face prolonged retirements without the financial wherewithal to meet day-to-day needs. Moreover, if low savings rates continue at the national level, they will, over time, lead to higher interest rates and slower economic growth—further increasing the difficulty of dealing with the problems raised by the changing demographics of our population. For these and many other reasons, doing something now to enhance retirement savings is critical.

Traditionally, retirement security for Americans has been based on the so-called "three-legged stool"—Social Security, employer-sponsored retirement plans and personal savings. Dealing with our nation's ongoing savings shortfall effectively will require that each of those legs be strengthened. In particular, Congress should not ignore the critical personal savings leg of the three-legged stool and the Individual Retirement Account, or IRA, has proven over the last 25 years to be the most effective method for focusing personal savings.

Mr. Chairman, the members of the Savings Coalition ask you and the other members of this Committee to enact the provisions of H.R. 1546—the Retirement Savings Opportunity Act of 1999, introduced by Congressman Thomas. Among other important changes, that legislation would substantially expand personal savings by increasing the maximum permitted IRA contribution from $2,000 to $5,000, eliminating the complex and counterproductive income limits on IRA participation, and allowing additional catch-up contributions to IRAs for those approaching retirement.

IRAs and Roth IRAs Work

Before going into the provisions of H.R. 1546 in more detail, let me congratulate the members of this committee for beginning the process of bringing the Individual Retirement Account "out of retirement" in 1997. Our experience at Merrill Lynch indicates that the new Roth IRA (which originated in this Committee under the name American Dream Savings Accounts) could well be the most effective new savings generator since the successful expansion of section 401(k) plans in the 80s and early 90s.

One need go no further than the advertisements in the newspapers and other media to see that the Roth IRA changes that Congress enacted in 1997 have revitalized America's interest in the IRA. With expanded advertising, more and more people have begun asking questions about the new savings options available to them. In the process, they are becoming better educated about the importance of saving for retirement. For many, there has been a growing awareness of how far behind they are in saving for a financially secure retirement.

Although it is still early, our Financial Consultants tell us that many of our customers are responding to the pro-savings message that the Roth IRA sends. Significantly, they are increasing their savings not only through Roth IRAs, but also through traditional IRAs and other savings vehicles.

As with any new financial product, consumer interest builds over time. But under almost any reasonable measure, the Roth IRA has been a tremendous success. Industry-wide statistics are not yet available for 1998, the first year that the Taxpayer Relief Act of 1997 IRA changes went into effect, but preliminary results at Merrill Lynch show an unprecedented increase in IRA activity. Through December 1998, we have seen an increase of more than 80 percent in the number of total IRA contributions over the same period in 1997—an astounding increase for a new savings vehicle. This includes new Roth IRAs and increased contributions to traditional IRAs. And we can expect contributions for 1999 and beyond to increase even more as consumer awareness grows, just as IRA contributions grew steadily between 1982 (the first year IRAs became universally available) and 1986 (when IRA access was severely restricted).

One interesting aspect of the Roth IRA expansion is that we have seen considerable spillover savings resulting from the Roth IRA advertising. For example, we have experienced a sizable increase in traditional deductible IRA contributions. To some extent that increase is attributable to the changes that were enacted in 1997 expanding the availability of deductible IRAs. However, we have seen people who were always eligible for deductible IRAs come back because they did not realize they were eligible in the past. They have called to ask about the Roth IRA, but have decided to contribute to a traditional IRA or another savings vehicle. The Roth IRA legislation deserves the credit for putting those people back in the savings habit.

To illustrate how big a success the Roth IRA and other 1997 Act IRA changes have been, one need only compare the early stages of today's developing IRA market with the early stages of other new savings vehicles created by Congress—including earlier versions of the IRA. Once again, we won't have complete statistics for quite some time, but when you compare the IRA activity we have seen in 1998 with our early experience with other products, the success of the 1997 IRA changes becomes clear.

In calendar year 1998, Merrill Lynch established more than two and one half times more new IRAs than we established during the same period in 1982, the first year of universal IRA eligibility. This despite the fact that the IRA available in 1982 was simpler, available on a fully-deductible basis to most Americans, and more tax-advantaged (due to higher marginal income tax rates that were in effect in 1982). Additionally, with the ongoing popularity of the 401(k) plan, the Roth IRA has succeeded in the face of a variety of other alternative choice's. Similarly, the new Roth IRA has been extremely well received when compared with other recently introduced tax vehicles. In 1998, for example, Merrill Lynch established one hundred times more Roth IRAs than Medical Savings Accounts.

These recent developments, confirm what we already knew from earlier experience, the IRA works at increasing individual savings. The IRA has proven time and again to be the single most effective vehicle for encouraging personal retirement savings by Americans.

NEED FOR MORE CHANGE

Despite the initial success of the changes enacted in 1997, there is no question that current savings incentives will not be sufficient to reverse America's serious savings shortfall. The 1997 Act IRA changes were important steps in beginning the process of improving the incentives to save. But more change is needed.

Since the 1970s the U.S. personal savings rate has declined steadily. During the 1960s and 70s, our national savings rate averaged around 8% per year. In the last half of the 80s, it dropped to about 5.5% and in the 90s it has dropped to a 3.6% annual average. Last year, the savings rate was an anemic ½ of 1 percent, the lowest level since the Great Depression of the 1930s.

It is the baby boom generation that is in the most danger. Research by Stanford University economist Douglas Bernheim, who compiles an annual Baby Boom Retirement Index for Merrill Lynch, has consistently shown that the baby boom generation has fallen as much as two-thirds behind the rate of savings that they need to maintain their current standard of living in retirement. It is our responsibility to help the baby boom generation (and future generations) to start saving more. If we do not accomplish that goal soon, the financial burden that will be placed on our Social Security system, our economy, and ultimately our children and grandchildren, in the next millennium could be disastrous.

While there are many causes for our national savings shortfall, one of the main reasons is that our tax system continues to penalize savings and investment. What became known as the Roth IRA was an innovative step to correct that imbalance. The additional proposals made in H.R. 1546, are the next logical steps toward providing every American with a meaningful opportunity to save for a secure retirement.

Let me highlight a few of the changes proposed in the H.R. 1546 that we believe would have the most beneficial impact.

WHY 2K?

The current $2,000 maximum IRA contribution has been in place since 1981. H.R. 1546 would increase the maximum IRA contribution to $5,000 for both Roth and traditional IRAs (and would index that limit for future inflation). That change is long overdue—almost 20 years overdue. The limit on IRA contributions has been stuck at $2,000 since 1981. If the IRA contribution limit had been adjusted for inflation since IRAs were created in 1974, Americans could now contribute about $5,000 per year to an IRA. Of all retirement savings plans, only the IRA limit has never been indexed for inflation.

As things stand today, the maximum IRA contribution is not adequate to meet the growing retirement needs of Americans. Future retirees can look forward to longer life expectancies and more years in retirement. When combined with continuing inflation in medical costs (which are especially important for those in retirement) and the long range financial challenges facing the Social Security Trust Fund, it becomes clear that the need for a significant personal savings component in retirement is becoming even more critical than it was in the past. A two-legged, stool consisting of Social Security and employment-based retirement plans, cannot be expected to meet the increasing need. Also, for many of the more than 50 million workers who are not covered by an employment-based retirement plan, IRAs may be the only retirement savings opportunity.

Interestingly, we have found that more than 90% of our customers contributing to an IRA fund it at the annual $2,000 maximum. They save the maximum amount permitted and commit that amount to long-term retirement savings. With higher contribution limits, we fully expect that many of those individuals will save more.

Even for those who do not contribute the maximum in every year, the higher contribution limit will allow flexibility to make IRA contributions in the years that they have the resources to make the contributions. For example, a family where one spouse remains at home to care for children will often not have disposable income for large IRA contributions. When the children are older, however, the couple may be better able to make IRA contributions. The higher contribution limit will allow that couple to make larger IRA contributions during the years they can afford to do so.

Let me also note that in the course of our experience with millions of IRAs we have found that there is a very strong correlation between the size of an account and the attention and discipline that an individual affords to that account. Put simply, once an account achieves a certain "critical mass," it becomes the individual's nest egg and they become much more disciplined with respect to that account balance. They become less likely to make withdrawals and more likely to continue adding to the account. Conversely, relatively small accounts have a tendency to go dormant after only one contribution and are more likely to be withdrawn. Of course, every person's "critical mass" is different, but by raising the maximum initial IRA contribution, the chances that more people will start down the savings path (and stick to it) will be increased substantially.

ELIMINATE COMPLEXITY

Today, eligibility for traditional deductible IRAs, Roth IRAs and spousal IRAs can be determined only after the taxpayer works through a complex maze of eligibility requirements that include a variety of income limitations and phase-outs. Which of the various eligibility limits applies depends, in part, on the type of IRA the individual wishes to establish and whether the individual (or the individual's spouse) actively participates in certain types of employment-based retirement plans.

The current IRA eligibility limitations (which were initially included in the Tax Reform Act of 1986) are unnecessarily complex and counterproductive—doing far more harm than good. Those limitations substantially impair the potential effectiveness of IRAs as a savings promoter and should be repealed as proposed in H.R. 1546. Without the income limits, we would see increased savings among *all* income classes and would also eliminate the marriage penalties that are inherent in the structure.

Even with the improvements included in the 1997 Act, many middle income Americans are still not eligible for a fully deductible IRA. For couples with income above $51,000 and individuals with income above $31,000, the fully deductible IRA is generally not an option. Although the Roth IRA was wisely made available to a broader segment of the population, the application of income limits on Roth IRAs remains detrimental.

To begin with, the current income limits impose a severe marriage penalty on certain couples. Take, for example two individuals who will earn $30,000 each this year. If they are unmarried, both are allowed to make fully deductible $2,000 contributions to an IRA. If they marry, however, their IRA deductions will be reduced to $200 each. Under today's tax rules, that couple faces an increase of $1,250 in their Federal income taxes just for getting married, and $1,000 of that marriage penalty (about 80%) is attributable to the eligibility limits currently imposed on deductible IRAs. H.R. 1546 would eliminate that marriage penalty.

Our experience has also shown that the people who are harmed most by the income limits are not the wealthy. To the truly wealthy, the relatively small IRA tax advantage has little affect on their overall tax burden. The people who are harmed by the income limits are those who are stuck in the middle. These are people who do not necessarily have sophisticated tax planners and accountants giving them advice. They will only proceed in committing their money into an IRA if they are confident that they will not get tripped up by the rules. Some of these people will delay contributions to make sure they will qualify, and then later forget to make the contribution or spend the money before they get around to making a contribution. Others may qualify for a full or partial IRA this year, but still will not contribute because the contribution permitted this year is too small, or because they assume they won't qualify in the future and they don't want to start contributing if they are not sure they will be able to continue the process in future years. Still others are confused and believe they may have to withdraw the funds if their income goes up in the future.

The end result of today's complicated limits on IRA eligibility is that contributions are not made by many of those who are technically eligible (or partially eligible) under the rules in a given year. This same chilling effect has been in effect since Congress originally imposed income limits on deductible IRA eligibility in 1986. Before the 1986 Tax Reform Act, the IRA was available to all Americans with earned income. The year after the income limits on IRAs went into effect, contributions by those who remained eligible dropped by 40%.[1]

In restoring universal IRA eligibility and—the rule that was in effect before 1986—H.R. 1546 would help all Americans to save more. By eliminating the complexity in the current rules, Americans will be presented with a consistent and understandable pro-savings message—a clear consensus path to follow toward retirement security. That message will be reinforced by the general media, financial press, financial planners, and word-of-mouth. As families gain confidence in the retirement savings vehicles available to them, more and more will commit to the consensus path.

Catch-up Contributions

H.R. 1546 would also allow those age 50 and older to make additional IRA contributions of $2,500 per year. This change could be a critical step in helping people who are closer to retirement to save more. We believe that this type of targeted change could be particularly effective because as people approach retirement age they become more focused on retirement needs. In many cases, individuals forego making an IRA contribution in a particular year because of insufficient income, illness, temporary unemployment, a decision to stay home with children, or pay for their children's education. Annual contribution limitations prevent these individuals from making-up for lost retirement savings once the cash-flow crisis is over or their income rises.

Women, in particular, are more likely to have left the paid workforce for a period of time to care of children or elderly parents. During those years they were probably not eligible (or did not have the resources) to make retirement savings contributions. Allowing an IRA catch-up would help ensure that a woman's decision to fulfill family responsibilities does not have to lead to retirement insecurity.

It is also worth noting that many of those in today's population who are approaching or have reached age 50 did not have IRAs or 401(k) plans available through most of their working careers. They did not have the same opportunities to save that today's generations have. Instead, due to changes in the structure of the American workplace, they were caught in the transition from a relatively robust system of defined benefit pensions to the self-reliance focus of today's defined contribution landscape. Giving the baby boom generation the chance to catch-up for years they may not have saved adequately is not only fair, it is critical to helping them build a bridge to a financially secure retirement.

In the end, each American must accept significant responsibility for his or her own retirement security. But the government must help by reducing the tax burden on those who save and by making the choices simple and understandable. With that end in mind, our national retirement savings strategy must include an effective set of incentives that will expand personal savings. And the proven IRA vehicle should be the backbone of that effort.

---

[1] Testimony of Lawrence H. Summers, currently Deputy Secretary of the Department of the Treasury, before the U.S. Senate Committee on Finance, September 29, 1989.

The IRA changes enacted in the 1997 Act were a significant first step toward an improved set of rules for promoting personal savings. But more remains to be done. Today, with an improved federal budgetary picture, it is time to act on additional proposals, like those included in H.R. 1546, that will directly address America's impending retirement savings crisis. Enhanced retirement savings incentives are the most effective investments we can make as a nation. Those investments will pay back many times over in increased retirement security for Americans and in a stronger economy. For these reasons we urge the members of this Committee to include proposals that will strengthen the IRA as part of any legislation that is reported this year.

SAVINGS COALITION OF AMERICA MEMBER ORGANIZATIONS

Aetna Retirement Services
Alliance of Practicing CPAs
American Association of Engineering Societies
American Century Investments
American Council on Education
American League of Financial Institutions
Americans for Tax Reform
Bank of America
Charles Schwab Corporation
Citigroup
Coalition for Equitable Regulation and Taxation
Consumer Bankers Association
Credit Union National Association
Edward D. Jones & Company
Financial Network Investment Corporation
G.E. Capital
HD Vest Financial Services
Household International
Independent Insurance Agents of America
Investment Company Institute
Institute of Electrical & Electronics Engineers—U. S. Activities
Merrill Lynch & Company, Inc.
Mortgage Bankers Association of America
National Association for the Self-Employed
National Association of Federal Credit Unions
National Association of Independent Colleges and Universities
National Association of Uniformed Services
National Taxpayers Union
Prudential Securities, Inc.
Retirement Industry Trust Association
Savers & Investors League
Securities Industry Association
The Bankers Roundtable
United Seniors Association
United States Chamber of Commerce
Wheat First Butcher Singer
A.G. Edwards, Inc
America's Community Bankers
American Bankers Association
American Council for Capital Formation
American Express Financial Advisors
American Nurses Association
Association of Jesuit Colleges and Universities
Bankers Pension Services
Chase Manhattan Bank
Citizens for a Sound Economy
College Savings Bank
Countrywide Credit Industry
Delaware Charter Guarantee & Trust Company
Fidelity Investments
First Trust Corporation
Gold & Silver Institutes
Home Savings of America
Independent Community Bankers of America
Institute for Research on the Economics of Taxation
International Association for Financial Planning
Lincoln Trust Company
Morgan Stanley Dean Witter
NASDAQ Stock Market
National Association of Enrolled Agents
National Association of Home Builders
National Association of Realtors
National Rural Electric Cooperative Association
PaineWebber, Inc.
Resources Trust Company
Retirement Accounts, Inc.
Scudder Kemper Investments
Sterling Trust Company
USAA
United States Chamber of Commerce

Chairman ARCHER. Thank you, Mr. McCarthy.

I don't have any questions, but I do want to explore one aspect of where we are in this country and what concerns me and that is the dearth of savings.

We have heard a number of times today, the term "personal savings." And is it not true that really what we need to be concerned about is total net private savings, not just personal savings? Because in the end the benefit of personal savings is to invest, to create jobs and productivity, at least according to my basic sense of economics. And in that regard all of private savings, whether they be personal or whether they be held by a business entity, reaches that goal.

The personal savings, to be productive, must be invested in some sort of a productive vehicle. If that productive vehicle is able to accumulate additional savings internally, those are equal to the personal savings that are invested and become, to me, a far better measuring tool as to where we are and where we want to go. And, as I understand it, private—not just personal but private net savings in this country are at an alltime historic low and are negative and not positive. Is that correct as you understand the figures right now?

Mr. MCCARTHY. I would agree with the Chairman's remarks regarding the need to look at the savings in aggregation.

The personal savings rate as a statistic compiled by the Bureau of Economic Analysis is, in fact, negative. I would say that it is at best an imperfect measure in the sense that it is a residual effect. It doesn't take into account wealth that grows outside.

But I don't think anybody is arguing that savings is adequate as it stands now. It clearly needs improvement—both ranked with other industrialized nations and to create capital formation and thus bring down things like equilibrium interest rates and stimulate economic growth, we believe that H.R. 1546 and a number of other proposals before this Committee right now are steps in that direction.

Chairman ARCHER. To go back to your analysis, which I cannot argue with, because if the accumulation of wealth increases, then certainly our savings have gone up, but, on the other hand, if the market goes down and, say, personal savings rates have gone down, so that works both ways. When the market goes up, we do not count that in this standard to determine what our personal savings rate is, but when it goes down, we do not count it as a negative.

Mr. MCCARTHY. The Federal Reserve flow of funds data takes into account equity holdings in-household, and it does meter it both ways. It catches it up on the upside and catches it on the downside, and that becomes the basis for our analysis into things like whether people are adequately prepared.

Chairman ARCHER. I thank you very much, all of you, for your testimony.

Does any Member wish to inquire?

Mr. Portman, and then Mr. Weller.

Mr. PORTMAN. Thank you, Mr. Chairman.

I want to thank the panelists who are with us now and also Jeanne Hoenicke, who spoke earlier regarding the necessity for reforms in our pension system, to try to increase that savings rate that the Chairman was just talking about, private and personal.

APPWP has been very helpful in putting together this proposal over the years, Mr. Stewart, and has been particularly helpful in working with us and people in the trenches who every day deal with these issues; and I want to ask you a couple of quick questions about limits. Can you explain why it is so important to raise defined contribution limits?

Mr. STEWART. First of all, it is not really an increase, it is more of a restoration of the limits that H.R. 1102 would impose.

Second, the firm that I work for works with mostly small- to medium-sized businesses. In lot of those, the businessowners are telling us they have had a tough 5 to 10 years getting their business started. They can't afford to start a retirement plan. The key decisionmaker may be in their forties or fifties at the time they get the business on solid ground. They need to make up for the past years that they have not been able to contribute to a plan. The restored limits would incent them to put enough money away in a qualified tax plan and to get that tax-qualified status they need to share some of those benefits with the rank and file workers.

Mr. PORTMAN. That is the point, and we tried to make that point this morning. This is a question of getting the decisionmakers to make the right decision and get them to have the same stake in this plan that the lower-paid workers would have. Just in terms of limits, in 1986, the limits on 401(k)s and 403(b)s was $30,000. We are proposing raising it from $10,000 to $15,000.

Paula, thank you for your testimony. You are representing so many groups I don't know where to start, but all of them have been active in the coalition over the last few years and you tend to represent, when you look at these three groups listed, more of the small business community.

Can you give us a sense of how important it is to reduce setup costs and ongoing PBGC premium costs for small business and whether those provisions of the bill are going to make any difference in terms of getting more small employers involved in establishing pensions?

Ms. CALIMAFDE. If I can go back to the limits question quickly, because from the small business perspective and also I think it is the large business perspective, it is important to understand that the upper middle income taxpayers and upper income earners have, in effect, been disenfranchised from the retirement plan system. And if you imagine the Social Security system if you took out all of your upper middle income taxpayers or your upper income taxpayers or earners and said you get no benefits or very reduced benefits, what would happen to that system? Many people believe that it would have serious consequences to that system being kept energized; and, in a sense, that is what has happened in a qualified retirement system. These limits have kept out the key employees of the companies from having any really meaningful benefits coming from the retirement plans; and, consequently, the normal pressure to have a plan or increased contributions isn't there.

Small businesses want to sponsor these plans. As I mentioned earlier, it is a cost-benefit analysis. If the costs of the plan are too high in relationship to what the benefits of the owners and key employees can get, they just simply will not sponsor the retirement plan.

I think what is interesting about H.R. 1102 is that it keeps all of the reforms that were put in in the eighties to stop abuse and it strips away all of the unnecessary complexity, and so it will definitely reduce costs for small businesses.

My estimation is this bill, if passed, would encourage small businesses to sponsor retirement plans.

Mr. PORTMAN. Mr. MacDonald, the Chairman talked about the need to look at investments in productive vehicles, that is the key, and I could not agree more, and that is why I think the pension area is so important.

You mentioned 28 percent of investments in equities are now pension investments. If you can just touch on that, getting into the key issues with regard to savings, what will the impact be on savings by having an expansion of pensions and having more money being invested in these kinds of vehicles?

Mr. MACDONALD. We personally believe, both from a GTE perspective and an ERIC perspective, that the expansion of the limits is going to encourage employers to stay with their plans, particularly defined benefit plans. And what you are really talking about here is the ability to have a disciplined, secured, guaranteed approach. It is funded. It is there. It is in the bank. It creates that savings. It has automatic participation. And that is what we are ultimately trying to do with all of our people. We are trying to get them to think about the retirement security that they need to have when they end their career.

Mr. PORTMAN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Portman.

I am constrained to interject another little bit of an issue into this discussion today, very briefly.

I have long felt that if individual workers realized their equity ownership as beneficiaries of a pension plan, they would be better citizens. What would it take to create a system where every worker would get a statement at the end of each year as to what their ownership was in the stocks and bonds held by the pension funds?

Mr. MACDONALD. I can only speak for my company, but those statements exist today in our company. We go to great pains, and I think many large corporations do, to talk about two things: What is in the account and what are you accruing as an accrued benefit and how that is invested. Each year we go to great pains to talk about the investment of those funds and provide that information to people. It is a matter of fiduciary responsibility. It is there.

The people who run those investment funds have to report to people like myself and tell me. So it is only a matter of reproducing and providing it to those same people.

I also think that it gives them a spirit of ownership. Using the ESOP is a good example of that. If they were able to reinvest in dividends and have the employer tax deduction, in essence what you are really doing is creating further ownership in your own company, and that is what we are looking for. We are looking for loyalty and commitment. That is what will encourage those types of participations in those types of plans.

Chairman ARCHER. In your report to your workers, do you literally give them how much money is in their account and identify their beneficial ownership in *x* number of shares in each of the corporations to show what their actual ownership is, beneficial equity ownership in each of corporations? Or do you simply just list the total number of corporations that the entire pension fund is invested in?

Mr. MACDONALD. In fairness, it is the latter. We list the total corporations that we are involved in.

However, to your first point, they don't have to wait until the end of year. They can literally call up every day if they wanted to and get their pension estimated, their accrued benefit to date on an IVR system, put in when they want to retire, what the assumptions are that they want to use, so they are constantly projecting. That is our way to get them to understand the criticality of savings.

Chairman ARCHER. If you went one step further, it would be even better because if the individual workers saw I have *x* thousands of dollars in my account and that means that I own 10 shares of IBM and I own 5½ shares of—whatever, the various corporations, it would identify I think more particularly to each worker their stake. But I applaud you for what you are doing.

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. I thought the panels were very good, Mr. Chairman, and their presentations were pretty strong.

Given the current level of activity with respect to conversion of traditional defined benefit plans to cash balance plans, in some instances resulting in long-term workers being disadvantaged, what notification requirements could you support for the workers whose benefits are being changed and would you support mandatory individual statements for those employees who ask for them?

Mr. STEWART. There are provisions in H.R. 1102 that APPWP supports. As far as disclosure, we feel there needs to be adequate disclosure for plan members to know what their benefits are going to be—what their benefits are before the conversion and what they are going to be after the conversion.

We don't want to necessarily increase the burdens on the plan sponsors, but I might say about cash balance plans that in many cases, it is the employees who are asking for cash balance plans because they don't necessarily appreciate or know enough about the traditional defined benefit plan. They like the idea of a cash balance plan because they can see an account building up in their name, sort of getting back to what the Chairman was talking about.

But we would support adequate disclosure.

Mr. NEAL. Anyone else?

Mr. MACDONALD. If I may just interject for a second, the issue of providing people with information I think most companies are very comfortable with, but somehow this cash balance thing has gotten completely out of sync. There appears to be a feeling that it is all done for savings. That is not the issue here.

The savings issue is really an accounting process that people work through the accounting ledger. What is going on is that the demographics of the work force are changing. Case in point. We just bought a company in 1997, BBN. It is an Internet company, 2,000 employees. This year, we will end with 7,000 employees; and, next year, we will end with 14,000 employees.

When I talked about our pension plan, rule of 76, age plus service for early retirement, they fell asleep. These are Internet working people. They are basically looking at 3 to 5 years, and then they are going somewhere else. Portability is becoming the issue. There are a lot of us who would like to stay and have the handcuffs and keep people in the jail. We are competing for talent. You have to basically look at the needs and what the talent is. There is a shortage of labor. We have to do what employees are demanding. This is not an issue of savings. This is an issue of the war for talent in the marketplace.

Mr. NEAL. Any other panelists?

Ms. CALIMAFDE. In the small business area, there are relatively few defined benefit plans, so this is a nonissue for small business, unfortunately.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman.

I want to thank the panelists for participating today.

Mr. Stewart, just looking back at statistics, when we talk about cash balance conversions, since the eighties, 7 million workers have been affected by transition from cash balance plans involving 400 companies, including 22 Fortune 100 companies. When I think about it, for a worker, their pension and retirement program is pretty sacred. From the standpoint of a company, what is in the interest of a company to convert from a traditional pension plan over to a cash balance plan?

Mr. STEWART. On Friday I was consulting with one of our existing customers in Chicago. It is a fairly large nationwide company that has locations in several different parts of the country. They have a traditional defined benefit plan and a traditional 401(k). They have a lot of younger workers, as was alluded to earlier. Their formula is a little bit complicated, and they want to attract newer, younger workers who are probably going to be moving on. The statistics would say that the average U.S. worker would have seven to eight jobs before they retire.

So it isn't necessarily a cost savings that they are looking at. In fact, the specific instructions that they gave us as we went home to prepare a proposal for them, was to keep costs the same. We just want a plan that will be more understandable to our employees, that they can appreciate a little more.

I think in the traditional DB arena, employees just don't know enough about——

Mr. WELLER. Reclaiming my time, the Wall Street Journal has, of course, highlighted some of the problems with the conversions, and I am sure that you have read those thoroughly. And in the Chicago area there have been some conversions affecting many of my constituents.

Senator Moynihan and I have put in legislation two companion bills in the House and Senate that would require individual statements showing a comparison of the benefits under the old plan and the new plan for each of the employees because we feel that employees have a right to know the impact because we assume that the company knows the impact on the company bottom line, but the employees need to know the same.

What disturbs me, though—and we have an example of where one consultant pitched a cash balance plan to a potential client. He said, "One feature which might come in handy is that it is difficult for employees to compare prior pension benefit formulas to the cash balance approach." Don't you feel that employees have a right to know the impact of any conversion?

Mr. STEWART. That is an unfortunate comment that the consultant had made. I agree that employees should know about the change in any benefit plan, whether it is health plan or a pension plan.

Mr. WELLER. Do you feel that employees deserve a comparison sheet before the conversion showing under their current situation their current pension plan and the proposed change, what it will mean for them in retirement?

Mr. STEWART. I think the Association would advocate a middle ground approach which is not so burdensome as an individualized statement per member. Here is a scenario for a 30-year-old, 40-year-old, 60-year-old with *x* number of years of service, average compensation being different.

Mr. WELLER. How can the corporation calculate the impact on the corporate bottom line without knowing the individual bottom line for each individual employee?

Mr. STEWART. Most of these conversions would involve plans with thousands of employees. They wouldn't have it broken down one by one. It would be on a bottom-line, plan-level basis.

Mr. WELLER. Senator Moynihan and I believe that we have offered some middle ground legislation. We don't prohibit you from making a conversion. We just believe that employees have a right to know with individual statements. Would you support the legislation Senator Moynihan and I have offered?

Mr. STEWART. We would be willing to work with you to try to come up with an acceptable middle ground approach.

Mr. WELLER. I would like to work with you and your associates. The corporation certainly knows and whether you are a new employee or long-time employee you should know the bottom line on the individual impact on your retirement with any conversion that might occur.

Mr. STEWART. I appreciate your comment. I think employees do need to be aware, and the more that the employees know about the plan the better the plan is going to be.

Mr. WELLER. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you very much, Mr. Chairman.

Let me thank all of our witnesses for their participation, not just in the hearing today but in helping Mr. Portman and I on H.R. 1102 and your other work in pension areas.

First, following up on the conversation about employee education, this morning Ms. Dunn commented on the importance of making sure that employees are educated on retirement options and what they need to do to make sure that they have secure retirement.

H.R. 1102 clarifies when employers offer retirement planning education that it is not taxable to the employee and that it clarifies that employers can offer retirement planning on a nondiscriminatory basis in a fashion similar to a cafeteria benefit plan without the cost being taxable to the employee.

Mr. Chairman, I would like to enter into the record a letter of support of these provisions from the Consumer Federation of America. CFA points out that education and planning increases savings. More specifically, those savers who develop an overall financial plan report roughly twice the savings of those without a financial plan, but CFA knows that most Americans are ill-equipped to develop their own retirement planning guide.

Chairman ARCHER. Without objection, so ordered.

[The information follows:]

Consumer Federation of America

June 14, 1999

The Honorable Bill Archer
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Archer:

It is our understanding that you intend to hold a hearing this week in the House Ways and Means Committee on retirement and health security. You are to be congratulated for drawing attention to the pressing need both to increase personal savings and to improve the availability and affordability of health care.

CFA shares your concern that too many Americans lack adequate health care, are not covered by an employer-sponsored retirement plan, and are not saving enough toward retirement and other personal goals. In fact, CFA is working on a number of initiatives to increase savings, particularly among families of more modest means, and to educate consumers to make smart savings and investment decisions. We would be pleased to work with you and your committee in any way that we can to promote these shared goals.

In the meantime, I would like to reiterate our support for a provision in H.R. 1102 that we believe has the potential to increase savings, by clarifying that the value of employer-provided retirement planning services is not taxable to employees.

As you know, employees are increasingly required to make decisions about how much to save through company pension plans and how to invest those savings -- decisions that will determine their ability to retire in comfort. CFA is deeply concerned that many Americans are not saving enough to ensure their retirement security and are not investing their savings wisely. We believe employer-provided retirement planning services can help to combat these problems.

Our research indicates that planning increases savings. Specifically, a survey CFA conducted in 1997 with NationsBank (now Bank of America) found that those savers who had developed an overall financial plan reported roughly twice the savings of those without a plan. And this was true even among those with modest incomes.

Research also indicates, however, that most Americans are ill-equipped to develop their own retirement plans. On survey after survey, investors flunk even the most basic tests of

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121 • www.consumerfed.org

investment knowledge. And few have taken the preliminary steps -- such as calculating how much they will need to save for retirement -- necessary to create a retirement plan. These hard-working, but financially unsophisticated Americans desperately need help developing a retirement savings strategy.

Unfortunately, professional planning services continue to be unaffordable for many Americans who need them most. Encouraging employers to offer retirement planning services offers the potential to bring the benefits of planning to those who could not otherwise afford those services. Section 520 of H.R. 1102, the "Comprehensive Retirement Security and Pension Reform Act," takes a small, but significant step in that direction:

• by clarifying that, when employers offer retirement planning education, it is not taxable to the employee; and

• by clarifying that employers can offer retirement planning on a non-discriminatory basis in a fashion similar to a cafeteria benefits plan without the cost of those services being taxable to the employee.

To help ensure that Americans receive the assistance they need to ensure their future retirement security, we urge you to support Section 520 of H.R. 1102 as part of your larger strategy to increase personal savings. If you have any questions, or if we can be of any assistance, please feel free to contact me at (719) 543-9468.

Sincerely,

Barbara L. N. Roper

Barbara Roper
Director of Investor Protection

Mr. CARDIN. I appreciate your response to some of Mr. Portman's questions as to the specific provisions in H.R. 1102 as to what impact it would have.

The Chairman raises, I think, the initial challenge. We need to increase more private savings. Part of what H.R. 1102 does is, as Mr. Stark points out, is restore some of the previous limits. It doesn't really increase in many cases, it just restores.

The question is, will that really increase the amount of money that will be put away for savings and retirement if Congress were to enact these different limits? I guess that would be the first question that I would appreciate your response to.

Mr. STEWART. In our opinion, APPWP, yes, it would lead to more plan formation. The money contributed to a plan, as you know, is more difficult to get at. It is going to be saved for retirement—for long-term retirement needs, yes.

Ms. CALIMAFDE. Mr. Cardin, I would like to give that a shot.

I think there are sort of two answers or two ways of looking at this. One is, at the National Summit on Retirement Savings it became clear that education was going to be critical to increasing awareness about retirement security. And I don't know if you have been hearing these ads on TV, and I don't know if they are on the radio now, by ESOP and EBRI where they are talking about how important it is to save, to save early and to save in a tax-free environment, but they are very effective.

And my hope is that, as this information gets disseminated, young people in their thirties who would probably not put a lot of money into a 401(k) plan are going to start thinking twice and say maybe I better participate a little bit more now because I know what that tax-free growth is going to do when I am 60.

The other answer is, in the small business area, all of the employees are carried along with the retirement plan, and a lot of these employees really can't save. They are just making enough money to live. So the retirement plan sponsored by the company is their savings. If they get a 5-percent profit-sharing contribution or a 7-percent profit-sharing contribution, that is real money growing tax-free that they wouldn't have saved otherwise.

To the extent that H.R. 1102 is going to make it easier for small businesses to sponsor plans, and one of those factors I think is increasing the limits or returning the limits to where they were 17 years ago, I think you are going to see greater savings occurring even amongst the lowest bands of the income levels because those people are employees, they have to get retirement benefits, and very often they are very meaningful retirement benefits.

Mr. CARDIN. You really anticipated my second question. We need to get to younger workers and low-wage workers earlier so they start putting money away, and the provisions here would really make a difference on younger people, smaller employers actually setting up plans.

Mr. MacDonald.

Mr. MACDONALD. Yes, just looking at it from a defined contribution benefit, if you eliminate the 25-percent cap, you are really affecting the low-paid worker. The high-paid worker is going to get to the $30,000 maximum. But what you are really doing is going to the low-paid worker and allowing him or her to save more. That is number one.

Number two, it bothers me that perhaps some of the legislation will be driven by Wall Street Journal articles. Yesterday's article was completely inaccurate. First of all, it described GTE as going to a cash balance plan. That is not the case whatsoever. In fact, I looked for the retraction this morning in the Wall Street Journal. It will be run tomorrow.

The bottom line is if we can increase the limits from 160 to 235, you immediately are securing a benefit, you are guaranteeing a benefit for that person. That savings exists. So between taking the 25-percent cap off the defined contribution as well as securing the defined benefit plan which is a secured guaranteed plan, you have ensured savings for people.

Mr. CARDIN. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Perhaps the Members of the Committee would benefit from a brief explanation of the difference between a defined benefit plan, a cash balance plan and a defined contribution plan?

Ms. CALIMAFDE. Do you want to try that?

Mr. MACDONALD. There is not enough time in the day.

Chairman ARCHER. It really would take that long?

Ms. CALIMAFDE. I will do defined benefit and defined contribution. You end up with cash balance plan.

Chairman ARCHER. What is the difference between a cash balance and a defined contribution?

Ms. CALIMAFDE. I will try.

They both have individual account balances. The defined contribution plan, whatever is in that plan when the participant retires, is what the participant receives. So the earnings investments, whether good or bad, follow along with that employee.

As I understand the defined benefit plan, when it converts to a cash balance, it looks like a defined contribution plan, but it isn't all the way a defined contribution plan. What is happening is that there are individual account balances so participants can see them, but I believe that the investment earnings are still guaranteed, aren't they? So a cash balance is really a hybrid type of plan.

Mr. MACDONALD. Let me put it a different way.

The employer, in a cash balance plan, still assumes the risk. It is the employer's responsibility to ensure that the accrued benefit is paid so that when—it may be on a fixed scale starting from a younger age to an older age—The fixed amount is there. The employee has the ability to take it on a portable basis elsewhere, but the employer still assumes the risk. In a defined contribution plan, in theory, you could be putting your money in, and it could be going away.

Chairman ARCHER. So under the cash balance concept then, the principal amount cannot decline? The employer guarantees that that principal amount will not decline?

Mr. MACDONALD. Whatever the accrued benefit obligation is, it is there. It is a defined benefit plan. Everyone gravitated away from——

Chairman ARCHER. So what you are doing is converting the defined benefit into a cash balance so that the employee will be able to take that with him or with her if they change jobs, in effect?

Mr. MACDONALD. That is one example, yes.

Ms. CALIMAFDE. Another thing, the individual sees their own account balance.

One of the problems of a defined benefit plan, and it is unfortunate in a sense, is that it is one big fund and the employee knows if they stay with the company until retirement, they might get 50 percent of their salary paid for as long as they live or their spouse lives, but they have an amorphous kind of promise.

In a defined contribution plan, they have an account balance that they see every year. So this is an attempt to try to give sort of that individual account balance concept to the defined benefit area.

Mr. MACDONALD. Another example, Congressman, the defined benefit is like a hockey stick. It limps along, and then all of a sudden when I get the right age and the total amount of service, in my case age plus service equals 76 points, it jumps right up. But I have no idea what that accrued benefit is when it jumps up because it is based on final average earnings. The accrued benefit in a cash balance plan is an amount of money that is set aside each and every year and people can track it. They know what they have.

Ms. CALIMAFDE. It is interesting because the young, more transitory employees like the defined contribution plans, the 401(k) plans. The older employees understand that the defined benefit plan will provide a stream of payments following them throughout their lifetime, and that is why it is sort of hard for companies to put these plans together in a way that the employees are appreciating them the most and getting the most out of them.

Chairman ARCHER. Thank you for that explanation. I don't know if I am the only one who needed it.

Does any other Member wish to inquire?

Mrs. Johnson.

Mrs. JOHNSON of Connecticut. We have mentioned several times in this hearing the need to set priorities, and one of the great advantages of the Portman-Cardin bill is that through its many provisions the hope is that it will bring more people into the pension system. People not participating in the private pension system will have a chance to come into that system.

That will certainly cost some money, but since the goal is to get people in earlier, to have even small holdings held over a longer period of time, that seems to me to be of a higher priority than raising the amount one can contribute to an IRA. Because even though that is very nice, if you talk to any one of your kids who is married and raising children, they don't have the money—they are lucky if they can get one IRA contribution in, and it is tough to try to be saving as much as the current law allows.

So to move from $2,000 to $5,000, that is nice; but my understanding is that will not bring new people into the system. While it will allow those within the system to retire with greater comfort, by the criteria of expanding pension savings opportunities, that proposal is not powerful. Would you disagree with me on that?

Mr. MCCARTHY. I would disagree.

First of all, the demographics and work patterns in the American work force are changing to the point—we talked about an Internet company, the transitory nature of the worker. As a result, there are many instances now where, even if the employer is sponsoring a plan that is an attractive plan and a generous plan, because of worker transition from place to place and waiting for vesting or waiting for entrance eligibility into plans, they are frequently not covered for periods of time. That is especially true of people who drop in and out of the work force, whether they are attending to child care or any other need.

I agree with you that maximum coverage is the goal. What I am asking that you recognize is that there is a number of different worker profiles that need to be addressed. One of those is the fact that 50 percent of workers are not covered whatsoever and, as a result, need to have a simple and portable vehicle.

What we are finding is—and I agree with you also, completely, that the issue is critical mass. We find, and EBRI (the Employee Benefit Research Institute) will tell you this, that there is a critical mass and it varies by person. But once you achieve that critical mass, your mindset changes and your behavior changes and you go from being a spender and a consumer to a saver. The savings becomes a thing to be nurtured.

As a result, we think that raising the limit, which is really where the limit would be if it had been indexed originally, will help people get to that critical mass. One contribution and then a dormant account is not anybody's goal. A contribution of enough size so that you can buy a couple of different funds or enough shares of a couple of different companies, so that you can see some investment performance and at some point you become the owner of a segregated pot of assets that doesn't leak away to these ancillary demands. And you have gotten enough size that you begin to care about the health and well-being of that fund of assets.

Ms. CALIMAFDE. Mrs. Johnson, I would like to try my hand at that one.

When I think about the marriage penalty—and that would affect me and it would affect a great number of taxpayers across the country. When you look at the numbers, it appears that each family might get $100 or $200. I think the way that our economy is today, that $100 or $200 probably would not go very far. When you contrast what that might cost compared to H.R. 1102 and what this could conceivably do for small business employees, I have a very hard time justify spending $100 and spreading it to everybody versus giving what could amount to real retirement security for many, many Americans. That does not quite answer the question.

I guess if you ask me directly I would say I would rather see the money go into H.R. 1102. I think that would ultimately help the country. But if I had to compare the marriage penalty to increasing the IRA, I would increase the IRA limits. So I think there are different steps of priorities.

Mr. MACDONALD. I would argue that we can't lose sight of the fact of section 420. The last panel talked about health care. The ability to fund retiree health care through pension assets is important. This is a package, and many of us look at it that way.

Mrs. JOHNSON of Connecticut. Thank you.

Chairman ARCHER. Let me jump in. We are in an area that intrigues and interests me tremendously. We are now speaking of personal IRAs as retirement accounts. That is a whole concept that we are speaking of here. Yet the pressure has been on the Congress and it has built over the years to permit the withdrawal of those funds so they are not there for retirement. Those political pressures are not going to go away.

There is one developing today that is very desirable, a new widening of the assistance for adoption and a strong push to allow IRAs to be withdrawn for adoptions, and on and on and on.

So we can't simply discuss this in the vacuum that we are talking about retirement accounts. We also have to consider the fact that these funds can be taken out under certain circumstances for first-time home buyers and for medical care, and those pressures will continue to mount on the Congress. So I just want to say that it is more than just talking about it as a retirement account.

Mr. CARDIN. I want to concur in your comments. One of the frustrating points is that we try to develop policies to encourage more money being put aside for security or retirement. On the other hand, we all yield to the easy pressure to allow invasion of retirement funds for worthwhile purposes but certainly not for retirement. We make it too easy.

I think as we look to expand the program and do different things that we really should be reevaluating those policies. It is hard to retract what has already been done, but as we look for changes, I would welcome in joining the Chairman to see if we can't do something about some of these provisions.

Mr. MCCARTHY. I manage a book of business which is about $160 billion in IRA accounts. Last year, we paid out slightly more than $10 billion in distributions. If you look at our distributions, over 80 percent of them go to people over 59½, as the law incents that. About 15 percent—between 15 and 17 percent goes to people under 59 and a half who are experiencing some type of dislocation, that they need these funds and funds are not available for them for one of the enumerated exceptions under the IRS Code 72(t) which is where all of the medical expense, adoption expense and all those exemptions come in.

Less than 2 percent in the aggregate of these exception reasons—we see in the distribution flow that we have, and it is probably the largest in the industry, less than 2 percent in the aggregate represents all of these exceptions combined.

What you see is a phenomenon very akin to 401(k) loans. If you create the perception of access, people will deposit money because they don't think that they are throwing the money over a high brick wall and they can only go visit it until they are 59½. What you see when you put a loan provision into a 401(k) plan is participation jumps up, a multiple of what you get in actual loan disbursements. So, as a result, the perception of access creates new savings, and that is what 72(t) and these acknowledgments of other life events do.

EBRI will tell you that employer plans outstrip in value the value of all of the owner-occupied residences in the country. And, as a result, since it is such a large portion of people's holdings, if you don't acknowledge these other life events, as a result people are not going to save. They are going to have a zone of paralysis and say I can't afford to lock my money up until I am past 60.

Mr. MCCRERY. Mr. McCarthy, are you saying that enabling people to withdraw their IRA money for purposes other than retirement actually encourages savings?

Mr. MCCARTHY. I am saying that absolutely and emphatically. The perception overweight in people's mind as compared to their actual behavior, and you get a lot more savings because people can need it. But once you get that critical mass, you don't want to take that money out. You are going to find another way to meet that need unless you absolutely have to.

Mr. MCCRERY. So if we had a different tax system and we had an unlimited IRA, you could put in whatever you want tax-free and you paid tax on it when you brought it out, that would encourage savings?

Mr. MCCARTHY. I was wondering when that question was going to come. I am all for it. It would make my peers in the other tax product areas jealous, but I would be all for it.

Mr. MCCRERY. It would be a consumption tax, basically?

Mr. MCCARTHY. Essentially.

Mr. MACDONALD. There would be one fundamental difference with an IRA, and I am not here to debate my colleague, but in a 401(k) plan when you take that loan out, indeed you can take that loan out, but you have to repay it and you repay it through payroll deduction. So you are protecting that savings. And when you leave the company, that loan has to be paid down as well. So there is a little difference in having the freedom of savings in that regard.

Mr. MCCRERY. But Mr. McCarthy's point is a good one. The more flexible you make these savings vehicles, the more attractive the savings vehicles are and the more likely they are to, in fact, not spend when they get the money but saving. And that is good, not bad.

Chairman ARCHER. Well, the gentleman is correct that the Chairman—one of the aspects of the Chairman's tax nirvana is a zero tax on savings, and I hope that someday this country can get there because I believe we will benefit enormously from it in the future.

But there are so many cross currents in this—and you talk about human behavior. I know myself that I simply took savings out of another vehicle to put into an IRA to take advantage of the tax benefit. That was not an increase in net savings. It was merely a transfer from one vehicle to another vehicle. An awful lot of us who are in a position to do that are definitely going to do that. We are going to do all that we can to lighten our tax burden within the letter of the law.

To what degree that impacts on behavior, I am sure we have final studies to be able to analyze, but we need more savings and we need to do those things that protect existing savings, which is just as important as increasing new savings.

If we dig a hole in an existing savings, that hole has got to be filled up before we get an increase in savings. So protecting existing savings, which is the death tax and other things of that nature, are just as important as the incentive for new savings. Then we have to find a way to get new savings, too, and try to accomplish both of them in the most effective way.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. I appreciate the opportunity to respond briefly to a statement made by one of the witnesses.

As I understood it, you said that by eliminating the marriage penalty couples would receive $1,400. It is higher for some and less for others, but on average it is $1,400. I certainly believe that opportunity to eliminate the marriage tax penalty and free up $1,400 that otherwise would go to Uncle Sam that people could deposit into their IRA or 401(k) or whatever they set aside for retirement is a good idea.

Thank you, Mr. Chairman.

Ms. CALIMAFDE. Mr. Weller, are you referring to if you completely repealed it? Because I was looking at a phase-in.

Mr. WELLER. A complete repeal would be $1,400.

Ms. CALIMAFDE. I can't remember the number. I was talking about if you phased in, what it would be worth.

Mr. WELLER. The Marriage Tax Elimination Act, which has 230 cosponsors, does entirely eliminate the marriage tax penalty. But you may recall last fall the House passed a partial elimination of the marriage tax penalty which benefited 28 million couples. That is about $240. So that is real money for people. That is a month of child care or it is 10 percent of what you might want to put into your IRA.

Ms. CALIMAFDE. I am not saying that it is not. Don't get me wrong. But if that same amount of money for that bill went toward something like H.R. 1102 and you were able to get literally millions of employees now being covered and receiving a 5-percent contribution to that plan and it was able to stay in that plan for a number of years, I don't think that there would be any comparison as to if you looked at it 20 years later, which person would be better off, the one who got the $240 that they would most likely spend versus the person who might have gotten $500, $600 in a tax-free account that they couldn't touch for a number of years.

Mr. WELLER. As one who desires to eliminate the marriage tax penalty and supports retirement savings, I would beg to say if you eliminate the bias against married couples they are going to have more money to set aside for savings. If you do nothing about the marriage tax penalty, it is still there.

Ms. CALIMAFDE. Ideally, you could do both. That would be the ideal world.

Chairman ARCHER. Thank you.

So often we get a little myopic in the Congress. I fear we are doing some of that on the floor today as an emotional response to Littleton.

But as much as I want to get to a zero tax on savings, the Tax Code is not the real enemy in savings in this country. The real enemy of savings is a plastic credit card. We had no greater incentives in the Tax Code when this country did save, but we didn't have the credit card. So the battle is with instant gratification and the ability to realize that instant gratification through the credit card. Do you have any suggestions as to what, if anything, we might do about that?

Ms. CALIMAFDE. The only thing I can think of is education.

I think what the fellow on my far left mentioned, I have seen that, too. When someone has an account balance in a 401(k) plan and it is relatively small, let us say it is $400, they may take it out in a plan loan to buy a prom dress or something—things that are not critical. Once that number starts getting to a level, and in my mind the level seems to be $1,000 in savings, all of a sudden it seems like something that they need to protect and they don't want to invade it. If you just can acquire enough, then it seems that there is a tendency to leave it alone.

The second is just education. We are all living longer. You cannot retire only on Social Security and live in the manner you are accustomed to, in most cases, and you are going to have to provide for your own retirement; and to do that the retirement system is the best method to accrue these funds. So I think it is education.

Chairman ARCHER. I certainly agree with that. But human nature is a very, very powerful force. When you are presented with the opportunity to acquire something that you feel like you need, you may not need it but you want it desperately today. You do not have to be concerned about whether you have money in an IRA or whether you have money anywhere because that plastic is in your pocket. All you have to do is present it and you have got it. Then the bill comes at the end of the month and it is hard to see what your total debt is because the only thing that is really featured is your minimum monthly payment, this is the real enemy today in this country for savings.

But I am not dismissing the need to do what we need to do in the Tax Code, but I think we need to focus some way or other on the big picture.

I recognize Mr. Portman who has been trying to get into this discussion.

Mr. PORTMAN. I restrained myself earlier trying to compare IRAs to pensions and the marriage penalty and so on, but I will say what Ms. Calimafde just told you is the answer to the problems is H.R. 1102.

Ms. CALIMAFDE. Here, here.

Mr. PORTMAN. Seriously, I think a key point is education—what Ms. Dunn raised earlier and then what Ben Cardin followed up with, this letter from the Consumer Federation of America. We should do a lot more in terms of education, and more should be done at the workplace where most Americans are going every day by getting folks into saving, whether it is an IRA or a pension plan.

One other point about the distinction—and, as you know, there is the IRA $2,000 to $5,000 increase in our bill as well, but I do think we need to keep in mind the power of the matching contribution and how that generates over time such additional savings; and, second, how these are forced savings plans.

When you have this sort of program in place it forces you to save, and that is going to help those folks who are not saving now who tend to be in a small business where there is nothing or they are in a larger business who are low- or middle-income folks who think they can't save enough, and the education is a critical part of it, and it is a part of the legislation.

Thank you for giving all of this time on the pension front and for the witnesses today.

Chairman ARCHER. I compliment all of our witnesses and all of the Members who have expressed an interest in this issue because I believe it is truly vital as we move forward. We have got to do everything that we can to increase savings.

Now, the employer contribution, Mr. Portman, that you mentioned is so important because it magnifies the total savings, is not counted, as I understand it, in the personal savings rate. It is counted in the net private savings, and that is the point that I was trying to make. It is very, very important that we not just be focused on the personal savings rate but that we focused totally on net private savings.

Thank you very much.

The Chair invites our final panel of witnesses to take their place at the witness table: Ms. Slater, Mr. Sandmeyer, Mr. Loop, Mr. Thompson, Mr. Coyne, and Mr. Speranza. The Chair invites our guests and staff to take their seats so we can conclude the hearing today.

Welcome to each member of our final panel. Thank you for coming and participating today. I am sorry that you perhaps had to wait a little longer than you wanted to wait, but, hopefully, it was productive for the Committee.

Ms. Slater, would you lead off. Would you identify yourself for the record and then proceed with your testimony?

STATEMENT OF PHYLLIS HILL SLATER, PRESIDENT AND OWNER, HILL SLATER, INC., GREAT NECK, NEW YORK; AND IMMEDIATE PAST PRESIDENT, NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS, SILVER SPRING, MARYLAND

Ms. SLATER. Thank you, Mr. Chairman.

My name is Phyllis Hill Slater, and I am president and owner of Hill Slater, Inc., a second generation, family-owned business that has been serving the engineering and architectural community for 3 decades.

I am also the immediate past president of the National Association of Women Business Owners and address you today in both capacities.

I am here today to talk to you about the death tax and its destructive effect on me and other small business owners, especially the 9 million women-owned businesses in the United States.

As a woman-owned business, I am awarded contracts that will stay in force only if my daughter can continue the business when I am not here to do so. How can I pass my business with its employees and contracts on to my daughter if I must pay a 55-percent gift tax or estate tax? The 55-percent tax on the market value of all of my assets at my death will affect not only the future of my business but also will require my family to liquidate assets to pay the tax 9 short months after my death. And if I want to gift my business or my assets early, I must pay the same rate of tax. This is a tax on assets on which I have already paid taxes.

My father started our business, and we have worked hard and long hours to grow our business to 22 employees. There are those who say that the death tax is paid only by the rich. Well, consider this.

In 1997, 89 percent of the estate tax returns filed were from estates of $2.5 million or less, and more than 50 percent of the revenue generated is from estates of $5 million or less. So the small- and the medium-sized estates are spending the time and money to comply with the death tax. And according to Alicia Munnell, former member of President Clinton's Council of Economic Advisers, the costs of complying with estate tax laws are roughly the same amount as the tax revenue collected.

There are those who say that the tax is needed to redistribute the wealth. Well, consider this. Alan Binder, a President Clinton appointee, concluded in his book, "Toward a Theory of Income Distribution," a radical reform of inheritance policies can accomplish comparatively little income redistribution. And Joseph Stiglitz, chairman of President Clinton's Council of Economic Advisers, in the Journal of Political Economy found that the estate tax ultimately might cause an increase in income inequality.

Now some of you may say, but the public views the death tax as a good tax and a tax on the rich. Wrong.

In numerous surveys, national polls and membership questionnaires, 75 percent of the respondents concluded that the death tax should be eliminated.

In a national poll conducted last year, the respondents concluded that the death tax was more unfair than the payroll tax, the income tax, capital gains tax, alternative minimum tax, gasoline tax, and property tax. Of all of these taxes they are going to pay. Why?

Because the death tax, number one, is a 55-percent tax rate, the highest rate in our tax system; two, a tax at the worst time when a death occurs, and three, a tax on assets that have been taxed at least two or three times before.

The reason that the Family Business Estate Tax Coalition comprised of over 6 million members and other groups support the elimination of the death tax as the right solution is because we all realize that increasing the lifetime exemption is a short-term solution to a long-term problem. The lifetime exemption was raised years ago and it was not enough. It will never be enough. With a little bit of inflation and profits in our businesses, we will grow past exemption and be back asking for more very soon. The families of America need a permanent fix to the most unfair tax of all that generates no net revenue and the fix is elimination.

What do NAWBO and I want? We want the death tax, the gift, estate and generation-skipping tax to be eliminated. We believe that there is a responsible, bipartisan legislation in both the House and the Senate to do that now. Congresswoman Dunn and Congressman Tanner have introduced H.R. 8 and Senators Kyl and Kerrey have introduced S. 1128. Both bills eliminate the death tax in a realistic manner. We want families in America to be freed from being held hostage to the death tax and allow them to use their resources to plan for the growth of their families and their businesses. This Congress can do something very family friendly. Eliminate the death tax now.

Thank you.

[The prepared statement follows:]

Statement of Phyllis Hill Slater, President and Owner, Hill Slater, Inc., Great Neck, New York; and Immediate Past President, National Association of Women Business Owners, Silver Spring, Maryland

Good morning, my name is Phyllis Hill Slater and I am the President and Owner of Hill Slater, Inc. a second-generation family owned business that has been serving the engineering and architectural community for nearly three decades. I am also the immediate Past President of the National Association of Women Business Owners and speak to you here today in both capacities.

I am here today to talk to you about the "death tax" and its destructive effect on me and other small business owners, especially the 8.5 million women-owned businesses in the U.S. today. As a woman-owned business, I am awarded contracts that will stay in force only if my daughter can continue the business when I am not here to do so. How can I pass my business with its employees and contracts on to my daughter if I must pay a 55% gift or estate tax? The 55% tax on the market value of all of my assets at my death will affect not only the future of my business but also will require my family to liquidate assets to pay the tax, nine short months after my death. And, if I want to gift my business or my assets early, I must pay the same rate of tax. This is a tax on assets on which I have paid taxes.

My father started our business and we have worked hard and long hours to grow our business to 22 employees. There are those who say that the death tax is paid only by the "rich," well consider this:

In 1997, 89% of the estate tax returns filed were from estates of $2.5 or less, and more than 50% of the revenue generated was from estates of $5 million or less.

So the small and medium sized estates are spending the time and money to comply with the death tax. And, according to Alicia Munnell, former member of President Clinton's Council of Economic Advisors, the costs of complying with the estate tax laws are roughly the same amount as the tax revenue collected.

There are those who say that the tax is needed to redistribute the wealth; well consider this:

Alan Binder, a President Clinton appointee, concluded in his book, Toward a Theory of Income Distribution, "a radical reform of inheritance policies can accomplish comparatively little income redistribution." And Joseph Stiglitz, Chairman of President Clinton's Council of Economic Advisors, in Journal of Political Economy, found that the estate tax ultimately might cause an increase in the income inequality.

Now, some of you may be saying, "but the public views the death tax as a good tax and a tax on the rich." WRONG!

In numerous surveys, national polls, and membership questionnaires, 75% of the respondents conclude that the death tax should be eliminated. In a National Poll conducted last year the respondents concluded;

That the death tax was more unfair than the Payroll Tax, Income tax, Capital Gains tax, Alternative Minimum Tax, Gasoline Tax, and Property Tax; all of the taxes that they are going to pay. WHY Because the death tax is; 1) A 55% TAX RATE, (the highest rate in our tax system), 2) A TAX, AT THE WORST TIME,WHEN A DEATH HAS OCCURRED, 3) A TAX ON ASSETS THAT HAVE BEEN TAXED AT LEAST TWO OR THREE TIMES BEFORE!!

The reason that the Family Estate Tax Coalition of over 6 million members and other groups support the elimination of the death tax as the right solution is because we all realize that increasing the lifetime exemption is a short term solution to a long term problem. The lifetime exemption was raised years ago and it was not enough. It will never be enough, with a little bit of inflation and profits in our businesses we will grow past the exemption and be back asking for more very soon. The families of America need a permanent fix to the most unfair tax of all, that generates no net revenue, and that fix is elimination!

What do I and the NAWBO want. We want the death tax, (the gift, estate and generation skipping tax) to be eliminated, and we believe that there is responsible, bi-partism legislation, in both the House and the Senate, to do that now! Congresswoman Dunn and Congressman Tanner have introduced HR 8 and Senator Kyl and Senator Kerrey have introduced S1128. Both bills eliminate the death tax in a realistic manner. We want families in America to be freed from being held hostage to the death tax and allow them to use their resources to plan for the growth of their families and their businesses.

Chairman ARCHER. Thank you, Ms. Slater.

Our second witness is Ronald Sandmeyer. If you will identify yourself for the record, you may proceed.

STATEMENT OF RONALD P. SANDMEYER, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SANDMEYER STEEL COMPANY, PHILADELPHIA, PENNSYLVANIA; ON BEHALF OF NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. SANDMEYER. Mr. Chairman and Members of the Committee, thank you for the opportunity to appear here today to discuss estate taxes. My name is Ron Sandmeyer, Jr. I am here today on behalf of the National Association of Manufacturers. The NAM is the Nation's largest national broad-based industry trade group. Its 14,000 companies and subsidiaries include more than 10,000 small- and medium-size manufacturers. I am President and chief executive officer of Sandmeyer Steel Co., one of more than 9,000 family-owned or closely held small manufacturers in the NAM.

Every year when NAM surveys small members such as our company, repeal of Federal estate and gift taxes emerges as the single most important tax policy issue affecting their ability to grow. This may surprise some who only see a tax when it is collected, but I know, Mr. Chairman, that you were once a small manufacturer and that you have seen what I have seen.

Sandmeyer Steel is a third generation, family-owned business in Philadelphia, founded by my grandfather Paul Sandmeyer in 1952. We produce stainless steel plate products that are sold to fabricators and equipment manufacturers who make process equipment used in a variety of different process industries. My brother and I have been working with our father to try to do what we can to make sure that our company survives the difficult transition from second to third generation.

A good transition includes both a successful management succession plan as well as a successful ownership succession strategy and, if successful, a transition leaves the company independent, strong and capable of continued growth. This is important not just to us but also to our 140 employees and their families.

The death tax can be devastating to the ownership succession component of the transition between generations in a family-owned business. Fewer than one in three family-owned companies survive to the next generation. The 55-percent estate tax rate does not allow much room to breathe. Very few small- and medium-size businesses have that kind of liquidity and almost no manufacturer does. The mere threat and uncertainty of the death tax is a constant burden to our business. It requires costly sacrifices today. Meetings with lawyers, meetings with financial planners are expensive and they drain a lot of time from the company's key decisionmakers.

Money spent on things such as attorney fees and life insurance premiums could be better invested by us in new pieces of equipment or in hiring and training additional employees. Time and money spent preparing for the death tax achieves no economically useful purpose but a business has to pay this cost every year not just at some uncertain date in the future when an even bigger bill comes do.

Uncertainty is unavoidable in estate planning. First of all, a businessowner cannot know when the tax will have to be paid. It is also hard to anticipate how much tax will ultimately be owed because you do not know what the IRS will accept as the valuation of your business. Without a fair market value sale, valuation is subjective and open to debate and possibly even litigation.

There are no simple tools to solve the liquidity problem. Electing an extended payoff can burden a business with an IRS lien for more than a decade.

The family business tax relief available under current law is so complicated and so narrowly crafted that it is hard to find an attorney willing to advise a client that the family business will qualify. Even then there will be times when the correct business decision will conflict with what might be the optimum tax strategy. For example, trying to make an owner more liquid and increase liquidity outside the business so the estate tax can be ultimately paid can result in the business being ineligible for the limited relief that might have existed. Even the increase in the unified credit is of limited help to the family businessowner. The credit provides a lump sum of money that survives the tax, but once you have built that into your plan, all future growth is taxed exactly as before. Rate reduction is the only relief short of full repeal that reduces your risk on every decision to reinvest and grow your company.

There are several proposed bills that repeal the death tax. The NAM supports all of them. Repeal it any way you can. Representative Cox has a bill with 200 cosponsors that repeals the estate, gift and generation-skipping taxes immediately. H.R. 86 would immediately free thousands of small business owners to devote more time and attention to growing our businesses.

Representatives Jennifer Dunn and John Tanner of this Committee have a different bill, H.R. 8, that phases out the tax by reducing rates 5 percent a year until the tax is finally eliminated. Dunn-Tanner has found some supporters who have not been able to support the Cox bill. Aside from eventually eliminating the tax also, the phaseout provides real and immediate relief by lowering rates in the short term.

Repeal unfortunately has not found as firm a footing in the Senate. It has not gained the bipartisan support that both Cox and Dunn-Tanner enjoy in the House.

That situation changed recently when Senator Kyl introduced the Estate Tax Elimination Act, S.1128. His new bill repeals all the death taxes and does away with a step-up in basis. The NAM strongly endorses S.1128 with one caveat. We only support elimination of the step-up in basis for inherited assets as long as it is coupled with immediate and total repeal of the death tax. The step-up in basis partially offsets a confiscatory estate tax regime. It is critically important to keep the current basis rules in place until the death tax is totally eliminated. The Kyl bill does permit, however, a limited step-up to mirror the existing unified credit so that no dollar free from estate tax today would be taxed as capital gains under his bill.

This bill has bipartisan support from several Finance Committee Members. It costs less than the Cox proposal and it creates a potential revenue stream for the government. But most importantly, death would no longer be a taxable event. There is all the difference in the world between taxing at death and taxing at the time of a voluntary sale. Death, though certain, is unpredictable and involuntary. When it occurs the money to pay the taxes is still tied up in the business. A voluntary sale on the other hand is at a time of one's choosing. The taxable value is known and the money from the sale is on the table to pay the resulting capital gains tax. That is why capital gains taxes don't force companies out of business but the death tax usually does.

It is clear that momentum has been building for death tax repeal and I would urge you to eliminate death as a taxable event.

Thank you.

[The prepared statement follows:]

Statement of Ronald P. Sandmeyer, Jr., President and Chief Executive Officer, Sandmeyer Steel Company, Philadelphia, Pennsylvania; on behalf of National Association of Manufacturers

Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today to discuss estate taxes.

My name is Ronald P. Sandmeyer, Jr., and I am here today on behalf of the National Association of Manufacturers. The NAM is the nation's largest national broad-based industry trade group. Its 14,000 member companies and subsidiaries, including approximately 10,000 small and medium manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. The NAM's member companies and affiliated associations represent every industrial sector and employ more than 18 million people.

I am President and CEO of Sandmeyer Steel, one of the more than 9,000 family-owned or closely held small manufacturers in the NAM. Every year when the NAM surveys its small members, repeal of federal estate and gift taxes emerges as the single most important tax policy issue affecting their ability to grow.

This may surprise some who only see a tax when it is collected, but I know that you, Mr. Chairman, were once a small manufacturer, and that you have seen what I have seen.

Sandmeyer Steel Company is a third generation family-owned business in Philadelphia, Pennsylvania. We produce stainless steel plate products that are sold to fabricators and equipment manufacturers who make equipment used in a variety of different process industries. My grandfather, Paul C. Sandmeyer, founded the company in 1952.

My brother Rodney and I are the third generation at our company. We have been working with our father to try to make certain that our company survives the difficult transition from second to third generation. A good transition includes both a successful *management* succession plan and a successful *ownership* succession strategy. A successful transition is one that leaves a company strong and capable of continued growth. This is important not just to us, but also to our 140 employees and their families.

The death tax can be devastating to the ownership-succession component of this transition between generations in a family-owned business. A Vermont Life study, which shows that fewer than one in three family-owned companies survives to the next generation, is not surprising. The 55 percent estate tax rate does not allow much room to breathe. Very few businesses or business owners have that kind of liquidity, and almost no manufacturer does.

It is a mistake to regard the death tax as a one-time burden for a company. The mere threat and uncertainty of the death tax looming out there is a constant burden to our business. Any business that hopes to survive the death tax must make costly sacrifices today. Meetings with lawyers and financial planners are expensive and drain a lot of time from a company's key decision makers. Money spent on attorney fees and life insurance premiums would be better invested in new pieces of equipment or in hiring and training additional employees.

Time and money spent preparing for the death tax simply does not help a business in any other way. This diversion of valuable human and financial capital achieves absolutely no economically useful purpose. It does not increase productivity, expand a workforce or put new product on the shelf. A business pays this cost every year, not just at some uncertain future date when an even bigger bill comes due.

There is no simple solution in estate planning. Uncertainty is unavoidable. To begin with business owners do not know when they will have to pay the tax. Then it is hard to anticipate how much tax will be owed, because you cannot know in advance if the IRS will agree with what you think is a fair valuation of your business. Without a fair market value sale, the valuation is purely subjective and is open to costly debate and dispute.

There are no simple tools that solve the liquidity problem. Electing an extended pay-off under section 6166(b) can burden your business with an IRS lien for more than a decade, in addition to the debt service payments themselves.

What about the family business tax relief available under current law? Well, it's so complicated and so narrowly crafted that it is hard to find a single attorney anywhere who is willing to advise a client that the family business will qualify. Even then, there will be times when the correct business decision will conflict with the optimum tax strategy. For example, trying to increase an owner's liquidity outside of the business so the tax can be paid ultimately can result in the business being ineligible for the limited relief that might have existed.

Even the increase in the unified credit is of limited help to a family business owner. The unified credit produces a lump sum of money that survives the tax, but once you have built that into your plan all future growth is taxed exactly as before.

Rate reduction is the only relief short of full repeal that would significantly affect business decisions. Reduce the tax rate, and you reduce the risk on every decision to reinvest and grow your company.

There are several proposed bills that repeal the death tax. The NAM supports all of them. Repeal it any way you can.

Representative Cox has a bill that simply repeals the estate tax, the gift tax and the generation skipping tax immediately. His bill, H.R. 86, would immediately free thousands of small-business owners to devote more time and attention to growing our businesses. He has attracted 200 cosponsors to the cause of repeal.

Representatives Jennifer Dunn and John Tanner, of this committee, also have a repeal bill before the House in H.R. 8. Their bill phases out the death tax by reducing the rates 5 percent per year until the tax is finally eliminated. The Dunn-Tanner approach has found some supporters who have not been able to support the Cox bill, particularly those who are concerned about the budget impact of outright repeal.

The phase-out, aside from eventually eliminating the tax, also provides real relief in the short term. By lowering marginal rates, the Dunn-Tanner bill would improve the ultimate rate of return on every investment made in your company.

Senator Kyl has introduced two bills that repeal the death tax. The first was a companion to the Cox bill that gained 30 cosponsors in the Senate. Despite the enthusiastic support of the NAM and numerous other business groups, full and immediate repeal has not found a firm footing in the Senate, and in particular it has not gained the bipartisan support that both the Cox bill and the Dunn-Tanner bill have won in the House.

That situation changed recently when Senator Kyl introduced the Estate Tax Elimination Act, S. 1128. His new bill repeals all the death taxes and does away with the step-up in basis. We strongly endorse S. 1128 with one caveat: we only support elimination of step-up basis for inherited assets as long as it is coupled with immediate and total repeal of the death tax. Lawmakers added the step-up basis provision to the tax code to partially offset a confiscatory estate-tax regime. It is critically important to keep the current basis rules in place until the death tax is totally eliminated.

Actually, the Kyl bill does permit a limited step-up in basis to mirror the existing unified credit so that no dollar free from estate taxes today would be inadvertently taxed under his bill.

This new measure was introduced with bipartisan support from several Finance Committee members. The bill costs less than the Cox proposal, but it does this by creating a revenue stream for the government. Most importantly, however, under the bill, death would no longer be a taxable event.

From my own personal perspective, the new Kyl bill is so simple and fundamentally sound that I find it hard to believe someone hasn't introduced the concept sooner. Don't tax the transfer of a business from one generation to the next. But leave the basis unchanged and tax the gain on the sale if and when it ever occurs.

There is all the difference in the world between taxing at death and taxing at the time of a voluntary sale. Death, though certain, is unpredictable and involuntary. When it occurs, the money to pay the taxes is tied up in the business. A voluntary sale, on the other hand, is at a time of your choosing, and the money from the sale is on the table to pay the resulting capital gains taxes. And of course, the taxable value of a sale and the amount of the taxes that are payable is certain and known prior to the transaction, not months or even years later. That is why capital gains taxes don't force companies out of business, but the death tax can.

There are few provisions in the tax code that force successful companies out of business. Few provisions tax involuntary actions or events. The death tax is one. More often than not the death tax actually kills the company soon after the owner dies. And I remind you again, don't lose sight of or underestimate the costs incurred by people trying to make reasonable and prudent preparations just to pay the tax.

It is clear that momentum has been building for death tax repeal. I urge you to eliminate death as a taxable event.

Chairman ARCHER. Thank you, Mr. Sandmeyer.

Next witness is Mr. Loop. Mr. Loop, we are happy to have you with us. You may proceed.

STATEMENT OF CARL B. LOOP, JR., PRESIDENT, LOOP'S NURSERY AND GREENHOUSES, INC., JACKSONVILLE, FLORIDA; PRESIDENT, FLORIDA FARM BUREAU FEDERATION; AND VICE PRESIDENT, AMERICAN FARM BUREAU FEDERATION

Mr. LOOP. Thank you, Mr. Chairman, and Members of the Committee. My name is Carl B. Loop, Jr. I come to you today as vice president of the American Farm Bureau Federation and as president of Loop's Nursery and Greenhouses, Inc., a wholesale plant and nursery business in Jacksonville, Florida. It is indeed an honor for me to be here today to explain why farmers and ranchers feel so strongly that estate taxes should be abolished.

I would like to speak first as Carl Loop, vice president of American Farm Bureau Federation. Eliminating the estate tax is a top priority for Farm Bureau. We believe that the tax should be ended because it can destroy family farms and ranches and because the tax penalizes agriculture producers who work hard to become successful. When farms are sold to pay estate taxes, family businesses are ruined, employees jobs can be lost, open spaces can be destroyed, and communities can be damaged. Estate tax planning can sometimes help but is a complicated, expensive and time consuming endeavor. With about half the farm and ranch operators age 55 years or older, the future of American agriculture depends on Congress' willingness to eliminate estate taxes.

Now I would like to speak as Carl Loop, president of Loop's Nursery and Greenhouses. Eliminating the estate taxes is a top priority of the Loop family because the tax threatens to destroy our family business. I started my nursery business in 1949 with a borrowed truck and a $1,500 loan. For 50 years my family and I have worked hard to build our business into one of the largest wholesale nursery operations in the southeastern United States. We now employ between 85 and 100 people year-round and provide a stable tax base for local government.

Our business consists of nine acres of greenhouses plus the warehouses, cold storage and equipment needed to grow, harvest and market our products. Inflation has increased the value of both our land and equipment to the point that my family would have to sell part of the nursery to pay the death tax. That could prove fatal because our assets are single-purpose structures that can't be easily liquidated and their forced sale would destroy the business.

My son David and I run the day-to-day operations of Loop's Nursery and Greenhouses and it gives me great pleasure to know that he and my daughter Jane want to continue the business after my death. That may not be possible even though I have done everything I can to get ready for the taxes that will be due when I die.

To prepare for my death, I have purchased life insurance. I have recapitalized the business. I have issued two classes of stock, set up revocable and irrevocable trusts, gifted assets, given stock options, and shifted control of the business. After hours of worry, years of work, and large attorney fees, I still have no assurance that this plan will work and that estate taxes will not ruin our business.

If my family is forced out of business, 85-plus families will lose their incomes and Jacksonville will lose a valuable part of its business base. My family and I don't understand why the government wants to penalize us for being successful especially since we have already paid taxes on what we have earned. We think our operation is worth a lot more to our community and our government as an ongoing business when compared to the amount of a one-time estate tax payment.

Farm Bureau supports passage of H.R. 8, the Death Tax Elimination Act, which phases out death taxes through rate reduction. This bipartisan bill takes a common sense approach to ending the death tax and deserves your support.

Before closing, I would like to mention several other saving and health security tax proposals that would greatly benefit farmers and ranchers as outlined in our written statement. They are the full deductibility of self-employed health insurance premiums, the

FARRM, Farm and Ranch Risk Management, accounts, capital gains tax cuts, and the fair imposition of self-employment taxes.

Thank you for this opportunity. I would be glad to answer any questions.

[The prepared statement follows:]

Statement of Carl B. Loop, Jr., President, Loop's Nursery and Greenhouses, Inc., Jacksonville, Florida; President, Florida Farm Bureau Federation; and Vice President, American Farm Bureau Federation

My name is Carl B. Loop, Jr. I am president of Loop's Nursery and Greenhouses, Inc., a wholesale plant nursery operation in Jacksonville, Florida. I serve as President of the Florida Farm Bureau Federation and as Vice President of the American Farm Bureau Federation. Farm Bureau is a general farm organization of 4.8 million member families who produce all commercially marketed commodities produced in this country.

ESTATE TAXES

Farm Bureau's position on estate taxes is straight forward. We recommend their elimination. The issue is so emotionally charged that during consideration of the Taxpayer Relief Act of 1997, Farm Bureau members sent more than 70,000 letters to their representatives and senators calling for an end to death taxes. I wrote several of those letters because death taxes threaten the continuation of my family's livelihood.

In 1949, after graduating from the University of Florida, I started my nursery business with a $1500 loan and a borrowed truck. In the early years we got by living on the teacher's salary of my wife, Ruth. Everything that I earned was reinvested in the business. For 50 years I, along with my wife and children, have worked hard to build our business into one of the largest wholesale nursery operations in the southeastern United States.

I am proud that my nursery has allowed me to support my family and send my three children, Carol, 43, David, 40, and Jane, 33, to college. David, earned his degree in ornamental horticultural and agriculture economics and now runs the business on a daily basis. Without his involvement I wouldn't have been able to come here today. My youngest daughter, Jane, would also like to come into the business.

Loop Nursery and Greenhouses, Inc., grows flowering pot plants and tropical foliage in 350,000 square feet (nine acres) of greenhouses. Also part of the business are warehouses, cold storage and the equipment needed to grow, harvest and market our products. Between 85 and 100 people are employed year-round.

My family feels that our operation not only grows a needed product, but also makes a positive contribution to our community. In addition to employing 85-plus people, we are a community minded business that provides a stable tax base for city, county, state and federal government. We do not understand why the government wants to penalize us for being successful, especially since we already paid taxes on what we have earned.

Inflation has increased the value of both our land and equipment to the point that my family would have to sell part of the nursery to pay death taxes. This could prove fatal to our business because our assets can't be easily liquidated. Because greenhouses are single purpose structures, they don't have much market value and the only thing a forced partial sale would accomplish would be to destroy the viability of our business.

My son and daughter want to continue our family business and I would like to pass it on to them. For the last six years, I have been working with attorneys to plan for my death. I have purchased life insurance, recapitalized the business, issued two classes of stock, set up revocable and irrevocable trust agreements, gifted assets, given stock options, and shifted control of the business. After hours of worry and large attorney fees I still don't know if my estate tax plan will save our family business.

It seems to me and my family that Loop's Nursery and Greenhouses, Inc., is worth much more to our community and the government as an ongoing business when compared to the amount of a one-time estate tax payment. If my family is forced out of business by death taxes everything that I have worked for will be lost, my family will lose its livelihood, 85-plus families will lose their incomes and the community will lose a valuable part of its business base.

My situation is not unique. As Vice President of the American Farm Bureau, I talk with farmers and ranchers from across the country and I can tell you that people everywhere are concerned that death taxes will destroy their family businesses.

Many don't know how severely they will be impacted because they don't realize how much their property has increased in value due to inflation. Others understand the consequences but fail to adequately prepare because the law is complicated, because lawyers, accountants and life insurance are expensive and because death is a difficult subject.

It bothers me and my family that while death taxes can cost farm and ranch families their businesses and cost them hundreds of hours and thousands of dollars for estate planning, relatively little revenue is generated for the federal government. I am told, that estate tax raise only about 1 percent of federal tax revenues.

The potential impact of estate taxes on the future of American agriculture is enormous. Individuals, family partnerships or family corporations own ninety-nine percent of U.S. farms. About half of farm and ranch operators are 55 years or older and are approaching the time when they will transfer their farms and ranches to their children.

The situation in my state of Florida is acute. The value of farmland there has been inflated far beyond its worth for agriculture because developers are willing to pay high prices to convert farmland to other uses. It is not uncommon for land to be valued at as much as $10,000 an acre. On paper this makes a Florida farmer look like a wealthy person, but my farm neighbors aren't rich. They simply don't have the money to pay a huge estate tax bill without selling part or all of their business. While estate tax planning can protect some of the farms, it is costly and takes resources that could be better used to upgrade and expand their businesses.

Farm Bureau renews its call for the elimination of estate taxes. Action by Congress is needed to preserve our nation's family farms and ranches, the jobs they provide and the contribution they make to their communities. Farm Bureau stands squarely behind the enactment of H.R. 8, the bipartisan Death Tax Elimination Act introduced by Reps. Jennifer Dunn and John Tanner. This bill takes a common sense approach to ending death taxes by reducing the rates 5 percent a year.

FARRM ACCOUNTS

Like other small business persons, farmers and ranchers have predictable expenses. Each month they must pay for fuel, animal feed, equipment repairs, building maintenance, insurance, utilities, and meet a payroll. They must plan for seasonal expenses like taxes, seed, heat, and fertilizer. They must also budget for major purchases like equipment, land and buildings.

While many expenses can be predicted and to some degree controlled, farm income is neither predictable nor controllable. The prices that farmers and ranchers receive for their commodities are determined by forces that they can't control, commodity markets and the weather. Farmers and ranchers don't know from one year to the next if their businesses will earn a profit, break even, or operate in the red. Few other industries must face such a challenge year after year after year.

What all farmers hope for is that the good years will outnumber the bad ones. Believing that better times are coming, farmers and ranchers get through tough times by spending their retirement savings, borrowing money, refinancing debt, putting off capital improvements and lowering their standard of living. All of these activities damage the financial health of a farm or ranch and the well being of the family operating the business.

Unfortunately, 1998 was a very bad year for agriculture and many farms and ranches are operating under severe economic distress. Last year, in some parts of the country, extreme weather or disease destroyed the fall's harvest or made feed for livestock scarce. Others were blessed with good crops, but faced low prices because of troubled overseas markets. 1999 is also shaping up to be a very difficult year for those who produce our nation's food and fiber.

Congress saved many farm and ranch businesses from bankruptcy with emergency aid provided by the omnibus appropriations bill. Farm Bureau is most appreciative of that aid but wants Congress to take steps to break the cycle. If emergencies are to be minimized in the future, farmers and ranchers must have new and innovative ways to deal with uncertain incomes caused by weather and markets. Congress must act to give producers the risk management tools they need to manage financial jeopardy caused by unpredictable weather and markets.

Farm Bureau supports the creation of Farm and Ranch Risk Management (FARRM) Accounts to help farmers and ranchers manage risk though savings. Using Farm and Ranch Risk Management Accounts, agricultural producers would be encouraged to save money in good economic times for the ultimate lean economic years. I can't help thinking how different things would be now if FARRM accounts had been put on the books five years ago, and farmers and ranchers had FARRM savings to use this year.

FARRM accounts will encourage producers to save up to 20 percent of their net farm income by the benefit of deferring taxes on the income until the funds are withdrawn. The program is targeted at real farmers, contains guarantees that the funds will not be at risk, and prevents abuse by limiting how long savings could be in an account to five years.

Legislation to create FARRM accounts, H.R. 957, has been introduced by Reps. Kenny Hulshof and Karen Thurman. They've written their bill so that producers of all commodities, from all sizes of operations, who come from all parts of the country, can take advantage of FARRM accounts. That's the reason over 30 agricultural organizations and more than 150 representatives support the bill. The organizations are:

- Agricultural Retailers Association
- Alabama Farmers Federation
- American Cotton Shippers Association
- American Crop Protection Association
- American Farm Bureau Federation
- American Mushroom Institute
- American Nursery and Landscape Association
- American Sheep Industry Association
- American Society of Farm Managers & Rural Appraisers
- American Soybean Association
- American Sugarbeet Growers Association
- Black Farmers and Agriculturists Association
- Communicating for Agriculture
- Farm Credit Council
- The Fertilizer Institute
- National Association of Wheat Growers
- National Barley Growers Association
- National Cattlemen's Beef Association
- National Corn Growers Association
- National Cotton Council of America
- National Council of Farmer Cooperatives
- National Grain Sorghum Producers
- National Grange
- National Milk Producers Federation
- National Pork Producers Council
- National Sunflower Association
- North American Export Grain Association
- North Carolina Peanut Growers
- Peanut Growers Cooperative Marketing Association
- Society of American Florists
- Southeast Dairy Farmers Association
- Southern Peanut Farmers Federation
- USA Rice Federation
- U.S. Canola Association
- U.S. Rice Producers Association
- United Egg Producers
- United Fresh Fruit and Vegetable Association
- Virginia Peanut Growers Association

My position as Vice President of the American Farm Bureau gives me responsibility for the grassroots process that our organization uses to develop its policy positions. I listen to hours of debate on farm policy and I can't think of another idea that has such enthusiastic support as Farm and Ranch Risk Management Accounts. FARRM accounts are simple and that's why they are so appealing to farmers. Farmers like the idea that the government wants to make it easier for them save for a "rainy day." Congress should enact FARRM accounts into law.

CAPITAL GAINS TAXES

Farm Bureau commends Congress for capital gain tax relief passed as part of the Taxpayer Relief Act of 1997. Lower capital gains tax rates that took effect two years ago are providing real benefit to America's farmers and ranchers.

Capital gains taxes do however, continue to cause a hardship on agricultural producers because farming is capital intensive and farming assets are held for long periods of time. According to USDA, agricultural assets total $1,140 billion with real estate accounting for 79 percent of the assets. Studies indicate that farmers and ranchers hold real estate assets for an average of 30 years with farmland increasing in value 5 to 6 times over that period.

For farmers and ranchers the capital gains tax is especially burdensome because it interferes with the sale of farm assets and causes business decisions to be made for tax reasons rather than business reasons. The result is the inefficient allocation of scarce capital resources, less net income for farmers and reduced competitiveness in international markets.

Farmers also need capital gains tax relief in order to ensure the cost and availability of investment capital. Most farmers and ranchers have limited sources of outside capital. It must come from internally generated funds or from borrowing from financial institutions. The capital gains tax reduces the supply of money available because lenders look closely at financial performance, including the impact of the capital gains tax on the profit-making ability of a business, when deciding loan eligibility.

In addition, capital gains taxes affect the ability of new farmers and ranchers to enter the industry and expand their operations. While many think of the capital gains tax as a tax on the seller, in reality it is a penalty on the buyer. Older farmers and ranchers are often reluctant to sell assets because they do not want to pay the capital gains taxes. Buyers must pay a premium to acquire assets in order to cover the taxes assessed on the seller. This higher cost of land hinders new and expanding farmers and ranchers.

Farm Bureau believes that capital gains taxes should not exist. Until repeal is possible, we support cutting the rate of taxation to no more than 15 percent. We also recommend passage of H.R. 1503 to expand the $500,000 capital gains exclusion for homes to include farmland.

SELF-EMPLOYMENT TAXES AND RENTAL INCOME

Farmers, ranchers and other self-employed people pay 15.3 percent self-employment taxes (SE taxes) on net earnings from self-employment. Recent Internal Revenue Service (IRS) activities have wrongly expanded this tax so that farmers and ranchers now have to pay SE taxes on some investment income.

For 40 years, until 1996, farmers and ranchers paid taxes on self-employment earnings as intended by Congress. In that year, a Tax Court case and IRS technical advice memorandum incorrectly expanded the tax to include income from the cash rental of some farmland. The IRS took this position even though SE taxes are not generally collected from other property owners who have cash rental receipts.

Farm Bureau supports enactment of H.R. 1044, introduced by Reps. Nussle and Tanner, to clarify that farmers and ranchers should be treated the same as other property owners and not be required to pay SE taxes on cash rental income.

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

The majority of farmers and ranchers are self-employed individuals who pay for their own health insurance. Because of the high cost of health insurance, many cannot afford high quality coverage or must go without health insurance. Even though corporations that provided health insurance for their employees can deduct premium costs, only 60 percent of the self-employed person's health insurance premiums are tax deductible in 1999. The deduction is scheduled to increase over time until it reaches 100 percent in 2003. Farm Bureau supports the immediate full deductibility of health insurance premiums paid by the self-employed.

Chairman ARCHER. Thank you, Mr. Loop.

Our next witness is Mr. Thompson. If you would identify yourself, you may proceed.

STATEMENT OF SKYLAR THOMPSON, PRESIDENT AND CHIEF OPERATING OFFICER, MARKET BASKET FOOD STORES, NEDERLAND, TEXAS; ON BEHALF OF NATIONAL GROCERS ASSOCIATION, RESTON, VIRGINIA

Mr. THOMPSON. Thank you. Mr. Chairman and Members of the Committee, my name is Skylar Thompson, and I am president of Market Basket Food Stores in Nederland, Texas. I would like to give you a little background about our family business.

My father, Bruce Thompson, began his career in the retail food business in 1949. He spent 12 years working for large chains as department manager, store manager, and later as supervisor. In 1962, he decided to go into business for himself. He and my mother invested their entire savings along with some borrowed capital and bought their first store. They worked hard and a lot of hours and were able to buy more stores.

As a young boy I began my career in the business in 1970 working part-time until graduation from Texas Christian University in 1981. Over the years, I worked in a variety of positions with the company, gradually working my way up to president of the company.

After 37 years through a lot of hard work and a lot of dedicated support from our employees, we very gradually grew and expanded the business and now operate 32 stores in the Texas and Louisiana marketplaces. As a family business, we are committed to serving the needs in the communities where our stores are located and our associates live and work.

One of the biggest threats to our future viability and growth is this ominous cloud hanging over our head called the Federal estate tax. In the grocery industry, we now compete with multibillion dollar megachains with significant financial resources. In order to stay competitive, we must continually reinvest in our business, remodeling older stores, building new stores, adding services and newer technology to better serve our customers.

When the unfortunate death of my mother and father occurs in the future, the company will face substantial estate tax liability. Having to pay the Federal Government almost 55 percent of our estate will place a substantial drain on our capital base. It will potentially force us to liquidate assets, jeopardizing the future growth of our company and the continued employment of our loyal associates.

I am here today on behalf of the National Grocers Association to ask for repeal of this unfair and antifamily tax. This antifamily, antibusiness tax policy forces many families to face the prospect of selling, going out of business and denying the next generation of entrepreneurs the opportunity to take the risk and reap the rewards that this industry has to offer.

Representatives Jennifer Dunn and John Tanner have introduced the Estate and Gift Tax Reduction Act, H.R. 8, which would phase out the estate tax by reducing the tax rate 5 percentage points per year until it reaches zero. Representative Chris Cox has introduced the Family Heritage Preservation Act, H.R. 86, which calls for the immediate repeal of the death tax.

I want to thank the Chairman for his comments this morning, Representatives Dunn and Tanner for sponsoring the legislation, and the 22 Members of the Ways and Means Committee who have sponsored legislation to eliminate the estate tax and for recognizing its importance to every family-owned business whether retail or wholesale grocer, farmers, restaurant owners or other small businesses.

The case for eliminating the estate tax has been studied to death. Recently the Joint Economic Committee released a thorough study. The Economics of the Estate concluded that the estate tax generates cost to the taxpayer, the economy and the environment that exceed any potential benefits.

More importantly, NGA's own 1995 study of the family-owned members confirmed the real life need for the elimination of the Federal estate tax. In the event of the owner's death, 56 percent of the survey responded that they would have to borrow money using at least a portion of the business as collateral and 27 percent said they would have to sell all or part of the business just to pay the Federal estate tax. Grocers reported that this would result in the elimination of jobs, and that would surely be a shame.

Now is the time for Congress to act. The Federal estate tax robs privately owned entrepreneurs of the necessary capital needed to maintain their competitive position in the marketplace against multibillion dollar public companies. Failure to act now places the competitive diversity of our free enterprise system in serious jeopardy. On behalf of NGA's members and family-owned businesses across the country, we encourage the Ways and Means Committee to support repeal or reduction of the estate tax now.

Thank you.

[The prepared statement follows:]

Statement of Skylar Thompson, President and Chief Operating Officer, Market Basket Food Stores, Nederland, Texas; on behalf of National Grocers Association, Reston, Virginia

Mr. Chairman and members of the committee, my name is Skylar Thompson and I am President and Chief Operating Officer of Market Basket Food Stores in Nederland, Texas.

I'd like to give you a little background about our family-owned business. My father, Bruce Thompson, began his career in the retail food business in July 1949. He spent 12 years working for large food chains as department manager, assistant store manager and store manager. In February 1962, my father decided to strike out on his own and opened his first food store. As a young boy, I began my career in the business in 1970, working part time until graduation from college in 1981. Over the years, I have worked in a variety of positions with the company, gradually working my way up to becoming president and chief operating officer in November 1992. After 37 years, through a lot of hard work, long hours and dedicated support from our employees, we have gradually grown and expanded our company and now operate 32 grocery stores in the Texas and Louisiana market-places. As a family business, we are committed to serving the needs of the communities where our stores are located and associates live and work.

One of the biggest threats to our future viability and growth as a family-owned business is the ominous cloud hanging over our heads—the federal estate tax. In the grocery industry we now compete with multi-billion dollar mega-chains with significant financial resources. To stay competitive, we must continue to reinvest in our businesses; remodeling older stores and building new ones, adding services and new technology to better serve our customers. If we were to experience the unfortunate death of my father or mother, the company would face substantial estate tax liability. Having to pay the federal government almost 55 percent of one of our estates would place a substantial drain on our capital base. It would potentially force us to liquidate assets, jeopardizing the future growth of our company and the continued employment of our loyal associates.

I am here today on behalf of the National Grocers Association (N.G.A.) to ask for repeal of this unfair and anti-family tax.

The National Grocers Association is the national trade association representing retail and wholesale grocers that comprise the independently owned and operated sector of the food distribution industry. At one time this industry segment accounted for half of all food store sales in the United States. In recent years, however, a number of successful family-run companies have opted to sell because of the economic disincentives caused by the estate tax.

Summary of Position

N.G.A.'s retail and wholesale grocers are the backbone of their communities, whether they operate a single store or a larger community multi-store operation. Repeal of the estate tax is N.G.A.'s number one legislative priority. The death tax deserves to die. It does substantial harm to family business owners, their companies, their employees, their communities and to the economy as a whole. On behalf of the nation's independent retail grocers and wholesalers, N.G.A. strongly urges the Ways and Means Committee and the entire Congress to act now to support elimination of the estate tax. Privately-owned retail grocers are facing unprecedented competition from multi-billion dollar mega-chains and supercenter competitors. In order to compete, all businesses need capital to reinvest in their companies. Keeping up with new technology, remodeling and expanding their stores, adding new consumer services, building or buying new stores: all of these business decisions are predicated on having the necessary capital. The federal estate tax of up to 55 percent on the value of their business upon the death of an owner places them at a significant competitive disadvantage. Instead of using this capital to grow the company, it is earmarked to pay taxes.

This anti-family, anti-business tax policy forces many families to face the prospect of selling, going out of business, and denying the next generation of entrepreneurs the opportunity to take the risks and reap the rewards that this industry offers. A week doesn't go by that we don't hear or read about a successful family-owned grocer selling the business. Successful family-owned businesses are making the decision to sell now and pay the capital gains tax, rather than the punitive, confiscatory estate tax.

LEGISLATIVE PROPOSALS

Representatives Jennifer Dunn (R–WA) and John Tanner (D–TN) have introduced the Estate and Gift Tax Rate Reduction Act, H.R.8, which would phase out the estate tax by reducing tax rates by 5 percentage points each year until the rates are zero. Representative Chris Cox (R–CA) has introduced the Family Heritage Preservation Act, H.R.86, that calls for immediate repeal of the death tax. Numerous other estate tax elimination proposals have been introduced as well. I want to thank the 22 members of the Ways and Means Committee who have sponsored legislation to eliminate the estate tax and for recognizing its importance to every family-owned business—whether retail and wholesale grocers, farmers, restaurant owners, or others.

The important point for the Ways and Means Committee is to act now in support of estate tax repeal legislation. Privately-owned and operated businesses cannot compete competitively when the federal government makes small business its indentured servant. N.G.A. urges the Ways and Means Committee members to act now to preserve the future of privately-owned and operated businesses before it is too late.

STUDIES CONFIRM THE NEED FOR ESTATE TAX REPEAL

The case for eliminating the estate tax has been studied to death. Recently, the Joint Economic Committee (JEC) released its study, *The Economics of the Estate Tax,* concluding that the estate tax generates costs to the taxpayer, the economy and the environment that far exceed any potential benefits. Specifically, the report found the following:

- *The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.*
- *The estate tax is extremely punitive, with marginal tax rates ranging from 37 percent to nearly 80 percent in some instances.*
- *The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.*
- *The estate tax violates the basic principles of a good tax system: it is complicated, unfair, and inefficient.*
- *The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging saving and investment, and lowering the after-tax return on investments.*
- *The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.*
- *The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion in 1998.*

"The Case For Burying the Estate Tax" by Tax Action Analysis, The Tax Policy Arm of the Institute for Policy Innovation, reaffirmed the JEC study, and found that:

"Estate taxes strike families when they are at their most vulnerable: along with the family member, families can lose what the family member built. High marginal tax rates often force heirs to sell family farms or businesses just to pay the estate tax bill. Eliminating the estate tax altogether would eliminate all these complexities and injustices with no revenue loss to the Treasury. In fact, after ten years, eliminating the estate tax would produce sizeable economic gains, actually increasing federal revenues above the current baseline.

Eliminating the federal estate tax in 1999 would cause the economy to grow faster than in the current baseline, mainly due to a more rapid expansion of the U.S. stock of capital. By the year 2010:

- *Annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline.*
- *The stock of U.S. capital would be higher by almost $1.5 trillion, or 4.1 percent, above the baseline.*
- *The economy would have created almost 236,000 more jobs than in the baseline.*

• *Between 1999 and 2008, the economy would have produced over $700 billion more in GDP than otherwise.*

The damage that estate taxes do to capital formation further magnifies the loss to society. Doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss.

• *Between 1999 and 2008, elimination of the estate tax would cost the Treasury $191.5 billion.*

• *But the over $700 billion in additional GDP would yield $148.7 billion in higher income, payroll, excise and other federal taxes.*

• *In other words, higher growth would offset 78 percent of the static revenue loss over the first ten years.*

• *By 2006, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely."*

More importantly, N.G.A.'s own 1995 study of its family-owned members confirms the real life need for elimination of the federal estate tax. In the event of the owner's death, 56 percent of the survey respondents said they would have to borrow money, using at least a portion of the business as collateral, and 27 percent said they would have to sell all or part of the business to pay federal estate taxes. Grocers reported that this would result in the elimination of jobs. These findings were similar to those that were conducted as part of a broader industry-wide study conducted by the Center for the Study of Taxation.

Here is what other real family-owned grocers have to say about the effects of the estate tax:

From a New Jersey retailer: *"Estate tax has a negative impact on what should be positive business decisions. Many business owners feel that they cannot expand because they have to pay this tax. Also, Americans should be encouraged to save and invest to plan for their future. With estate tax, the more assets one has with death, the more they have to pay the federal government."*

An Alabama grocer stated: *"As the only son and heir to our family owned business, our family lives under the constant fear that we will be forced to sell or liquidate our business upon the death of my parents in order to pay the estate tax. Inasmuch as my father, who is eighty-five years of age, and my mother, who is not far behind, have worked hard to develop a business that could be passed on not only to their immediate family, but as a legacy for their four granddaughters. How would we be able to explain to them that all the hard work and dedication that has been put into the business for the past twenty-seven years was only to pay off the Federal Government because their grandparents passed away."*

A Washington retailer writes: *"I am a small businessman, a grocer, running 2 small grocery stores in Naselle and Ocean Park Washington. My wife and I have been operating this business since 1967. Having recently done extensive & expensive financial planning, I know first hand how badly we (our country) need to consider repealing our Death Tax. Without going into great detail, I will tell you this: Hire a financial planner, hire a lawyer, set up trusts and limited partnerships and buy a huge insurance policy and you may* survive a tax burden that is so huge you would have to close your business and sell your assets in order to pay it. The cost for all of this planning for my small business is ap-proximately $20,000 a year. This seams an extreme amount of money. Money that could be going to capital improvements, extra labor dollars, etc., etc."

An Oregon retailer states: *"My grocery business was founded by my parents 64 years ago. I am the second generation in the family business. My son hopes to carry the business to the fourth generation. This is highly questionable with death taxes at 55%. If it has to be sold to satisfy the government for the unfair and excessive tax, then another small independent business is gone, along with the jobs my stores offer to this community."*

CONCLUSION

Numerous studies exist that reinforce the need for elimination of the estate tax. Now is the time for Congress to act. Privately-owned and operated retail grocers, as well as other community businesses, face unprecedented competition and need capital in order to compete with multi-billion dollar mega-chains and supercenters, such as Wal*Mart. The federal estate tax robs privately-owned entrepreneurs of the necessary capital needed to maintain their competitive position in the marketplace with multi-billion dollar public companies. Failure to act now places the competitive diversity of our free enterprise system in serious jeopardy. On behalf of N.G.A.'s members and family-owned companies across the country, we encourage the Ways and Means Committee to support repeal of the estate tax now.

Chairman ARCHER. Thank you, Mr. Thompson. Thank you very much for staying within the 5-minute limit.

Our next witness is Mr. Coyne. If you will identify yourself for the record, you may proceed.

STATEMENT OF MICHAEL COYNE, MEMBER, TUCKERTON LUMBER COMPANY, SURF CITY, NEW JERSEY; ON BEHALF OF NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. COYNE. Yes. Good afternoon, Mr. Chairman and Members of the Committee. On behalf of the 600,000 members of the National Federation of Independent Business, the NFIB, I appreciate the opportunity to present the views of small business owners on the subject of estate taxes. My name is Michael Coyne. My family owns and operates Tuckerton Lumber Co., which is headquartered in Surf City, New Jersey.

My grandfather founded Tuckerton Lumber Co. in 1932. The company made it through the ravages of the Great Depression and the material shortages of World War II. Today Tuckerton Lumber Co. is a community institution. We have three locations and a separate kitchen and bath business. We have received the Best Home Center of Southern Ocean County Award and I might add that we have consistently beaten the largest home center chain in the country for this distinction.

Tuckerton Lumber Co. supports various community efforts, including funding for four annual scholarships to graduating area high school students. We have 75 employees. We truly do regard our employees as our best asset and we treat them accordingly. We provide for our employees and their dependents full health and dental benefits and a 401(k) plan. On average, our employee turnover rate is very low. One employee has been with our company for 34 years. Truly, we do regard all of our employees as family.

Mr. Chairman, the death tax endangers both my family's business and the jobs of our 75 employees. It literally puts seven decades of work, planning, blood, sweat, and tears at risk.

My experience with the death tax began just a decade ago when my grandfather passed away. The bulk of the estate, including the lumberyards, was transferred to my grandmother. Although we had good legal representation and had done the appropriate planning, it became obvious that the business would not survive another transition. We were and are facing an estate tax rate of 55 percent should my grandmother pass away any time soon.

After my grandfather's passing, we were put in the awkward position of having to worry about increasing the value of the business too much. We have always believed in putting any profit back into the business to keep it strong and healthy and to help it to grow. Now reinvesting profits can actually threaten our business.

For the past 10 years we have worked with estate lawyers and accountants to develop a plan for dealing with the estate tax and preserving the family business. In that time, we have invested over $1 million in life insurance policies, lawyers and accountants' fees and other efforts to ensure that the family business will remain intact.

I am not an economist but I am aware of studies that show the cost of the death tax to the economy is greater than the revenue it raises for the Federal Government. Considering the cost this tax has already imposed on my business before we have even paid the tax, I sincerely believe that this is the case.

Mr. Chairman, I have worked for my family's business 6 days a week, often late into the night, for the past 18 years. That is not as long as our most senior employee and not even as long as my brother-in-law, but it still represents a commitment that has consumed most of my adult life. The business is our life. It puts food on the table for my family and the families of our 75 employees. It is simply immoral that a tax has the power to take all of that away. We have played by the rules, played a key role in the development and success of our community and paid millions in taxes throughout the years. Despite all of that, the death tax would take away all that we have worked so hard to accumulate and preserve.

In closing, Mr. Chairman, I would like to encourage this Committee and Congress to bury the death tax. There is no reason to continue a tax that costs more than it raises. I understand that a majority of House Members have expressed support for completely eliminating the death tax, either cosponsoring the Cox bill or the Dunn-Tanner bill. I hope that this support will translate into action this year and help protect thousands of family businesses like Tuckerton Lumber Co.

I thank the Chairman and Members of this Committee for holding this hearing and for the opportunity to present my views and experience. I would welcome any questions Members might have.

[The prepared statement follows:]

Statement of Michael Coyne, Member, Tuckerton Lumber Company, Surf City, New Jersey; on behalf of National Federation of Independent Business

Good morning. On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of estate taxes.

My name is Michael. My family owns and operates the Tuckerton Lumber Company in Surf City, New Jersey.

My grandfather founded Tuckerton Lumber Company in 1932. The company made it through the ravages of the Great Depression and the material shortages of World War II. My grandfather purchased the company from his father and the business has been in the family ever since.

Today, Tuckerton Lumber is a community institution. We have grown over the years to an operation with three locations and a separate Kitchen and Bath business. We have received "The Best Home Center of Southern Ocean County" award, a Reader's Choice Award presented by *The Times Beacon Newspaper*. I might add, that we have consistently beaten the largest home center chain in the country for this distinction. Tuckerton Lumber Company supports various community efforts, including funding four annual scholarships to graduating high school students.

We also have sixty-five employees. We regard our employees as our best asset and we treat them accordingly. We fully fund and provide for our employees and their dependents full health and dental benefits and a 401(k) plan. On average, our employee turnover rate is very low. One employee has been with our company for thirty four years. Truly, we regard all of our employees as family.

Mr. Chairman, the death tax endangers both my family's business and the jobs of our sixty-five employees. It literally puts seven decades of work, planning, blood, sweat and tears at risk.

My experience with the death tax began just ten years ago when my grandfather-in-law passed away. The bulk of the estate, including the lumber yards, was transferred to my grandmother. Although we had good legal representation and had done the appropriate planning, it became obvious at the time of the transfer that the business would not survive another transition. We were facing an accelerated estate tax rate of 55% should my grandmother pass away.

Since 1980, the business has tripled in size in terms of sales. After my grandfather's passing, we were put in the awkward position of having to worry about increasing the value of the business too much. We have always believed in putting any profit back into the business to keep it strong and healthy and to help it grow. It also helps to have a cushion in order to weather times of economic slowdown.

Another problem we face concerns the land on which our main office and a fully stocked lumber yard is located. It is situated right in the heart of Long Beach Island, a beautiful barrier island that is a highly desired location for summer homes. Real estate values have remained very high for the last twenty-five years, yet moving our main office is out of the question. In order to prepare, we have worked with estate lawyers and accountants to develop a plan for dealing with the estate tax and preserving the family business. In the ten years that have passed, we have invested over $1 million in life insurance policies, lawyers, accountants and other efforts to ensure that when my grandmother passes away, the family business will remain intact.

Mr. Chairman, I have worked for my family's business six days a week often late into the night for the past eighteen years. That's not as long as our most senior employee, and not even as long as my brother-in-law, but it still represents a commitment that has consumed most of my adult life.

That is my story and the story of one family lumber company in New Jersey. My membership with NFIB has exposed me to the experiences of other family businesses. Jack Faris, President of NFIB, recently penned a column that highlighted the efforts of another family lumberyard in Missouri. That family was paying premiums of thirty thousand dollars a year for a life insurance policy against the death tax. I sympathize with that family, but I would point out our premiums were three times as high.

In preparation for this hearing, I was also exposed to several studies, one by the Joint Economic Committee here in Congress, that show the costs of the death tax to families, communities, and the economy far outweigh the revenues the tax raises for the Treasury. That's not news to me. The million dollars my family has invested to prepare for this tax has drained resources that could have been used to expand our business opportunities and create new jobs. Instead of planning for a better business, we're just working to keep what we have.

In 1997, the Taxpayer Relief Act initiated a series of reforms designed to reduce the burden on the death tax on family businesses. I welcome those changes and thank Congress for taking action, but for my business the relief might be described as too little, too late. My grandmother is 91 years old, and though we expect her to outlive us all, increasing the unified credit to $1 million will still leave her estate subject to a tax of millions of dollars.

This business is our life. It puts food on the table of my family and the families of our sixty-five employees. It is simply immoral that a tax, applied at the future death of my grandmother, has the power to take all of that away. We have played by the rules and paid millions in taxes through the years. The death tax would take away in after tax dollars all we have accumulated through the years. Although I represent the third generation involved in the business, we have not squandered what has been passed on to us. Quite the contrary, we have made the business grow through a lot of hard work, discipline and dedication.

In closing, Mr. Chairman, I would like to encourage this Committee and Congress to bury the death tax. There is no reason to continue a tax that costs more than it raises. I understand a majority of House members have expressed support for completely eliminating the death tax—either cosponsoring the Cox bill or the Dunn/Tanner bill. I hope this support will translate into action this year to help protect family businesses like Tuckerton Lumber.

I thank the Chairman and members of this committee for holding this hearing and for the opportunity to present my experience.

Chairman ARCHER. Thank you, Mr. Coyne.

Our final witness is Mr. Speranza. If you will identify yourself, you may proceed.

STATEMENT OF PAUL S. SPERANZA, JR., CHAIR, TAX COMMITTEE, GREATER ROCHESTER NEW YORK METRO CHAMBER OF COMMERCE; MEMBER, BOARD OF DIRECTORS, AND CHAIRMAN, TAXATION COMMITTEE, U.S. CHAMBER OF COMMERCE; ON BEHALF OF BUSINESS COUNCIL OF NEW YORK STATE, INC., AND FOOD MARKETING INSTITUTE

Mr. SPERANZA. Good afternoon, Mr. Chairman, and Members of the Committee. My name is Paul Speranza and I am pleased to appear today before you in my capacity as a member of the board of directors and chairman of the Tax Committee of the Chamber of Commerce of the United States. The Chamber represents over 3 million businesses in the United States and is the largest business federation in the world. I also represent the Business Council of New York State, which is the largest business federation in New York State. I am a member of the board of directors of that organization as well and that organization's representative on the Chamber of Commerce of the United States Board of Directors. I also represent the Greater Rochester New York Metro Chamber of Commerce and, last, I am representing the Food Marketing Institute, which represents the overwhelming majority of the Nation's neighborhood supermarkets.

I appreciate the opportunity to be here today and share with you my experiences with respect to estate and gift tax and also to share with you the views of the organizations that I represent.

I would request that my formal written statement be incorporated into the record and that of Food Marketing Institute also be included in the record.

The Federal estate and gift tax is complex, unfair, and inefficient. Number one, it raises approximately 1.5 percent of the revenue in this country, and coincidentally that is about the amount that it costs for planning, compliance, and collection in this economy.

Number two, the 55-percent estate tax rate is by far the highest in the world. As a matter of fact, the lowest effective estate and gift tax rate is about the same as the highest income tax rate, which shows a great disparity.

Number three, people are penalized who have saved, risked more, and worked hard, many of whom you have heard today. This estate and gift tax is a tax on the virtue of working hard and saving.

And last, when this onerous tax applies, workers can be laid off, businesses have to borrow funds, reduce capital investment, and liquidate or sell their businesses. This negatively impacts the owners of those businesses, their employees, their families, and many others.

Here is just one example of how this tax works. The tax court decided a case called the Estate of Chenoweth. In that case the asset in question was the stock of a privately held company. The stock was valued one way for the adjusted gross estate purposes for which the tax was applied. That very same block of stock was valued in a totally different way resulting in a substantially lower value for marital deduction purposes. What then happened is an unsuspecting surviving spouse had to pay a major amount of tax because of this convoluted interpretation using two different valuations. Now the interpretation may or may not be right as it relates to the law, but it is clearly wrong on the issue of logic and fairness.

I am a retail food industry executive. I work for a closely held, privately owned business and I am also a tax attorney. I have worked in the estate and gift tax field for approximately 30 years. When I was in law school, I took every course I could in the field and wrote a law review article in that area under the supervision of Professor Steven Lind. After law school, I went on to get a post-graduate degree in tax law at New York University School of Law which consistently has the number one tax program in the United States. There I studied under professors Guy Maxfield and Richard Stevens. Professors Stevens, Maxfield, and Lind are the foremost authorities on the estate and gift tax in the United States. Their treatise is the definitive work in this field.

Over the course of my career, I have worked with individuals, families, and their businesses to assist them in this very difficult and complex field which gets more complex as time goes by. At this point in time the law is incomprehensible, it is unfair, it is confiscatory and downright un-American.

Now, why do I share all of this with you? The reason I share this with you, is because it is time for Congress to put estate tax attorneys like me out of business and I am not the only one who thinks this way. We can do more productive things with our time. We really can. As a matter of fact, a survey was recently conducted in upstate New York which is where I live. I will describe this survey in more detail in a moment. This survey shows many innocent people are losing their jobs as a result of this tax.

Over the last 3 months, I have worked closely with the Public Policy Institute of New York State, it is a research and educational organization affiliated with the Business Council of New York State, to complete a survey on the impact of the Federal estate and gift tax on family-owned businesses in upstate New York. I have to tell you the economy in upstate New York is not doing well. This survey has not yet been formally published but the data submitted by 365 family businesses show that at least 15,000 jobs are at risk over the next 5 years just from those 365 companies as a result of the estate and gift tax.

Now, logic dictates that the number of jobs at risk is substantially larger in New York State when you consider all of the businesses in New York State and you then consider all the businesses in the Nation. I look forward to sharing the details of this survey when it is complete.

We have worked on this survey with Professor Douglas Holtz-Eakin, who is the chairman of the economics department at the Maxwell School of Citizenship and Public Affairs, Syracuse University, and I note in the Joint Committee's report for today's hearing that his work is mentioned. Syracuse University has the number one public administration graduate program in the United States. One of the most telling points that Professor Holtz-Eakin makes in this report is that the true cost of this tax falls upon those individuals who lose their jobs and their families.

Now, we want to thank you, Congresswoman Dunn and Congressman Tanner, for supporting and taking the leadership role on

H.R. 8, which obviously phases out the estate tax over a 10- to 11-year period of time at 5 percent a year. Thank you very much for your support. Above and beyond that, the U.S. Chamber and the other organizations that I represent support in principle S. 1128, the Kyl-Kerrey bill. That bill has been described earlier so I won't go into great detail. It eliminates the estate and gift tax immediately. It eliminates the step-up in basis, provides a carryover basis, and in most cases provides a tax rate on the disposition of assets at 20 percent. It also eliminates death as a taxable event. If that approach were to be used, I might add one additional point, that the Internal Revenue Code section 302 would need to be modified because family-owned businesses could end up paying a 39.6-percent rate versus a much lower capital gain rate.

So in conclusion, the estate and gift tax depletes the estates of taxpayers who have saved their entire lives but let us not forget the most important people. Those are the people who will lose their jobs as a result of the estate and gift tax.

Thank you for the opportunity for allowing me to testify before you today.

[The prepared statement follows:]

Statement of Paul S. Speranza, Jr., Chair, Tax Committee, Greater Rochester New York Metro Chamber of Commerce; Member, Board of Directors, and Chairman, Taxation Committee, U.S. Chamber of Commerce; on behalf of Business Council of New York State, Inc., and Food Marketing Institute

Mr. Chairman and members of the Committee, my name is Paul Speranza and I am pleased to appear before you today in my capacity as a member of the Board of Directors of the U.S Chamber of Commerce and as Chairman of the Chamber's Taxation Committee. The U.S. Chamber is the world's largest business federation representing more than three million business organizations of every size, sector and region. I also represent the Business Council of New York State, Inc., which is the largest business federation in New York. In addition, I represent the Greater Rochester New York Metro Chamber of Commerce, where I chair its tax committee. Lastly, I represent the Food Marketing Institute, which represents more than half of the food stores in the United States. I appreciate this opportunity to relate to the Committee my experiences with the impact of the federal estate and gift tax, and to express the views of the U. S. Chamber and the other organizations that I represent on pending legislative proposals providing relief from the federal estate and gift tax.

BACKGROUND OF THE FEDERAL ESTATE AND GIFT TAX

The federal estate tax was enacted in 1916 principally to finance this country's involvement in World War I. After 1916, and despite some early efforts to repeal taxes on wealth transfers during peacetime, the federal estate tax has remained a consistent feature of the federal tax system. The history of the federal estate tax for the years following World War I to present day essentially involves a gradual expansion of the estate tax base, coupled with increases in the rates of estate tax imposed. In 1976, the federal estate tax and gift tax structures were combined and a single, unified, graduated estate and gift tax system was created.

Under the current federal estate and gift tax, the rates are steeply graduated and begin at 18 percent on the first $10,000 of cumulative transfers and reach 55 percent on transfers that exceed $3 million. A unified tax credit is available to offset a specific amount of a decedent's federal estate and gift tax liability. Under the *Taxpayer Relief Act of 1997,* this exemption amount was increased to its current $650,000 level, and will continue to be increased incrementally until it reaches $1 million by the year 2006. The exemption amount, however, will not be indexed for inflation after 2006.

In addition, the *Taxpayer Relief Act of 1997* created a new exemption for "qualified family-owned business interests." However, this exemption, plus the amount effectively exempted by the applicable unified credit, cannot exceed $1,300,000. Whether a decedent's estate can qualify for the maximum $1,300,000 exemption amount depends, among other things, on the mix of personal and qualified business assets in the estate at the death of the decedent, and satisfaction of an exceedingly complex array of conditions relating to the structure of the family business and the conduct of the heirs after the decedent's death. Indeed, after only two-year's of experience, it is clear that many family businesses will not qualify for this exemption.

THE FEDERAL ESTATE AND GIFT TAX IS COMPLEX, UNFAIR AND INEFFICIENT

When the government in a free society uses its power to tax, it has an obligation to do so in the least intrusive manner. Taxes imposed should meet the basic criteria of simplicity, efficiency, neutrality and fairness. The federal estate and gift tax, even with the credits and exemptions available under current law, fails miserably to meet any of these requisites.

Today's federal estate and gift is a multi-layered taxing mechanism so complex that it literally encourages attempts by professional advisers to avoid estate tax liability through a variety of transactions and techniques, many of which would not (and should not) be undertaken but for the desire to preserve a family's savings and capital. This in turn has lead to the allocation of billions of dollars of precious business resources towards estate tax planning and compliance costs, despite the fact that the actual revenue generated accounts for less than 1.5 percent of all federal tax collections. Coincidentally, the cost of planning, compliance and collection of this tax equals the amount of the tax collected.

Nor can the estate and gift tax be considered either neutral or fair to individuals or businesses. The tax is progressive in the extreme, with the lowest effective tax rate almost equal to the highest income tax rate. This penalizes those who have saved more, risked more, and worked harder than others. In this way, the estate and gift tax is actually a tax on the virtues of industry and thrift.

Moreover, the estate and gift tax is far more likely to affect small and medium-sized businesses today than it was sixty years ago. In fact, in 1995, over half of the estate and gift tax revenue generated was derived from estates valued at less than $5 million. Unfortunately, many small and family-owned business owners are either unaware of the need for estate tax planning or unable to afford it, which later results in an estate and gift tax liability that often threatens the continued viability of the business. In order to pay such liabilities, these businesses are forced to either lay off workers, borrow funds, reduce capital investments, liquidate, or sell to an outside buyer. These actions harm everyone connected with these businesses, including its owners, employees, customers, vendors, and families.

I am a retail food industry executive and a tax attorney; I have been involved with the federal estate and gift tax law for the last 30 years. While in law school, I wrote a law review article on this subject under the supervision of Professor Steven Lind. After law school, I received an advanced tax law degree from the New York University of Law, where I studied the Estate and Gift Tax Law with Professor Richard Stevens and Guy Maxfield. Professors Lind, Stevens and Maxfield are the nation's foremost authorities in this field and have written the definitive textbook on the estate and gift tax law. Throughout my career, I have assisted individuals, families, and businesses in the estate and gift tax field. The law in this field has become substantially more complex over the years. It has also become incomprehensible, unfair, confiscatory and downright un-American.

I would like to give you one example to make this point, although there are many. *The Estate of Chenoweth,* 88 T. C. 1577 (1987), and related cases in certain circumstances value the same stock in a closely held family business for gross estate purposes higher than it values the very same asset for marital deduction purposes. This difference in the valuations of the very same asset can leave an unsuspecting surviving spouse with a major estate tax liability. *Chenoweth* may or may not be a correct interpretation of the law, but it is definitely wrong on logic and fairness. Why do I share all of this? Because the time has come for Congress to put estate tax attorneys like me out of business. We can find more productive things to do. I know that there are other estate tax attorneys who agree with me on this matter. As I will explain in more detail below, a recent survey conducted in upstate New York shows that innocent people are losing their jobs as a result of this cruel tax.

Over the last three months, I have worked closely with the Public Policy Institute of New York State, a research and educational organization affiliated with The New York Business Council, to complete a survey on the impact of the federal estate and gift tax on family business employment levels in Upstate New York. While the survey has not yet been formally published, the data submitted by the 365 family businesses respondents reveals that for these respondents alone, at least 15,000 jobs in Upstate New York are at risk over the next five years as a direct result of the estate and gift tax. This figure includes jobs that would not be created because of the allocation of resources away from business expansion and towards planning for the estate and gift tax, as well as jobs that would have to be terminated upon the death of the patriarch or matriarch of the business. In fact, over one-third of the respondents indicated that they would be compelled to take the dramatic and clearly undesirable step of selling or completely liquidating the business in order to meet the estate and gift tax burden.

While I look forward to sharing the detailed results of this survey with the Committee upon its publication, the evidence we have gathered supports overwhelmingly the conclusion that the estate and gift tax has a crippling effect on job growth, job creation and business expansion in Upstate New York's family-business community, which is one of the most vital components of the region's economy. I feel almost certain that these conclusions would not be substantially different if the survey were conducted in other states. Professor Douglas Holtz-Eakin, the Chairman of the Economics Department at the Maxwell School at Syracuse University, has worked with us on this. According to *U.S. News and World Report,* the Maxwell School has been rated as the number one graduate public policy school in the United States. Professor Holtz-Eakin's analysis points out that the ultimate cost of this tax is borne by those who lose their jobs as a result of it.

PENDING FEDERAL ESTATE AND GIFT TAX LEGISLATION

As noted above, The Taxpayer Relief Act of 1997 provided a narrow class of family businesses with modest relief from the estate and gift tax. While virtually any form of relief is welcome, the U.S. Chamber and the other organizations that I represent feel strongly that any future estate and gift tax reform legislation should provide relief to all estates, regardless of the size, financial structure or composition of the estate's assets.

The U.S. Chamber and the other organizations that I represent continue to support legislation that provides for immediate repeal of the estate and gift tax. The case for immediate repeal is compelling: the estate and gift tax penalizes savings, results in direct and substantial harm to family-owned businesses and farms, reduces the rate of job creation, is complex, costly and inefficient to comply with (and collect) and does not produce substantial federal revenue. While outright repeal of the estate and gift tax should thus remain the ultimate goal, the U.S. Chamber and the other organizations that I represent realize that current budget limitations may prevent this Congress from taking that step. If so, additional interim estate and gift tax relief should be enacted, and should be geared toward what is the most harmful aspect of the regime: the outrageously high rates of tax imposed.

Both family business owners and estate tax practitioners agree that Congress should avoid any attempts to define what does, and what does not, constitute a "family business" for purposes of targeting estate and gift tax relief. The competitive marketplace requires that family businesses structure their assets and operations in ways that are as varied as the industries in which they engage. It follows that conditioning the benefits on the way that a family business may chose to structure itself simply cannot achieve an equitable distribution of estate and gift tax relief.

In addition, Congress should avoid merely accelerating the increase in the estate and gift tax exemption that already is scheduled to be fully phased-in to the $1 million level by the year 2006. This would provide additional relief to only those estates at the lowest end of the taxable range and would not provide any meaningful relief to the medium and larger-sized businesses that make more substantial contributions to employment levels and local economies. For these businesses, merely accelerating the increase in the exemption level is insufficient to mitigate the impact of estate and gift tax rates that can result in more than half of the value of the family business going directly to the U.S. Treasury.

Currently, the United States has the highest estate and gift tax rates of any country, followed by France at 40 percent, Spain at 38 percent, Germany at 35 percent, and Belgium at 30 percent. For estates with a value that equals or exceeds $3 million, a maximum rate of 55 percent is imposed, even if the majority of the value of the estate is comprised of non-liquid assets. With such high rates of tax, it is common for the estate and gift tax liability of a business or individual to exceed the monetizable value of the estate's assets. Thus, even if one were to embrace the dubious notion that a tax at death is needed to insure progressivity within the tax code and "backstop" the income and capital gains tax systems, the 55 percent maximum rate is, by any reasonable definition, confiscatory.

There is simply no legitimate rationale for a maximum income tax rate of 39.6 percent, a long-term capital gains tax rate of 20 percent and a maximum estate and gift tax rate of 55 percent, which not surprisingly is the highest stated rate of tax in the Internal Revenue Code. Only recently has there been such a marked disparity between the maximum income tax rate and the maximum estate and gift tax rate.

The U.S. Chamber and the other organizations that I represent are thus fully supportive of H.R. 8, the bi-partisan legislation introduced by Representatives Jennifer Dunn (R–WA) and John Tanner (D–TN) that addresses directly the confiscatory estate and gift tax rate structure. The Dunn-Tanner legislation provides for a "phase-out" of the estate and gift tax over a ten-year period, accomplished by a five percentage point, across-the-board rate reduction in each of the ten intermediate years. The Dunn-Tanner legislation represents a fiscally responsible approach to repeal because it mitigates the revenue impact with a ten-year phase-in period. Moreover, the Dunn-Tanner legislation provides immediate rate relief over the interim period without introducing any additional complexity into the Code.

The U.S. Chamber and the other organizations that I represent also support S.1128, the bi-partisan legislation introduced recently by Senators Jon Kyl (R–AZ) and Bob Kerrey (D–Neb), and co-sponsored by a coalition of Republican and Democrat members of the Senate Finance Committee. Under the Kyl-Kerrey bill, estate and gift taxes would be repealed in their entirety (and immediately) and the "step-up" in basis rules applicable to property acquired from a decedent would likewise be eliminated. The Kyl-Kerrey bill would thus make death a non-taxable event, provide for the "carry-over" of tax basis with respect to property received from a decedent, impose a tax only when the heir decides voluntarily to dispose of the asset, and provide that the rate of tax imposed on the subsequent sale of such property by the heir will in no case exceed the top effective income tax rate of 39.6 percent (and in most cases, will be the lower applicable capital gains tax rate of 20 percent). Of course, no estate or gift tax will be payable in the case of a family-owned business that simply continues to pass the business property from generation to generation. It also should be noted that in the context of this proposal, Section 302 of the Internal Revenue Code should be modified to allow all such transactions at the 20 percent capital gains rate so long as the appropriate holding period requirement is met.

The U.S. Chamber and the other organizations that I represent urge this Committee to consider seriously proposals that address the punitive levels of estate and gift tax rates and provide for an equitable distribution of relief for the varying types of estates and businesses affected by the tax.

CONCLUSION

In conclusion, the estate and gift tax depletes the estates of taxpayers who have saved their entire lives, often forcing successful family businesses to liquidate or take on burdensome debt to pay the tax. Taxpayers should be motivated to make financial decisions for business and investment reasons, and not be punished for individual initiative, hard work, and capital accumulation. Let us also not forget the thousands of employees of family-owned businesses who will lose their jobs as a result of this unfair tax. They bear the heaviest cost of all. The U.S. Chamber and the other organizations that I represent believe that the estate and gift tax should be repealed immediately. However, short of immediate repeal, the estate and gift tax should be reformed in a manner that eliminates the well documented negative effects of this tax on individuals and the owners of family businesses.

Thank you for the allowing me the opportunity to testify here today.

Chairman ARCHER. Thank you, Mr. Speranza. The Chair is going to go slightly out of order because one of our Members, Mr. Tanner, needs to go to another meeting and he is very, very interested in this issue. So the Chair recognizes Mr. Tanner for any brief comments.

Mr. TANNER. Mr. Chairman, thank you very much, and I want to particularly thank you for this panel. I want to thank you all and of course thank Ms. Dunn for her interest in this as well.

What is striking, Mr. Chairman, you all have done a far better job than I think any of us could do but what is striking here is two things. One, it has been said that small businesses are the real economic engines in this country and create the vast amount of jobs that are created from time to time therein and also that all of you on this panel are not chief executive officers of the Fortune 500 or Fortune 100 companies but they are family-owned businesses and agriculture enterprises which I believe is the fabric of this Nation that must be maintained and preserved.

You all have been eloquent in your presentation and I hope that as we go forward, H.R. 8 can receive a place of high priority, Mr. Chairman, in your consideration of this entire matter. Thank you.

Chairman ARCHER. I share the gentleman's comments that this panel has done an outstanding job in presentation today. When I came to the Congress in 1971, one of my goals was to completely eliminate what we used to call estate tax. We are getting closer all the time and I am proud of the fact that the new Majority that came in in 1995 turned the direction of consideration around. The previous Majority wanted to move toward a greater taxation under the death tax by reducing the exclusion from 600,000 to 200,000. Our new Majority said it is totally wrong and we started moving the balance in the other direction down the field. Hopefully we will one day achieve the ultimate goal of complete elimination.

I have a lot of other desired goals. You mentioned the compliance costs and administrative costs of the death tax, and we have a similar situation with the income tax, where we have got the brightest and best minds of this country spending full-time figuring out how to make end runs around the income tax, and that is wasted effort.

Mr. Speranza, I compliment you. One of your colleagues sat at the witness table not too long ago, a gentleman from Alabama, for whom I have the highest respect, a man named Harold Apelinski, who makes his living off of advising people how to reduce their death tax liabilities. He said his goal was to put himself out of business and that is a truly laudable position that you have taken because you have a mind that can produce wealth instead of destroying wealth or trying to prevent the destruction of wealth. So I do thank you.

I am curious and I do not want to intrude into your personal financial holdings, but I think it is important to note that if any one of you has an estate which is likely to be valued at over $10 million, that the marginal tax will not be 55 percent. It will be 60 percent. So the confiscation goes up and we should not forget that. Many people don't realize that, but I know Mr. Speranza does and all you have got to do is look at the Code and you will find out that that is the case.

I would like to ask Mr. Coyne a question since you represent the NFIB and as a former small business person myself, I have great sympathy with what that organization stands for. Is your presentation which supports the complete repeal of the death tax, is that the number one tax priority for tax relief of the NFIB this year?

Mr. COYNE. I believe that is true. I know certainly for our business that is the case and has been for 10 years.

Chairman ARCHER. I can understand where it would be for your business, but I am curious as to whether it is also the number one priority for tax relief for the NFIB.

Mr. COYNE. The complete elimination of the death tax, yes.

Chairman ARCHER. Let me also make all of you aware that we are going to have no money for tax relief in the year 2000. Under the budget that was adopted by the Congress, there will be no surplus for tax relief in the year 2000. There will be a very nominal amount in the projections for the year 2001, but the projected surpluses wedge out over the 10-year period ahead of us so that over 10 years we will be able to give slightly under $800 billion in the way of tax relief and live within the allowable surpluses. So any bill that would immediately repeal the death tax is way beyond anything that we can do within the budget resolution and the scored revenue losses which we have to live with irrespective of the comparison to the administrative costs and compliance costs. I am very sympathetic to that but we have to live with the official estimates and the estimates are that over a 5-year period, immediate repeal would lose 170 billion dollars' worth of revenue. Over 10 years it would be roughly double that. So you can see the revenue constraints that we have to operate under and that is just a reality that we all need to be aware of as we pursue this ultimate goal. But I do compliment each of you and I wish more Members of the Committee were here to listen to you.

Ms. Slater, you made, I thought, an extremely compelling presentation, but I thank each of you for coming to be with us and I know there are Members here who do wish to inquire. I know Ms. Dunn wants to say something. So Ms. Dunn, you are recognized.

Ms. DUNN. Thank you very much, Mr. Chairman, and I appreciate your allowing six members of the business community who have had great experience with the onerous burden of the death tax to come before us. It means a lot for us to be able to hear their stories and I will just tell you that only in the United States are we given a certificate at birth and a license at marriage and a bill at death, and I think those of us here today would certainly like to see that bill at death removed.

A couple of points and then I have a couple of questions I would like to direct to the panel. We are looking at a tax that brings in 1.4 percent of government revenues. Last year that would have been about $23 billion and you have heard the panelists talk about the costs of compliance in the private sector alone being a similar amount, $23 billion. So that is a total of $46 billion that are being brought out of a potentially productive market.

The Chairman talked about the total elimination of the death tax and that it is difficult to do considering lots of other demands and not as many dollars as we would wish to put into tax relief. But I do want to say that H.R. 8, which many of you have mentioned in your testimony, would score at $44 billion over 5 years and it would score at under $200 billion over 10 years and that is a comparison to the $780 billion we are looking at for tax relief compared to $200 billion.

As the Chairman says, we have to live within those numbers and I think it is a tragedy because when you figure how much death tax really does take out of production and you assume that you would leave a great deal of that money with your companies as they move from family to family, I believe the scoring is way off and I think productivity would be huge and would offset any of this loss of income. That is my personal and other people's personal thought about this whole thing.

We are constrained by the scoring of the Federal Government, which is not a dynamic scoring and therefore does not take into consideration the behavior of people when they can keep those dollars and not invest those in compliance or have them taken by the government that itself spends probably 60 cents out of each dollar that comes from death tax.

We are the highest nation in the world with the exception of Japan when it comes to rates on inheritance. Japan is the only nation that supersedes the United States. We are at top rate 55 percent. As we know, the President in his proposal has tried to increase that by 5 percent this year. In Japan the highest marginal rate is 70 percent and certainly exorbitant.

I would also make one more point, and that is that the unified exemption that we have discussed that stands today at 650,000 is not a true exemption and that families who leave their property, their business, their farm to their children actually begin paying after they exempt 650,000 at a 37-percent rate, not an 18-percent rate and this is a terrible shame and certainly as we look at what we can do on death tax, I think we ought to make that unified exemption a true exemption and begin paying a tax at 18 percent above and beyond that.

I wanted to ask Phyllis Hill Slater a question. Ms. Slater, you have worked with many, many people, women-owned businesses, the minority community in your work as head of NAWBO and involvement in the community and I wanted to ask you if you would tell us a bit more about the effect of the death tax on the minority community and on women.

Ms. SLATER. Well, it is devastating because of the fact that this is free enterprise, part of the American dream, to own your own business, to move up, to be able to leave something to your family, to obtain wealth that you can pass on to keep the family strong, and we were told this was—these are the rules and this is what you do in order to be part of this great country of ours and now, you know, as soon as someone dies, they have to sell it, which loses a lot of jobs and also devastates the family.

When I look back and think about my father who served in World War II and, by the way, my family has served in every war that this country has ever been in, but my father did serve in World War II and he had graduated from Stuyvesant High School in New York City at the age of 16, so you know he was a smart guy. And he graduated from CCNY in 1949 after the war interrupted his education, and he worked very, very hard to become an engineer and to be a licensed engineer, and there was only 13 in his class at the time. He worked very hard. It is a slap in his face to say that now his family, his children, his grandchildren cannot, cannot live the dream that he worked so hard to realize.

We know now also that women businessowners are starting businesses even at a faster rate and one of the things that women businessowners are bringing to the business culture is a new way of doing business, changing the way we know business, more family oriented, bringing great, great practices, best practices to the business community and they want to pass it on also to their families. This is also a slap in their face because we do have to work a little harder and we have to be a little better in order to compete.

Ms. DUNN. Thank you very much, Mrs. Slater. I would like to ask unanimous consent to enter into the record an editorial by Harry C. Alford, Jr. He is the president and chief executive officer of the National Black Chamber of Commerce and he has written an op-ed that I think is very revealing that has to do with the quest for economic empowerment that gets you, quote-unquote, freedom and authority. Freedom and authority are the keys to Earthly happiness. Getting rid of the death tax will start to create a needed legacy and begin a cycle of wealth building for blacks in this country. He says we cannot begin to build wealth until we start to recycle our precious dollars. We cannot recycle our precious dollars until we have businesses and ventures to invest in. The death tax is in our way.

Mr. Chairman, if I may request unanimous consent to enter this op-ed into the record, please.

Mr. HERGER [presiding]. Without objection.

[The information follows:]

BLACKS SHOULD HELP IN DOING AWAY WITH THE "DEATH TAX," an Editorial by Harry C. Alford, Jr., President & CEO, National Black Chamber of Commerce, Inc.

We, as a people, have been freed from physical slavery for over 134 years and we have yet to begin building wealth. We cannot begin utilizing all of the advantages of this free economy until we have gained enough wealth to actively participate. It's just not civil rights; civil rights can get you dignity and respect but we need more. It's just not political empowerment; look at Zimbabwe or South Africa where we now have enormous political empowerment but, yet, no power due to lack of Black wealth. Civil rights and political clout are nice but economic empowerment will get you freedom and authority. Freedom and authority are the keys to earthly happiness.

The total net worth of African Americans is only 1.2 percent of the total—versus 14 percent of the population. We have been stuck at that number since the end of the Civil War in 1865. Getting rid of the "death tax" will start to create a needed legacy and begin a cycle of wealth building for Blacks in this country. That would be a great start to breaking the economic chains that bind us.

What is the death tax? The "death tax" is levied against the government—assessed value of the deceased's estate. The rates can start at 37 percent and can climb to 55 percent. In essence, your last remaining parent dies and the estate they leave to you and your siblings will be reduced by the IRS by an amount equivalent to 37–55 percent of the total worth.

Thus, the legacy left by your elders or left by you to your children can be significantly reduced or even wiped out.

An example: The Chicago Daily Defender—the oldest Black—owned daily newspaper in the United States—was forced into bankruptcy due to financial burdens imposed by the estate tax. We all remember what happened when the great Sammy Davis Jr. died—his wife was in bankruptcy within six months due to the vicious "death tax."

Store owner Leonard L. Harris, a first generation owner of Chatham Food Center on the South Side of Chicago, can envision all the work and value he has put into his business disappearing from his two sons. Says Mr. Harris; "My focus has been putting my earnings back in to grow the business. For this reason, cash resources to pay federal estate taxes, based on the way valuation is made, would force my family to sell the store in order to pay the IRS within 9 months of my death. Our yearly earnings would not cover the payment of such a high tax. I should know, I started my career as a CPA."

We cannot begin to build wealth until we start to recycle our precious dollars. We cannot recycle our precious dollars until we have businesses and ventures to invest in. The "death tax" is in our way!

Fortunately, we now have an opportunity to get the "legacy killer" out of our lives and future. There are two bills in the House and Senate as I write this editorial. HR 86 and S 56 will repeal the "death tax." HR 8 and S 38 will phase it out over a specified period of time. Please keep in mind that this estate tax only contributes about 1 percent of the total federal revenue, and of each dollar collected, 65 cents is spent on collecting the tax. The tax promotes virtually nothing but financial hardship and a serious insult to the hard work of our parents.

These bills are making progress on Capitol Hill. However, we need to provide a needed boost, especially to members of the Congressional Black Caucus who, many times, aren't where they should be on financial gain issues. Please call your applicable congressperson or senator and tell them you support these bills to end the "death tax." Tell them it is all right for Black folks to begin building wealth in this country. It is not against the law and it certainly is more enjoyable than poverty.

Building wealth will lead to better education, better health care, safer streets and sustainable communities. Poverty and the lack of economic empowerment will get you frustration and hopelessness. The only way to fight poverty is good government and laws that do not penalize hard work, success and savings. Let's put to death the "death tax"!

Ms. DUNN. Thank you.

Mr. HERGER. Thank you very much, Ms. Dunn. And thank you, Ms. Slater, for that very moving testimony. So many of those of us who are supporting this type of legislation hear that it is only the "fat cats," the very wealthy that we are helping and it is very interesting and very informative to hear your testimony that really we are helping some of the very groups and minorities that we most want to help in this Nation.

So thank you very much. Mr. Hulshof to inquire.

Mr. HULSHOF. Thank you, Mr. Chairman. Mr. Darden, I know you are pinch hitting now for Mr. Sandmeyer. I assume he had a plane to catch, had to get home or something of that nature, but what I wanted to point out and I assume you are also representing the National Association of Manufacturers?

Mr. DARDEN. Yes, sir.

Mr. HULSHOF. Please communicate to him that certainly he and his brother are in a distinct minority. By that I mean the fact that their family business is now in the third generation and when you consider nine out of ten family businesses don't make it through a third generation, I think—and while we can't lay the entirety of the blame at the feet of the death tax, I think the significant part of it needs to rely on the death tax. And so please communicate to him just how much of the minority he is, he and his family.

We are making progress, ladies and gentlemen, and the fact that you are here, the fact that, as Mr. Tanner pointed out I think earlier, that today the Americans Against Unfair Family Taxation announced a campaign to help us raise public awareness about the impact of death taxes on family-owned businesses and I look forward to, hoping some of those television sponsored radio ads will run in my home State of Missouri.

Today as the Chairman pointed out in his opening statement, the American Council for Capital Formation released its 24-country survey. Interestingly, just as a quick perusal of it, that many industrialized countries, including Australia, Argentina, Canada, India, Mexico, even the People's Republic of China do not have any death or inheritance tax and I think as was pointed out by Ms. Dunn, other than the country of Japan, our highest rate on family-owned businesses is the highest on the face of the planet. So I think we are making some progress in raising the profile.

My last count, ladies and gentlemen, is that of the 435 Members in this body and the House of Representatives, 184 have signed on to or cosponsored some sort of death tax relief, which is a significant number, and I am hopeful that your presence here will help us continue that momentum and yet we still have challenges in front of us.

I note that in today's National Journal of Congress Daily, it talks about next week's schedule in the Senate and I noticed that the Treasury Secretary designee Mr. Summers is up for confirmation hearings and if you weren't aware, and I would like your comment, perhaps as those hearings will commence soon, Mr. Summers reportedly stated back in 1997 that those of you that appear here today and those of us who want to see some relief from the Federal death tax are, quote, selfish.

I would like to have any one of you who chooses to to respond to that assertion. Does anybody care to make a comment to Mr. Summer's comment?

Mr. SPERANZA. I would like to. I would like to make two comments as it relates to that. Number one, I firmly believe that people have a right to understand where their estate goes. People generally do not understand tax gimmicks such as grits, grats, cruts, Q-tips, and the like. People work hard all their lives, such as the people you heard from today. They can't understand where their money is going and why it is tied up in the way that it is. I firmly believe that people who work hard to accumulate wealth ought to be able to understand their estate plans. I don't think that is being greedy to be able to know how your assets are going to be handled.

Number two is that the rates are confiscatory. The State of New York is an example. The law is going to change but if you were to make a gift today, there is a 21-percent gift tax rate. So if you add the 55- and the 21-percent New York State tax rate, you get 76 percent. To oppose the requirement that 76 percent of a gift goes to government, I don't think is greedy. I would like to make one last point. When you consider how you score these kinds of bills, and I understand you have to employ static scoring but logic shouldn't be lost. Whether you are greedy or not, just think of somebody considering making a gift at a 76-percent gift tax rate versus ratcheting down these rates over time or eliminating the estate and gift tax completely either under a Dunn-Tanner or Kyl-Kerrey approach. People will not transfer assets at such high tax rates. However, people will dispose of assets at a 20-percent tax rate. We see that right now with the capital gains rates in this country. People are not going to dispose of assets at the level of 55-, 61-, or 76-percent tax rates.

Mr. HULSHOF. I appreciate that comment. I notice my time is about to expire. At town meetings back in the Ninth Congressional District of Missouri, the guaranteed applause line is as follows. The death of a family member should not be a taxable event. And immediately those in attendance will erupt in applause. So I appreciate your being here and especially, Mr. Loop, appreciate your kind words regarding the farm and ranchers management account that you included in your written testimony.

I see my time is up so I will yield back. Thank you.

Mr. Loop, did you have a further comment if the Chairman will indulge you?

Mr. LOOP. I would like to comment because I certainly don't see this as greedy. These people are not wealthy people and this is particularly true when it comes to farm people. Farmland has appreciated in value. Most farm people don't have liquid assets. They don't realize they have an estate tax problem. Certainly these are not greedy people and they need relief from estate taxes.

Mr. HULSHOF. Thank you. Mr. Chairman, I yield back.

Mr. HERGER. Thank you, Mr. Hulshof.

Mr. McInnis will inquire.

Mr. MCINNIS. Thank you, Mr. Chairman. First of all, to my colleague, Mr. Hulshof, my response to your question with regard to Mr. Summers, if I was a Senator I would vote no on his confirmation based entirely on that particular remark. I think that is one of the least educated comments I have heard in my political career.

In regards to the gentleman, Mr. Loop, Mr. Loop, my family, my wife's side have been ranchers. They realize they have an estate tax problem. They have lived poor all their life. They are going to die rich because they have a lot of landholdings. The fact is there is nothing they can do about it. They can't afford counsel. People say go buy life insurance. They barely make enough every year. In fact, 3 out of 4 years they lose money. And in my particular district, I have a unique district in that I represent one of the wealthier districts in the country.

I have got the Rocky Mountains in Colorado. I have got resorts like Aspen and places like that that are forcing these prices up. And the only choice that these families have of course, as you know, is to sell parts of this land and once you sell the land, you can't sustain the size of the herd you have. Once you can't sustain the size of the herd, you can't sustain the family and it goes on down. Unfortunately it also hurts open space because of course the highest use of that land is to put in 2-acre lots or 35-acre lots and so on.

I want to mention a couple of things. One, all of you, I would like you to take a look at my bill. I have got a bill out there that increases the annual gift exclusion from $10,000 to $20,000. That has not been changed since the early seventies. One way that you can over some time do some type of planning is begin to transfer to the next generation and at $20,000 you can move some property over a period of time, some substantial property.

One other thing I might note, I had a good friend—Mr. Speranza, your comments were excellent. I had a very close friend of mine who sold an asset that he had, got hit with capital gains tax, and then unfortunately got terminal cancer and he died 4 or 5 months later so the effective tax rate on the estate was somewhere around 72 percent. When I was talking about the family, I said so all the family got was 28 percent. The 72-percent tax. So all it left the family was 28 percent. That was very interesting because the family member said, no, no, we didn't get 28 percent because in order for us to pay the 72 percent, we had to go to a fire sale. The assets that we had to sell, we didn't get to sit and sell them at their real value. We had to move them and we had to move them quickly to pay the Federal Government. So they figure after the fire sale discount that their actual—what they got out of that estate was 21 or—20 or 21 percent.

Now, another thing I might point out is kind of interesting in this particular family, they lived in a very small town. Seventy percent of the local Episcopal church, their budget, their annual budget was provided by this family and a number of other things, community, all of the money that that family made was banked in that community, was invested in that community, and was spent in that community. After that, after the death, the family could no longer contribute to the episcopal church more—a few dollars every week but certainly not of the same kind. It went on down. There is clearly a trickle down effect. What has happened is that money was removed almost instantly within the time limit, 3 months, whatever it is, from the local community there in Colorado to the State and to the Federal Government.

So I think that—and when you look at the estate tax, I want to point this out too. I can—and I have got—my studies are in business and tax and law and so on. In all of my studies and research, I cannot find one tax that is as unequitable, as unjustified as the death tax.

So I appreciate all of your comments today, Ms. Slater, what it does to business in the minority community. This is nothing but thievery by the Federal Government. So I don't think I have overstated my position. It is accurate. I feel very strongly.

Thank you, Mr. Chairman.

Mr. HERGER. Thank you, Mr. McInnis. I also represent a rural, agricultural, small business district and the type of horror stories that Mr. McInnis is relating is one that each of us who have lived in this kind area very long can relate to. So it really emphasizes how crucially important the work we have before us is.

With that, Mr. McCrery will inquire.

Mr. MCCRERY. Thank you, Mr. Chairman. Mr. Coyne, you said that you had spent a lot of time with your tax attorneys, and so forth, trying to prepare your grandparents' estate and your parents' estate, I guess. In all of those discussions, have you talked about the change that the Congress made in the estate tax law a couple of years ago with respect to closely held family businesses increasing the exemption in effect to I think it was $1.3 or $1.5 million per spouse?

Mr. COYNE. Certainly we have, and it was welcomed but my grandfather did pass away 10 years ago, and although grateful for all and any relief, we did get the sense that it was in our situation too little, too late, I guess.

Mr. MCCRERY. Well, Mr. Sandmeyer commented earlier that that provision, that liberalization, if you will, of the law was of little help because the rules were so complex that I think he said no good tax lawyer would recommend that a family held business even try to do that because of all of the conditions attached.

Mr. Darden, is that a fair recap of what he said?

Mr. DARDEN. Yes. The issue is whether or not the tax attorney is worried about being hit with a malpractice suit afterward if it turns out that the family does not qualify at the later date. The key objection to that provision is that it is uncertain whether or not—you can't base your business plans on the knowledge that you are going to qualify for that because there are so many different factors that may work in there. It does represent a tax savings to certain small businesses. But as far as a company or a family that has diverse assets and they are trying to grow the business, there is the concern that if you rely on getting that and you buy less insurance because you are counting on qualifying, then you are leaving the door open if you don't qualify.

Mr. MCCRERY. I see Mr. Speranza nodding his head that this is a problem.

Mr. SPERANZA. There is no question about it. It is not only me, but other tax advisors are very reluctant to use it. It is very complicated, number one.

Number two, people structure their businesses in a particular way for many, many purposes. To force family businesses to do things in a certain way to try to save taxes when there is no guarantee just doesn't work in most cases. It was a good attempt, but unfortunately it just didn't work.

One additional comment on the suggestion of raising the $10,000 annual exclusion amount to $20,000, I would respectfully report that in the tax community we chuckle over how many decades it is going to be before there is another change in these exclusion amounts. It was $3,000 for decades. It has been $10,000 for decades. That is not a way to plan.

What we really need is an overall approach that all of us have talked about today. With all due respect, we will take what we can get, but that is not the way to solve the problem, not in that area, not by raising the exemption. The bottom line is that businesses, family-owned businesses create jobs and a significant number of those businesses that create those jobs are worth more than the lifetime exemption amount. We just need estate tax relief for this country.

Mr. MCCRERY. I want to ask you in just a second what kind of relief, but let me hammer this point. Mr. Coyne, the reason that I asked you first, you have been in the midst of trying to plan, and I was just curious if you had discussed this provision of closely held family businesses. If you haven't that is OK. If you have and you are knowledgeable on this and you might be able to use this, tell me. I was the author of the bill that was included in the omnibus tax bill that made this change in the estate tax. I thought it was the best thing that we could do with the limited amount of money that we had to work with. Now what I am hearing is that I was wrong, that wasn't the best thing that we can do. I am not a tax lawyer, I am just a poor country lawyer with no particular knowledge of the Tax Code, and I admit I probably wasn't the best one to craft this provision. However, it was with good intent to try to help family businesses. But if you are telling me now that it is money wasted, maybe we can recoup that money and repeal that change and use that money to lower the rates, or whatever we can do.

So, Mr. Coyne, are you telling me that you don't care if we repeal that position?

Mr. COYNE. Well, you asked me if I was involved with the discussions of that. We, of course, hired tax attorneys and our accountants to discuss that. I was more involved with the day-to-day operation in trying to figure out—it was basically just tell us what is the best course to go so we can survive this because at the time my grandmother was 82 years old and married for 55 years and I guess the statistics on spouses surviving after that—fortunately, she is still strong and kicking but at the time it was really very daunting. I am not familiar with the intricacies of that.

Mr. MCCRERY. If you could ask if they would mind if we repealed that change in the Tax Code and apply that money to Jennifer Dunn's bill or somebody else's approach. And then Mr. Speranza, I will give you a chance to answer my question.

If it is no good to do what we did with the family business and no good to do what we did increasing the gift allowance and if it is no good increasing the unified credit, what should we do?

Mr. SPERANZA. One of two things. Number one, the Dunn-Tanner approach is excellent. If you repealed the provision you just talked about, you then have some funds for perhaps the first 5- or 10- or 15-percent reduction in the estate tax rates.

Number two, is is important to take death out of the mix as a taxable event. If you consider the Kyl-Kerrey approach, an approach that all the organizations I represent support in principle, that would be an excellent way to proceed as well. A 20-percent tax rate in the view of the organizations I represent, is going to actually release capital that is now tied up. It will actually generate additional tax revenue. People will not make gifts now. They just won't do it. So I would suggest either Dunn-Tanner or Kyl-Kerrey as the approach to use.

Mr. MCCRERY. Thank you.

Mr. HERGER. I want to thank the members of this panel for your taking the time to appear before us and give your testimony and share with us your personal experiences as well as all of the members of the other panel.

With that this hearing of the Ways and Means Committee on reducing the tax burden stands adjourned. Thank you very much.

[Whereupon, at 3:10 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Thomas McInerney, President, Aetna Retirement Services, Hartford, Connecticut

I. INTRODUCTION

We appreciate this opportunity to present our views on ways to improve the retirement security of Americans. The tax code can be an important tool in advancing the retirement security of American workers. The private pension system in this country is doing a relatively good job at providing retirement benefits to a large portion of the American workforce. This is in part due to the tax-preferred treatment accorded contributions to qualified retirement plans under the tax code.

We support the improvements to these tax code provisions that are included in H.R. 1102, the comprehensive pension reform legislation sponsored by Mr. Portman and Mr. Cardin. Many of these changes have been sorely needed for many years, and we believe if enacted they will have a beneficial effect on plans and plan participants, enabling them to better provide a secure retirement through their employer-sponsored plans.

There continues to be a significant gap in coverage, however, among workers of smaller businesses. Less than 20 percent of businesses with fewer than 25 employees sponsored a retirement plan. This means that only 13 percent of these 23 million working Americans has the opportunity to participate in an employer-sponsored retirement plan. This is despite Congress's recent efforts, most notably in 1996, to create plans that small businesses will utilize, for instance, the SIMPLE IRA and 401(k) plan, which were authored by Mr. Portman in the House.

II. RETIREMENT PLANS FOR SMALL BUSINESSES

A. Why don't more small businesses offer a retirement plan?

A survey done by the Employee Benefits Research Institute (EBRI) in 1998 found that small businesses had several reasons why they decide not to offer a retirement plan. First, employees often prefer today's wages to tomorrow's benefits. This is likely to be especially true of lower-income workers. Second, administrative costs are too high. Third, small employers are concerned about fiduciary responsibilities and potential liability. Finally, employers are often uncertain about their future revenue stream and find it difficult to commit to sponsoring a plan.

On the other hand, the EBRI survey found that small businesses might consider starting a retirement plan if certain things were to occur. The availability of a business tax credit could make a difference in the small business starting a plan. Also, reduced administrative requirements, allowing owners to save more in the plan, or easing of the vesting requirements were amongst other factors cited by small businesses as influencing their decision to start a plan.

B. The SIMPLE 401(k)

Congress in 1996 attempted to respond to the needs of small business by enacting the SIMPLE IRA and the SIMPLE 401(k). Initial evidence seems to indicate that the SIMPLE IRA has proven attractive to some small businesses, primarily, we believe, those with one- or two-employees. One of the retirement policy concerns with relying on an IRA for retirement security is that the participant-owner has easier access to the funds than to the funds in an employer-sponsored plan ("leakage").

On the other hand, the SIMPLE 401(k) has not been much utilized by the small employer community. The small employer market has not found it attractive thus far, we believe for several reasons. The SIMPLE 401(k) requires the employer to make a 100 percent matching contribution up to 3 percent of pay for those deferring, or a 2 percent contribution for all those eligible. The marketplace has deemed this requirement too costly. Moreover, while it is expensive for the owner, the owner cannot get the full benefit that a regular 401(k) plan permits because the maximum deferral permitted is $6,000 rather than $10,000.

Second, small employers continue to be concerned by the start-up costs and the related administrative costs of the plan. A full plan document is still required as well as a summary plan description, spousal notices, loan documents and annual plan reporting.

III. IMPROVING THE SIMPLE 401(K)

All of these current concerns/issues can be addressed to expand coverage for employees working in small businesses. We believe that the SIMPLE 401(k) was the right path for Congress to take in attempting to provide small businesses with options for creating retirement plans. Much like the other changes proposed in H.R. 1102, there are a number of refinements that we would suggest be made to the current SIMPLE 401(k) to enable it to have the impact with the small business community that Congress intended. We hope these can be included with H.R. 1102 as it moves forward in the legislative process.

A. Reducing employer cost

First, Congress should act to address the problem of employer cost. There are several ways this could be done. Small businesses have judged the current match requirements to be too expensive. We would propose a somewhat lower match, but also some flexibility in the match requirements over a period of years recognizing some of the financial challenges small businesses often face. For instance, you could require a match of 50 percent of the deferral amount up to 4 percent of pay with an option for a 100 percent match. To provide flexibility, you could permit no match for the first two plan years or grant a tax credit to the employer for a match in the first 2 years. In addition, you could allow an employer to skip a match in one out of five years after the first five years, provided notice is given to employees.

In addition, the employer's administrative costs of running a plan could be reduced. For instance, the plan document should be simplified to consist of no more than one page, which the IRS could put on its website and which the accountant for the small business could easily access. Another simplification would be to combine the filing of the annual plan return (Form 5500) with the employer's tax return, for instance, using a one-page schedule.

Employers should not have to worry about setting up another plan once they begin to outgrow the SIMPLE 401(k) plan, at least for some reasonable period of growth. We would suggest that the employer be able to maintain this new SIMPLE

401(k) plan until its workforce reaches 100, the cut-off for the current SIMPLE 401(k) plan.

B. Making the plan more valuable

We fully support the change included in H.R. 1102 to raise the maximum deferral for both forms of 401(k) plans. This should give owners a better incentive to set up these plans. In addition, we applaud the catch-up provisions for workers over 50 and would suggest adding a catch-up provision for workers that have been out of the workforce for some specified period of time. Finally, we support the provision in the Portman-Cardin bill permitting business owners to borrow from the plan under the same terms as their other employees.

C. Balancing the employee's need for security with the employer's fear of liability

As mentioned above, one of the reasons small businesses do not set up retirement plans is their fear of ERISA liability as fiduciary of the plan assets. We suggest the creation of a safe harbor from ERISA liability along the lines of the current 404(c) safe harbor. To take advantage of this new safe harbor, a SIMPLE 401(k) sponsor would have to place the plan assets in an established bank, insurance company, mutual fund or other entity regulated by the Federal or State government. This entity must publish an annual internal control audit. All participants must have toll-free telephone or internet access to the entity to verify balances independent of their employer. The plan sponsor would have to meet all existing requirements for remitting contributions to the entity on a timely basis. If these and other 404(c) requirements are met, the plan sponsor would enjoy fiduciary protection.

IV. CONCLUSION

Our experience tells us that there is no single solution for the pension coverage gap in the small business sector of our economy. This sector is highly segmented by demographic and market forces, such as age of the owner and the business, the type of business, the size of the workforce, the age of the workforce and other factors. The existing SIMPLE 401(k) should remain in place for the "bigger" small businesses. Creative thinking on a defined benefit plan for small businesses should be encouraged as well.

We believe, however, with these changes for businesses of 25 employees or less, the SIMPLE 401(k) could become a popular tool for providing retirement security for workers in these particularly small businesses. We urge the Committee to give consideration to these changes as it contemplates the many excellent reforms included in the Portman-Cardin legislation and other pension reform bills.

Statement of America's Community Bankers

Mr. Chairman and Members of the Committee:

America's Community Bankers appreciates this opportunity to submit testimony for the record of the hearing on retirement and health security. America's Community Bankers (ACB) is the national trade association for progressive community bankers across the nation. ACB members have diverse business strategies based on consumer financial services, housing finance, small business lending, and community development, and operate under several charter types and holding company structures.

ACB members are actively involved in offering prototype IRAs and qualified plans and recognize the critical need to increase the current rate of retirement saving. It has been widely reported that the "baby-boom" generation is not saving out of income at anywhere near the rate needed to provide adequate retirement income. ACB recognizes that many households are currently reaping the benefit of stellar returns on equity holdings in 401(k) and other accounts but these sources do not represent truly new savings, merely higher, and potentially temporary though of course welcome, returns on existing retirement assets. At the same time, despite your best efforts, Mister Chairman, Congress seems unable to act to eliminate the looming insolvency of the current Social Security system. ACB believes that it is imperative that Congress do more to enhance the attractiveness of individual retirement plans and employer-sponsored plans. Inducing a higher level of retirement savings through sound tax policy is one way to eliminate some of the unavoidable pressure on Social Security. H.R. 1546, the *Retirement Savings Opportunity Act of 1999*, introduced by Rep. Thomas and H.R. 1102, the *Comprehensive Retirement Security and Pension reform Act*, introduced by Reps. Portman and Cardin are excellent vehicles for accomplishing much needed reform of the pension provisions in the tax code and ACB is strongly supportive of their enactment.

Under current law in order for an individual to make the maximum IRA contribution for a year he or she is required to work through a daunting maze of eligibility and income limitations that apply to the interaction of traditional IRAs, Roth IRAs, and spousal IRAs. This interaction does not even consider the separate eligibility and contribution rules that apply for the so-called Education IRA, which cause additional confusion for IRA participants. (The mind-boggling complexity of the relationships of the various IRA eligibility rules, as well as the internal complexity of the Roth IRA rules, are set out in Attachment A, *Complexities to Consider in the Roth IRA*.) The confusion caused in the minds of investors by the inconsistent and complex eligibility rules may be inhibiting participation, particularly among middle class individuals who participate in employer plans and who are in the phase-out ranges of income. This includes plan participants who marry and lose eligibility to make traditional IRA contributions and plan participants who quit work and are unaware that they have become eligible for a spousal IRA.

The income limits on the eligibility of participants in employer plans was imposed by the *Tax Reform Act of 1986*. H.R. 1546 would eliminate the eligibility rules and restore universal eligible for traditional IRAs. In addition, H.R. 1546 would eliminate the income limit (based on "modified adjusted gross income") on eligibility to contribute to a Roth IRA and would change the $100,000 modified AGI limit on Roth IRA conversions to $1 million.

It should be noted that the current $2,000 overall limit on IRA contribution has remained unchanged since 1981. IRAs are alone among tax-advantaged retirement plans with a contribution limit that is not indexed for inflation. In fact, if the original $1,500 IRA contribution limit had been indexed for inflation since 1974, it would currently be approximately $5,000. H.R. 1546 and H.R. 1102, in effect, recognize this fact by increasing the overall IRA contribution limit to $5,000 and H.R. 1546 would index this amount for future inflation.

H.R. 1546 would permit IRA owners who are 50 years of age and older to make additional annual IRA contributions of $3,000. H.R. 1102 would increase the elective deferrals permitted under 401(k), SEP, Simple Retirement Accounts, and 457 plans permitted to be made by 50 year-olds by $5,000. These "catch-up" contributions would create fairer treatment for middle class IRA participants who are often unable to make the full IRA contribution in their younger years because of family obligations.

Both H.R. 1546 and H.R. 1102 would make an incremental expansion of the Roth IRA concept that, given the popularity of the Roth IRA, is simply a matter of common sense. Both bills would permit 401(k) plans to offer an option whereby employees may treat elective deferrals as after-tax contributions and the earnings, which will accumulate tax-free, will be tax-free upon distribution. Providing the Roth IRA option in a 401(k) is likely to substantially increase the employee's retirement nest egg, not only because of the inherent advantage of the Roth IRA concept for younger participants, but because of the discipline that would be imposed by contributions being made under a payroll deduction plan.

Another basic idea that should be considered is the redefinition of participation in a defined benefit plan. Because of the imposition of vesting periods, an employee who changes every three years or so might never gain any vested retirement benefits but be debarred from contributing fully to a regular IRA account.

In many cases the *Tax Reform Act of 1986* imposed limits on the benefits and compensation that could be taken into account in funding ERISA benefits. The *Omnibus Budget Reconciliation Act of 1993* reduced limits still further and *the Retirement Protection Act of 1994* made reductions in the rates of cost-of-living indexing. H.R. 1102 would restore these benefit and compensation limits and indexing rates schedules that were reduced. Similar increases in benefits and indexation rates would be made for other plans. For example, the annual benefit limit of section 415(b)(1) for defined benefit plans would be increased from $90,000 to $180,000. The compensation limit under section 401(a)(17) would be increased from $150,000 to $235,000. With respect to defined contribution plans, the dollar amount of the annual addition would be increased from $30,000 to $45,000 and corresponding 25% limitation would be eliminated altogether. The limit on elective contributions under 401(k), SEP, and 403(b) would be increased from $7,000 to $15,000. In the case of 457 Similar increases would be made for 457 plans, Simple Retirement Plans, and plans maintained by local governments and tax-exempt organizations.

The dollar limits have become unrealistic over time so that the increases will benefit primarily middle class employees. Senior management will still largely rely on nonqualified deferred compensation plans and incentive stock options. Even the increase in the section 401(a)(17) limit will benefit all employees in a defined benefit plan by accelerating the full funding of the plan. In the case of defined contribution plans, eliminating the 25% limit will provide middle class workers with additional flexibility to make catch-up contributions to offset participation lapses during their younger years or when they had interrupted employment to raise families.

Several other provisions in H.R. 1102 would encourage employers to create new retirement plans. For example, the complex top-heavy rules that often inhibit plan creation by smaller employees would be modified and simplified. PBGC premiums would be reduced for new plans of small employers and phased in for other new single-employer plans. In addition, small employers will be eligible for a section 38 credit for a portion of the costs of starting up a retirement plan.

H.R. 1102 will increase pension portability by permitting rollovers among section 457, 403(b), qualified plans, and IRAs. The bill would also permit rollovers of employee after-tax contributions to an IRA. Unaccountably, employee after-tax contributions are not permitted to be rolled over to another qualified plan—this shortcoming serves no sound policy purpose and should be eliminated. In addition, H.R. 1102 would eliminate two other rules that inhibit portability in the context of a merge or acquisition. Optional forms of benefit distribution would no longer be required to be preserved where plan benefits are being transferred directly to another plan. The requirement in current Treasury regulations that such optional benefits be preserved in a transfer of benefits to another plan inhibited the consolidation of the acquired employees' benefits after a merger or acquisition. Similarly, the so-called "same desk" rule of section 401(h) would be eliminated. This rule prevents an employee from rolling over a section 401(k) plan to a new employer's plan or an IRA, where the employee continues to perform the same job for the new employer after an acquisition. The employee is required to remain in the seller's plan because, as a technical matter, he or she has not incurred a "separation from service."

Although, strictly speaking, the minimum distribution rules of section may not impact an employer's decision to set up a retirement plan or an employee's decision to participate or establish an IRA, they no longer reflect the realities of the workforce and do not serve a valid policy purpose. (It should be noted that they do not apply to the Roth IRA.) H.R. 1102 would substantially simplify the minimum distribution rules.

Mr. Chairman the need to encourage retirement saving and enhance retirement security is critical and you are to be applauded for holding this hearing to explore ways to achieve this goal. Enactment of H.R. 1546 and H.R. 1102 would contribute substantially to achieving it and ACB strongly urges the Committee to pass them. Once again, Mr. Chairman, ACB is grateful to you and the other members of the Committee for the opportunity you have provided to make our views known on this very important issue. If you have any questions or require additional information, please contact James E. O'Connor, Tax Counsel of ACB, at 202–857–3125.

ATTACHMENT A

The Considerable Complexities Of The Roth IRA

Section 408A of the Internal Revenue Act of 1986 (the Code), which was added by the *Taxpayer Relief Act of 1997* [1] (the 1997 Act) and is effective for tax years beginning after December 31, 1997, created the Roth IRA, a new individual retirement plan with great potential to encourage new retirement savings and take some pressure off Social Security. Section 408A was amended by the *Internal Revenue Service Restructuring and Reform Act of 1998* [2] (the 1998 Act) and on February 3, 1999, final regulations from the Internal Revenue Service (TD 8816) were published under section 408A. The potential of the Roth IRA has been constrained in several ways. The combined annual limit on IRA contributions has remained stuck at $2,000 since 1981 because of budgetary constraints and misplaced social fairness concerns. In addition, the proliferation of individual saving arrangements is confusing. A more immediate constraint, however, because it reflects, in many instances, specific judgments and reactive decisions of Congress and the IRS, is the complexity of the Roth IRA provisions and the complexity of their interaction with traditional (deductible) IRA provisions. This complexity makes the Roth IRA confusing for trustees and participants, has added significant overhead costs, and may have discouraged competition among potential plan sponsors.

[1] Public Law 105–34 (111 Stat. 788).
[2] Public Law 105–206 (112 Stat. 685).

Contributions

Contributions may be made to a Roth IRA beginning on January 1, 1998. Like the traditional IRA, contributions may be made to a Roth IRA for a particular year until the unextended due date (i.e., April 15th for calendar year taxpayers) of the income tax return for that year.[3] Unlike a traditional IRA, contributions to a Roth IRA are not deductible,[4] but the entire amount of any "qualified distribution" will be tax-free. (See *Qualified Distributions,* below.) Note that, by comparison with the permanent exclusion from taxation for Roth IRA earnings, the tax advantage conferred on nondeductible contributions to a traditional IRA is limited to the deferral of taxation of their earnings until distribution. Deductible contributions cannot be made to a traditional IRA during and after the year in which an individual (or spouse, in the case of a spousal IRA) reaches age 70½, but contributions may be made to a Roth IRA at any age[5]—to the extent that the individual has compensation at that age.

Individuals are permitted to maintain a traditional IRA (making deductible and/or nondeductible contributions) and a Roth IRA simultaneously, but the maximum annual combination of contributions is still limited to the lesser of $2,000 or the individual's compensation for the year,[6] excluding rollover contributions to the Roth IRA. (It should be noted that an "education IRA" is not included in the definition of an "individual retirement plan" under section 7701(a)(37) and, thus, contributions to an education IRA do not count against this annual contribution limit.) The final regulations provide that, as is permitted for traditional IRAs under section 408(c), an employer or employee association may establish and even administer a trust set up to hold contributions made to separate employee accounts, each of which is treated as a separate Roth IRA.[7] In fact, it seems apparent that the regulations are clarifying that section 408(c) is just one of the traditional IRA provisions applicable to Roth IRAs under the general overlay rule of section 408A(a). Thus, the employer intending to create a Roth IRA trust for its employees should do so by specific reference to the provisions of section 408(c) in order to avoid taking on ERISA duties and liabilities. Likewise, a parent or guardian may make contributions to a Roth IRA on behalf of a minor, provided the minor has compensation in the amount of the contribution.[8] As with traditional IRAs, a 6% penalty on excess contributions applies to the Roth IRA,[9] but the penalty can be avoided by distributing the excess before the extended due date of the return for the year of contribution.[10] (See *Corrective Distributions,* below.

Active Participation in an Employer's Retirement Plan

Traditional IRAs

Individuals are permitted to deduct the full $2,000 contribution to a traditional IRA regardless of how high their adjusted gross income level may be[11]—provided they are *not* participants in an employer's retirement plan.[12] Where an individual is an "active participant" in an employer's retirement plan, the portion of an IRA

---

[3] See section 219(f)(3) of the Internal Revenue Code.
[4] See section 408A(c)(1) of the Code.
[5] See section 408A(c)(4) of the Code.
[6] See section 408A(c)(2) of the Code.
[7] See Treasury regulation section 1.408A–2 A–3.
[8] See the preamble to the final regulations, *General Provisions and Establishment of Roth IRAs.*
[9] See section 4973(f) of the Code.
[10] See sections 408A(d)(2)(C) of the Code.
[11] See section 219(b)(1) of the Code.
[12] The IRS provides guidance for determining whether an individual is an active participant in Notice 87–16, 1987–1 CB 446. If an individual's employer maintains a defined benefit plan, he or she is treated as an active participant merely on the basis of being eligible to participate for any part of the plan year ending with or within the individual's tax year, even where he or she elects not to participate or ultimately fails to perform the minimum service required to accrue a benefit. If the employer maintains a defined contribution plan (a money purchase, profit-sharing, which includes a 401(k), or stock bonus plan), an individual is an active participant where employer or employee contributions or forfeitures are allocated to his or her account for a plan year ending on or within the individual's tax year.

contribution that is deductible will decline from the full $2,000 to zero as his or her adjusted gross income [13] increases above a certain dollar amount.[14]

Roth IRAs

Unlike traditional IRAs, no limitation is imposed on Roth IRA contributions because the owner is an active participant in an employer's plan.[15] The 1998 Act also conferred a benefit by clarifying that the amount of the Roth IRA contribution that self-employed individuals are permitted to make for a given year will not be reduced by any contributions that they make on their own behalf to SEP IRAs or SIMPLE IRAs,[16] as well as corporate or Keogh plans. But individuals are not permitted to make contributions to a Roth IRA above certain levels of "modified adjusted gross income" [17]—regardless of whether they participate in an employer's plan.

Modified Adjusted Gross Income Limitations on Regular (Annual) Roth IRA Contributions

The limitations on regular Roth IRA contributions are as follows:

(1) For a married couple filing a joint return, eligibility to make regular Roth IRA contributions is phased out between "modified AGI" of $150,000 and $160,000 (regardless of whether or not either spouse is a participant in an employer-sponsored plan). The statutory calculation of the annual contribution a joint return filer is permitted to make is $2,000 (or, if less, compensation) reduced by an amount that bears the same ratio to $2,000 (or, if less, compensation) that the excess of modified AGI over $150,000 bears to $10,000.[18]

(2) For a single individual, eligibility is phased out between modified AGI of $95,000 and $110,000. The contribution calculation for the single filer is $2,000 (or, if less, compensation) reduced by an amount that bears the same ratio to $2,000 (or, if less, compensation) that the excess of modified AGI over $95,000 bears to $15,000.[19]

(3) For a married individual who files a separate return, eligibility is phased out between modified AGI of $0 and $10,000. The contribution calculation for the separate filer is $2,000 (or, if less, compensation) reduced by an amount that bears the same ratio to $2,000 (or, if less, compensation) that the excess of modified AGI over $0 bears to $10,000.[20]

Rounding and De Minimis Rules

The rounding and *de minimis* rules applicable to traditional IRAs *do* apply to Roth IRAs. If the contribution under the calculation formula is not a multiple of 10, it is rounded to the next lowest multiple of 10. If the calculation yields a deductible

---

[13] Three terms applicable to the IRA contribution limits should be understood: "compensation"; "adjusted gross income"; and "modified adjusted gross income." IRA contributions must be made from compensation and the definition becomes important because Roth IRA contributions may be made well into an individual's retirement.

(1) Compensation may be defined simply as the amount reported on the Form W–2 of an employee or the "earned income" of a self-employed individual. The term compensation includes alimony, but it does not include: (1) gifts; (2) distributions from pension plans (including 401(k) plans and IRAs), commercial annuities, and deferred compensation arrangements; and (3) Social Security benefits. See section 219(f)(1) of the Code.

(2) Adjusted gross income, as used to limit contributions by active participants in employer plans, includes the taxable portion of social security and railroad retirement and passive activity losses and credits, but U.S. Savings bond proceeds paid for higher education, adoption assistance paid by employers, and the foreign income of U.S. citizens to the extent otherwise excluded are added back. The amount of any deductible IRA contribution is also added back to AGI. See section 219(g)(3)(A) of the Code.

(3) Modified adjusted gross income, which limits the ability of all individuals to make Roth IRA contributions, excludes amounts otherwise included in AGI resulting from the conversion of a traditional IRA to a Roth IRA. See section 408A(c)(3)(C)(i)(I) of the Code and Treasury regulation sections 1.408A–3 A–5 and A–6. For taxable years beginning after 2004, required minimum distributions from IRAs are also not included in modified adjusted gross income for the purpose of determining eligibility to convert a traditional IRA to a Roth IRA (i.e., the $100,000 modified AGI limitation). See section 408A(c)(3)(C)(i)(II) of the Code.

[14] See section 219(g) of the Code.

[15] See section 408A(c)(3) of the Code.

[16] See section 408A(f)(2) of the Code and Treasury regulation section 1.408A–3 A–3(c)(2).

[17] See section 408A(c)((3)(A) of the Code.

[18] See sections 408A(c)(3)(A) and (C)(ii)(I) of the Code.

[19] See sections 408A(c)(3)(A) and (C)(ii)(II) of the Code.

[20] See sections 408A(c)(3)(A) and (C)(ii)(III) of the Code.

amount of less than $200, but more than zero, the owner may deduct a $200 IRA contribution.[21]

Spousal Roth IRA

As with a traditional IRA, a working spouse may make a Roth IRA contribution on behalf of a spouse who has insufficient compensation to make his or her own Roth IRA contribution, providing they file a joint return.[22] After the husband or wife makes a regular contribution of up to $2,000 to his or her Roth IRA and/or deductible IRA, he or she is then permitted to contribute to the other spouse's Roth IRA and/or deductible IRA an additional $2,000 or, if it is less, the amount of both spouses' combined compensation reduced by the first Roth and/or traditional IRA contribution.

In other words, the "excess" compensation of the higher paid spouse is used to boost the eligibility of the other spouse to make a Roth IRA contribution, although the actual contribution to the spousal Roth IRA may come from the funds of either spouse. In the most common set of facts where a working spouse has at least $4,000 of compensation, he or she may contribute $2,000 to the spousal Roth IRA of a non-working spouse, as well as $2,000 to his or her own IRA. The issue of insufficient compensation will more likely arise for Roth IRA owners than for owners of traditional IRAs because, as mentioned, contributions may be made to a Roth IRA after age 70½.

Interplay of Roth and Traditional IRA Contribution Limits

Taxpayers should be mindful of the interplay of the Roth IRA and the traditional IRA rules so they may maximize the benefits of the $2,000 total IRA contribution they are permitted to make (if only as a nondeductible IRA contribution) while avoiding the 6% penalty on excess contributions that is applicable to Roth IRAs, as well as traditional IRAs. The distinction between AGI and modified AGI should be borne in mind in those years where additional AGI is created by the conversion of a traditional IRA to a Roth IRA.

A. In the case of the *1998* return of a *single individual:*

(1) Where he or she is an *active participant* with AGI under $30,000, his or her entire $2,000 contribution may be deducted as a contribution to a traditional IRA or the entire $2,000 may be contributed to a Roth IRA.

(2) Where the AGI of an active participant is between $30,000 and $40,000, the deductibility of a $2,000 IRA contribution would be gradually eliminated, but he or she could choose between contributing the remainder, or the full amount, of the $2,000 to a Roth IRA.[23]

1998	$30,000–$40,00
1999	$31,000–$41,00
2000	$32,000–$42,00
2001	$33,000–$43,00
2002	$34,000–$43,00
2003	$40,000–$50,00
2004	$45,000–$55,00
2005 and thereafter	$50,000–$60,00

For example, if a single individual, who participates in an employer's pension plan, reports $36,000 of AGI on his 1998 return, he could make a deductible IRA contribution of no more than $800 [$2,000 minus $2,000 ($6,000/$10,000)]. See section 219)(g)(3)(B)(ii) of the Code.

(3) Where the single active participant's *modified AGI* is between $95,000 and $110,000, the amount of the $2,000 contribution that can be contributed to a Roth IRA will be phased down to zero. Nevertheless, within, or above, this modified AGI range, the single filer may contribute the remainder of his or her $2,000 contribution to a traditional IRA, but only as an after-tax (nondeductible) contribution.[24]

B. Where the single individual is *not an active participant* in an employer plan, he or she may contribute the entire $2,000 as a deductible IRA contribution—re-

[21] See section 408A(c)(3)(A) of the Code.

[22] See section 219(c) of the Code.

[23] The deductibility of traditional IRA contributions is phased out for single individuals who are active participants in employer plans according to the following schedules:

[24] See section 408(o) of the Code for the rules on nondeductible contributions to traditional IRAs.

gardless of how high his or her AGI may be.[24] On the other hand, the ability of a single (or married) individual to make a Roth IRA contribution is not affected by whether or not he or she is an active participant, but the ability of a single individual to contribute to a Roth IRA will still phase out between modified AGI of $95,000 and $110,000.

C. With respect to a spouse who joins in a *joint return for 1998* and is an *active participant:*

(1) If joint return AGI is less than $50,000, his or her $2,000 may be used to make a fully deductible contribution to a traditional IRA or the full $2,000 may be contributed to a Roth IRA.

(2) Where joint AGI is between $50,000 and $60,000, the active participant spouse may still contribute the full $2,000 to a Roth IRA, but within this joint return AGI range the deductibility of the active spouse's traditional IRA contribution will be phased out for 1998. The active participant spouse could split the $2,000 between the portion that may be deducted as a traditional IRA contribution and a Roth IRA contribution. The deductibility of traditional IRA contributions is phased out for married individuals who file jointly and are active participants in employer plans according to the following schedules:

1998	$50,000–$60,00
1999	$51,000–$61,00
2000	$52,000–$62,00
2001	$53,000–$63,00
2002	$54,000–$64,00
2003	$60,000–$70,00
2004	$65,000–$75,00
2005	$70,000–$80,00
2006	$75,000–$85,00
2007 and thereafter	$80,000–$100,00

Note that the ratio of the statutory formula will change for tax years after 2006. For example, if a married couple, one of whom participates in an employer's pension plan, reports $84,000 of AGI on their 2008 joint return, the active participant could make a deductible IRA contribution of no more than $1,600 [$2,000 *minus* $2,000 ($4,000/$20,000)]. See section 219)g)(3)(B)(i) of the Code. The contribution of the other spouse would not be reduced.

(3) Between joint AGI of $60,000 and joint modified AGI of $150,000, the active participant spouse could not make a deductible IRA contribution for 1998, but could still contribute the full $2,000 to a Roth IRA.

(4) Between $150,000 and $160,000 of joint modified AGI, as the ability to contribute to a Roth IRA is phased down to zero, the remainder of the $2,000 contribution may only be used to make a nondeductible IRA contribution.

D. Where a couple files a joint return and *neither* spouse is an active participant, each can make a $2,000 deductible IRA contribution, no matter how high their AGI is for 1998 or a subsequent year. Alternatively, all or part of the $2,000 may be contributed to a Roth IRA—subject to the phase-out of Roth IRA contributions between joint return modified AGI of $150,000 and $160,000.

E. For tax years beginning after 1997, where a couple files a joint return and only *one spouse* is an active participant in an employer's plan, the deductibility of traditional IRA contributions made by or on behalf of the spouse who does not participate in an employer's retirement plan will, for most couples, no longer be affected by the other spouse's active participation. The deductibility of the traditional IRA contribution made by or for the spouse who is *not an active* participant will be phased out only as the couple's joint return AGI increases from $150,000 to $160,000. The statutory calculation of the deductible contribution is $2,000 reduced by an amount that bears the same ratio to $2,000 that the excess of AGI over $150,000 bears to $10,000.[25] The couple must file a joint return and the spouse who is an active participant in the employer's plan will still be subject to a deductibility phase-out that begins at AGI of $50,000 for 1998.

(1) Below $150,000 of joint return AGI, the entire $2,000 maximum contribution made by, or on behalf of, a spouse who is not an active participant (where the other spouse is) may be deducted as a traditional IRA contribution or allocated entirely to a Roth IRA.

[24] See the general rule of section 219(b)(1), as modified by section 219(g)(1) of the Code.

[25] See section 219)(g)(7) of the Code, as amended by a technical correction in the 1998 Act.

(2) IRA deductibility and Roth eligibility phase out between $150,000 and $160,000 of joint return AGI and modified AGI, respectively, for the nonparticipant spouse of an active participant, but he or she should be mindful of the fact that for a year where a traditional IRA is converted to a Roth IRA, the amount converted to the Roth will be included in AGI, but will not be included in modified AGI. Thus, even though AGI for the year may exceed $160,000 because of the conversion, the $100,000 modified AGI limit on the "conversion" of a traditional IRA to a Roth IRA (see "*Conversion to a Roth IRA,*" below) makes it highly likely that both spouses will be able to make the full $2,000 Roth contribution.

(3) Where the joint return modified AGI of a couple, one of whom is an active participant and the other is not, is above $150,000, all or a portion of each spouse's $2,000 total IRA contribution can only be made as a nondeductible traditional IRA contribution.

F. In the case of a married individual who files a *separate return:*

(1) Regardless of whether the individual or his or her spouse is an active participant in an employer's plan, a married individual's permitted Roth IRA contribution phases down to zero as separate return modified AGI increases from zero to $10,000.[26]

(2) Where the married individual filing a separate return is an active participant, or where his or her spouse is an active participant, the ability of either spouse to make a deductible IRA contribution will phase out between separate return AGI of zero and $10,000.[27] Any difference between $2,000 and the deductible and the Roth IRA contributions that are permitted may be contributed as a nondeductible IRA contribution.

(3) On the other hand, if neither the individual nor his or her spouse is an active participant, there will be no AGI limitation on the ability of a married individual filing separately to make deductible IRA contributions.[28]

The regulations interpret section 408A(c)(2) as providing that, where the total contributions for a year to a Roth IRA and a traditional IRA exceed the lesser of $2,000 or compensation, the excess contribution is deemed to have been made to the Roth IRA.[29] It would seem, however, that should an individual's contributions to a Roth IRA and a traditional IRA—after age 70½—exceed the lesser of $2,000 or compensation, the excess contribution should be deemed to have been made to the traditional IRA (to which contributions cannot be made after age 70½), but the regulations do not address this situation.[30]

CONVERSION TO A ROTH IRA

In addition to making the regular contributions of up to $2,000, owners may roll over or "convert" amounts in other IRAs to their Roth IRAs. The entire amount converted to a Roth IRA will be included in gross income, except that nondeductible contributions to a traditional IRA may be converted to a Roth IRA tax-free as a return of basis.[31] The chief benefit conferred by a valid Roth conversion is that a contribution, far in excess of the regular contribution limit, can begin generating tax-free earnings. The 10% premature distribution penalty will not apply to a valid conversion distribution, despite the fact that the distribution from the traditional IRA would fail to qualify for one of the exceptions under section 72(t)(3)(A).[32]

When considering a Roth IRA conversion, the distinction between AGI and "modified AGI" must be borne in mind. While the amount distributed from a traditional IRA in a conversion transaction is included in gross income and is, thus, included in the calculation of AGI, it is excluded from the calculation of a modified AGI amount used to determine eligibility to make the conversion.[33] Only those taxpayers whose modified AGI for the distribution year does not exceed $100,000 will be able to make a valid Roth IRA conversion.[34]

[26] See section 408A(c)(3)(A)(ii) and (C)(ii)(III) of the Code, as amended by the 1998 Act.
[27] See section 219(g)(3)(B)(iii) of the Code.
[28] See section 219(b)(1) of the Code.
[29] See Treasury regulation section 1.408A–3 A–3(d), Example 2..
[30] The excess contributed to the traditional IRA cannot be treated as a nondeductible contribution for purposes of section 408A(c)(2)(B) because under section 408(o) nondeductible contributions are limited to the amount allowed as a deductible IRA contribution, which would be zero after age 70½. Section 408A(c)(2)(A), however, uses the deductible IRA amount without reference to the age 70½ limitation.
[31] See section 408A(d)(3)(A)(i) of the Code.
[32] See section 408A(d)(3)(A)(ii) of the Code.
[33] See section 408A(c)(3)(C)(i) of the Code.
[34] See section 408A(c)(3)(B)(i) of the Code.

It is clear under the statute that a single taxpayer whose modified AGI exceeds $100,000 is ineligible to make a conversion. It is not entirely clear, based solely on the statute, whether the $100,000 modified AGI limit could apply individually to joint return filers. (It should be noted that a married individual filing separately is not eligible for a Roth IRA conversion.[35]) The regulations, however, interpret the somewhat ambiguous term "taxpayer's adjusted gross income" in the statute as requiring that modified AGI be based on joint return AGI.[36] The use of the term "taxpayer" arguably gave the IRS sufficient interpretive flexibility that the $100,000 modified AGI limit could have been applied individually to the husband and wife who file a joint return. In any case, the application of such a severe marriage penalty to Roth IRA conversions is indefensible as a matter of sound tax policy.[37] In defense of the IRS interpretation, however, The term "taxpayer" is also used to refer to the husband and wife filing a joint return in sections 408A(c)(3)(A)(i) and 219(g)(2)(A)(i) of the Code.

The only exception to the rule that a married individual who files a separate return is ineligible to convert an IRA to a Roth IRA applies for a married person who has lived apart from his or her spouse for the entire year in which the distribution is made. Such a separated spouse may convert a Roth IRA, despite filing a separate return, provided the $100,000 modified AGI limit is not exceeded on the separate return he or she files.[38]

A traditional IRA may be converted to a Roth IRA in any year, but if the conversion is made after December 31, 1998, the entire amount distributed from the traditional IRA will be included in the gross income of the year of the conversion. If the conversion is made before January 1, 1999, a special tax break is available—the inclusion in gross income will be spread ratably over four years—25% will be included in 1998 gross income and 25% will be included in each of the next three years.[39] The 1998 Act, however, added a provision permitting an individual to file an election to include the entire amount converted in 1998 gross income.[40]. The election to forego four-year spreading must be made on Form 8606 and cannot be made or changed after the *extended* due date of the 1998 return.[41] The final regulations clarify that a Roth IRA owner who was married at the time of the conversion may continue spreading the conversion amount over four years, even though he or she becomes divorced or separated during that period.[42] (For the applicable rules where the Roth IRA owner dies during the four-year spread period, see *Death of the Owner,* below.)

The actual conversion to a Roth IRA may be structured as a rollover distribution from the traditional IRA followed by a contribution to the Roth IRA within the normal 60 day period, a trustee-to-trustee transfer, or a transfer between a traditional and a Roth IRA maintained by the same trustee (which the final regulations clarify includes a simple redesignation of the same account.[43]) Whatever form the conversion actually takes, it must qualify as a rollover under section 408(d)(3), except that, unlike rollovers from one traditional IRA to another, rollovers to Roth IRAs are not limited to one per year.[44] Section 408A(e) provides that conversion contributions to a Roth IRA may be made only from another IRA. In other words, no distributions from corporate, section 401(k), section 403(b), section 457, or Keogh plans may be converted to Roth IRAs.[45] In fact, however, it appears that amounts may be converted to Roth IRAs from corporate and other qualified pension and profit-sharing plans—it just requires a two-step process. The amount in the qualified plan must first be rolled over to a traditional IRA in the normal way[46] and then converted to a Roth IRA.

---

[35] See section 408A(c)(3)(B)(ii) of the Code.

[36] See Treasury regulation section 1.408A–4 A–2(b).

[37] Nevertheless, a slight bias toward the single return filer also exists in the $15,000 phase-out period for regular Roth IRA contributions, as opposed to a $10,000 phase-out for joint return filers, under section 408A(c)(3)(A)(ii). With respect to traditional IRAs, the active participant phase-out periods of section 219(g)(2)(A)(ii) will be $10,000 for single filers and $20,000 for joint return filers for years after 2006.

[38] See section 408A(c)(3)(D) of the Code.

[39] See section 408A(d)(3)(A)(iii) of the Code

[40] Ibid.

[41] See Treasury regulation section 1.408A–4 A–10.

[42] Treasury regulation section 1.408A–4 A–11(c).

[43] See Treasury regulation section 1.408A–4 A–1(b)(3).

[44] See section 408A(e) of the Code, which provides that the annual rollover limitation of section 408(d)(3)(B) does not apply.

[45] See also section 408A(d)(3)(B) of the Code and Treasury regulation section 1.408A–4 A–5.

[46] See sections 402(c)(1) and (8)(B)(i) and (ii) of the Code.

Amounts in both SEP[47] and SIMPLE IRAs[48] may be rolled over to Roth IRAs, but distributions to a participant from a SIMPLE IRA cannot be rolled over to a Roth IRA (as well as a traditional IRA or a SEP IRA) until he or she has been a participant for two years.[49] The 1998 Act added section 408A(f)(1) to the Code which provides that a SEP or SIMPLE IRAs may not be "designated" as a Roth IRA. Although amounts in a SEP or SIMPLE IRA may be converted, the plan itself cannot be converted (using the term in a non-technical sense), such that future contributions under the SEP or SIMPLE IRA agreement can treated as made directly to a Roth IRA.[50] This amendment is evidently intended to remove any uncertainty about whether contributions could be made to a Roth IRA under the higher SEP and SIMPLE IRA limits and whether deductible employer contributions and contributions under salary reduction arrangements may be made directly to a Roth IRA, with the result that employer deductions from, and employee reductions in, income created by the SEP and SIMPLE IRA contributions will never be recovered by the Treasury.

Where a Roth IRA conversion straddles two years—i.e., the rollover contribution takes place within the 60-day window,[51] but in the year following the rollover distribution—some special rules apply. The regulations interpret the requirement that a husband and wife must file a joint return to be eligible to make a conversion as requiring that the joint return be filed for the year that the rollover *distribution* is paid from the traditional IRA, but apparently not for the subsequent year when the conversion contribution is made.[52] Even though the rollover contribution occurs in 1999, so long as the rollover *distribution* is made within 1998, the regulations provide that the conversion qualifies for the four-year spread period.[53] This provision is logical and fair. It is the distribution from the traditional IRA that creates the tax liability and the income should be recognized in the year in which the distribution occurs.

The regulations also provide that, where a Roth conversion is accomplished over two years, the $100,000 modified AGI limit that determines eligibility to make the conversion is required to be satisfied for the year of *distribution*.[54] This provisions is not logical—eligibility to make the conversion should be determined in the year of the conversion—but it is sensible because eligibility to make the conversion is easier to determine at the end of the year. Nevertheless, the inconsistencies in the rules applicable to two-year conversions create complexities to bog down administrators. (See *Reversing a Roth Conversion* and *Qualified Distributions,* below.)

No exception has been created from the withholding requirements of the Code for conversion amounts included in gross income. Regardless, it is likely that most individuals who convert IRAs will not have to file estimated tax returns to avoid the section 6654(a) penalty for underwithholding, even those who convert large dollar amounts, because most individuals receive refunds from their 1040s. Even where the conversion causes a large increase in 1998 tax liability, a taxpayer who received a refund in the previous year will be covered under section 6654(d)(1)(B)(ii), which provides that, if 100% of last year's tax liability (105% if last year's AGI exceeded $150,000) is withheld in the current year, the penalty for underwithholding will not be applied. Taxpayers who sent a check with last year's return, however, must have 90% of the current year's tax withheld to avoid the penalty.[55] Such taxpayers may have a problem if they made a large conversion and did not adjust their W–2 withholding or file estimated returns. It is in 1999, the second year of the four-year spread period, that most taxpayers will have to remember to factor into their withholding the tax on 25% of the amount converted.

Minimum Distribution Rules

Roth IRAs, unlike traditional IRAs under section 408(a)(6), are not subject to the "minimum distribution rules."[56] The minimum distribution rules require distributions to commence by April 1st of the calendar year following the year in which the

[47] See section 408(d)(3)(A)(i) of the Code, as made applicable by the general rule of section 408A(a) of the Code.

[48] See 408(d)(3)(G) of the Code, as made applicable by the general rule of section 408A(a) of the Code.

[49] See sections 408(d)(3)(G) and 72(t)(6) of the Code and Treasury regulation section 1.408A–4 A–4(a) and (b).

[50] See Treasury regulation section 1.408A–4 A–4(c).

[51] See section 408(d)(3)(A)(i) and (ii) of the Code.

[52] See Treasury regulation section 1.408A–4 A–2(b).

[53] See Treasury regulation section 1.408A–4 A–8.

[54] See Treasury regulation section 1.408A–4 A–2(a).

[55] See section 6654(d)(1)(B)(i) of the Code.

[56] See section 408A(c)(5)(A)(iii) of the Code.

owner attains age 70½ [57] and the entire interest in the plan must be paid over the life or life expectancy of the owner or the owner and a designated beneficiary.[58] The annual distributions must at least equal the quotient obtained by dividing the individual's account balance by the applicable life or joint and survivor life expectancy.[59] Roth IRA owners and administrators must be aware of the minimum distribution rule, however, because of the fact that to be valid, a Roth IRA conversion must satisfy the requirements for a traditional IRA rollover under section 408(d)(3). Section 408(d)(3)(E) provides that amounts required to be received as minimum distributions are not permitted to be rolled over to an IRA.[60]

The regulations make clear that section 408(d)(3)(E) applies to any Roth IRA conversion with the following consequences: (1) To the extent that the required minimum distribution has not been made for the year, the first dollars distributed (including a trustee-to-trustee transfer) from the traditional IRA in the conversion will be treated as coming from the required minimum distribution for that year.[61] (2) To the extent that a required minimum distribution is deemed to have been included in a conversion distribution, it will be treated as if it were distributed to the owner prior to the rollover and then contributed as a regular contribution to the Roth IRA.[62] An owner who does not understand the impact of the minimum distribution rules on a Roth IRA conversion may be liable for having made an excess contribution and, in 1998, for a failure to pay income tax. In this regard, it should be noted that, although the required distributions from a traditional IRA are permitted to begin as late as the April 1st of the calendar year following the calendar year in which the owner turns 70½, such distributions in the subsequent year, as is made clear in the preamble to the final regulations, are being made for the year in which the owner turned 70½.[63] Thus, if a conversion distribution is made in the year the traditional IRA owner turns 70½, it will be treated as including the required minimum distribution.

Although up to $2,000 of the minimum distribution that is inadvertently included in the conversion may qualify as a regular contribution to the Roth IRA, any excess of the included minimum distribution amount over $2,000 will be treated as an excess contribution subject to the 6% annual excess contribution penalty.[64] A second penalty trap may be sprung on 1998 conversions. The amount of any minimum distribution that is mistakenly converted in 1998 will still have to be included in gross income for 1998, but it is not eligible for the four-year spread period because it is not part of the 1998 conversion. The Roth IRA owner will, thus, underreport taxable income if he or she applies the four-year spread period to the minimum distribution amount mistakenly treated as part of a 1998 conversion.

The impact of this rule is surreptitious and difficult to justify on a policy basis—the minimum distribution amount would not escape being included in gross income because it is included in the conversion. The Congress can be faulted for creating this trap. Taxpayers may be misled by the language of section 408A(c)(5) stating that minimum distribution rules "shall not apply to any Roth IRA." The minimum distribution rules should have been made statutorily inapplicable to conversions as a simplification measure. The IRS may feel bound to their interpretation by the overlay rule of section 408A(a), but more detail about the application of the traditional IRA rules where gaps exist in the Roth statute would be helpful (on this issue and in general).

In addition, required minimum distributions are currently included in modified AGI.[65] Assuming an IRA owner is even aware of this treatment, the owner may still fail to separately account for the minimum distribution as an item of modified AGI because, based on the misapprehension that the minimum distribution amount can be included in a rollover, he or she believes that the rollover eliminated any funds in the traditional IRA that could be used for a minimum distribution. Where the

[57] See section 401(a)(9)(C)(i)(I) of the Code.

[58] See section 401(a)(9)(A)(ii) of the Code and proposed Treasury regulation sections 1.401(a)(9)–1 B–1.

[59] See proposed Treasury regulation sections 1.401(a)(9)–1 E–1 through E–8 and F–1 through F–4.

[60] See also section 402(c)(4)(B) of the Code.

[61] See Treasury regulation section 1.408A–4 A–6(a), which is consistent with Treasury regulation section 1.402(c)–2 A–7(a).

[62] See Treasury regulation section 1.408A–4 A–6(c).

[63] See also section 1.408A–4 A–6(b) of the regulations, which refers to "a year for which a minimum distribution is required (including the calendar year in which the individual attains age 70½)."

[64] See section 4973(f) of the Code and proposed Treasury regulation section 1.401(a)(9)–1 G–1B(a).

[65] See section 408A(c)(3)(C)(i) of the Code.

inclusion of the minimum distribution causes modified AGI to exceed $100,000, such a misapprehension could cause an owner who has attained age 70½ to make a "failed conversion"[66]—with the consequences that the deferral in his or her traditional IRA would be lost for nothing and, if the conversion is made in 1998, that taxable income would also be understated by an improper use of the four-year spread period. For taxable years beginning after December 31, 2004, however, Congress has sensibly eliminated minimum distributions from modified AGI.[67]

The regulations discuss the consequences of a full or partial conversion of a traditional IRA that is distributing substantially equal annual payments for the life or life expectancy of the owner or for the life or life expectancy of the owner and a designated beneficiary under section 72(t)(2(iv) of the Code. Not only will the amount of the conversion distribution will not be a premature distribution from the traditional IRA subject to the 10% penalty tax of section 72(t)(3)(A), but the conversion will not modify the annuity schedule, such that the special penalty under section 72(t)(4)(A) of the Code will apply, nor will the subsequent annuity payments from the Roth IRA be subject to the 10% penalty—despite being nonqualified distributions. The regulations note, however, that, if the 10% penalty is not to apply, the "original series of substantially equal periodic payments" must continue from the Roth IRA (except for the owner's death or disability) until five years from the first payment and until the owner has attained age 59½.[68] The final regulations also clarify that where the conversion occurred in 1998 and the income inclusion is being spread over four years, the "income acceleration rule" of section 408A(d)(3)(E)(i) will be triggered by the annuity payments during the spread period. Thus, in addition to the inclusion of the amount of the annuity payment for each year, a dollar of the deferred income from the 1998 conversion will be accelerated into current income for each dollar of annuity payment made in 1998, 1999, and 2000 up to the amount of the 1998 conversion.[69] (See *Conversion Anti-Abuse Rule, below.*)

Reversing a Roth Conversion

A failed conversion of a traditional IRA to a Roth IRA may subject the distribution to the 10% premature distribution penalty[70] and, to the extent the rollover amount exceeds the regular contribution permitted to be made to the Roth IRA, it will be subject to the excess contribution penalty.[71] After enactment of the Roth IRA provisions, Congress realized that taxpayers may not discover, until they are preparing their tax returns for a year, that they were ineligible to make a Roth IRA conversion in that year (typically because modified AGI exceeded $100,000). Section 408A(d)(6) of the Code, added by the 1998 Act, makes it possible to effectively reverse (or "recharacterize," as the term is used in the regulations[72]) a Roth IRA conversion by transferring the contribution, together with its earnings from the Roth IRA, back to a traditional IRA and, thus, avoid the imposition of penalties. It is also possible, under the same provision, to recharacterize a contribution that was initially made to a traditional IRA, as if it had been made initially to a Roth IRA.[73] In either case, the recharacterization must occur by the *extended* due date of the tax return for the year of the failed conversion.[74]

The recharacterization provision is a means to avoid being penalized for a contribution or conversion that proves, in hindsight, to have been a mistake. A recharacterization transfer is not, however, an alternative to a Roth conversion. A conversion is necessarily a taxable event because amounts are being transferred to a Roth IRA that were deducted when they were contributed previously to the traditional IRA. If traditional IRAs could be converted to Roth IRAs without these deductions being brought back into income, the Roth IRA conversion would amount to the

[66] Treasury regulation section 1.408A–8 A–1(b)(4) defines a "failed conversion as "a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed from a traditional IRA or SIMPLE IRA (including a transfer by redesignation) in a transaction that does not constitute a conversion under section 1.408A–4 A–1."

[67] See section 408A(c)(3)(C)(i)(II) of the Code, as amended by the 1998 Act.

[68] See Treasury regulation section 1.408A–4 A–12.

[69] Ibid.

[70] See section 72(t)(3)(A) of the Code.

[71] See section 4973(f) of the Code.

[72] See Treasury regulation section 1.408A–5 A–1.

[73] See section 408A(d)(6) of the Code.

[74] See section 408A(d)(7) of the Code. Particularly with respect to 1998 conversions, in order not to lose the benefit of the four-year spread period by missing the deadline, owners should be mindful of the distinction between the deadline for conversions—the end of the 1998 calendar year for 1998 conversions—and the recharacterization deadline—the extended return due date (August 15th for automatic extensions and October 15th for requested extensions).

Treasury paying citizens (by forgiving a tax indebtedness) to save on a tax-free basis.

A recharacterization is not a taxable event because the contribution made to a Roth (or traditional) IRA—referred to by the regulations as the "FIRST IRA"—is withdrawn and contributed to a traditional (or Roth) IRA—the "SECOND IRA"—within the period covered by a single tax return. No deductions can be taken for the contribution to the FIRST IRA and no deductions taken in previous years will go unrecovered by the contribution to the SECOND IRA.

For example, assume a calendar year taxpayer makes a regular contribution to a traditional IRA on January 1, 1998, and then recharacterizes the contribution by transferring it (together with its earnings from the traditional IRA) to a Roth IRA on August 15, 1999 (filing the return under an automatic extension). No deduction could be taken on the tax return for the traditional IRA contribution because it was canceled within the span of the same tax return. On the other hand, if the first contribution in 1998 was made to the traditional IRA by means of a rollover from a qualified plan, the rollover contribution could not then be transferred from the traditional IRA to the Roth IRA and labeled a recharacterization. This is because the recharacterization transfer is not available for contributions for which deductions have been taken that should be brought back into income upon being transferred to a Roth IRA.[75]

As a technical matter, the recharacterization provisions permit all *or a portion* of a regular or conversion contribution made during the year to the FIRST IRA to be transferred to the a SECOND IRA before the extended due date of the return for the year, with the transaction being treated as if the contribution to the FIRST IRA had actually been made to the SECOND IRA. (The transfer to the SECOND IRA is treated as being made on the same date that the initial contribution was made to the FIRST IRA.) As mentioned, the earnings on the contribution or portion of the contribution being transferred from the FIRST IRA to the SECOND IRA must also be included in the recharacterization transfer.

The preamble to the final regulations makes clear that an excess contribution from a prior year, which would otherwise be treated as a contribution for the current year under section 4973(f) (to the extent that actual contributions for the current year are less than the contribution limit for the current year), cannot be recharacterized, unless the extended due date of the return for the year of the excess contribution has not passed. Although such excess contributions are otherwise treated as having been made in the year for which actual contributions are less than the contribution limit,[76] according to the preamble, only actual contributions may be recharacterized and the excess contribution was actually made in the prior year.

Where a portion of a contribution is being recharacterized or where there have been other contributions to the account, the regulations provide that the amount of earnings that must also be recharacterized will be determined by reference to a relatively simple ratio in section 1.408–4(c)(2)(ii) of the regulations.[77] The fact that the regulations appear to gloss over the difficulty of adapting this ratio to a partial recharacterization of specific securities makes it seem likely that the ratio is intended to be used on a conceptual basis. In other words, it makes sense to assume that a trustee will be able to exercise judgment in allocating earnings in a partial recharacterization to come up with a sensible result where the section 1.408–4(c)(2)(ii) regulations would not provide it. It should be noted that the final regulation, by eliminating the parenthetical phrase "(but not below zero)" from section 1.408–4(c)(2)(iii), as incorporated by reference, make it possible to recharacterize a portion of an account or a mixed account where either has declined in value.

The form of the recharacterization transfer is explicitly limited by the statute to a trustee-to-trustee transfer. (apparently to promote accurate recordkeeping[78]). The final regulations clarify that where the owner who made the contribution dies within the time for recharacterizing it, the executor, administrator, or other person with the responsibility for filing the decedent's final income tax return may make the recharacterization election.[79] The final regulations also clarify that where there is only one trustee involved in a recharacterization, an actual transfer from the FIRST IRA to a newly created SECOND IRA is not required—the trustee may simply redesignate the FIRST IRA as the SECOND IRA.[80]

[75] See section 408A(d)(6)(B)(ii) of the Code.
[76] See e.g., proposed Treasury regulation section 1.219(a)–2(d).
[77] See Treasury regulation section 1.408A–5 A–2(c).
[78] See Treasury regulation section 1.408A–5 A–6(a).
[79] See Treasury regulation section 1.408A–5 A–6(c).
[80] See Treasury regulation section 1.408A–5 A–1.

The regulations provide that employer contributions and elective deferrals to SEP and SIMPLE IRAs cannot be recharacterized as IRA contributions.[81] This provision is only being consistent with the rule that contributions for which deductions were taken cannot be recharacterized—the deductions would have been taken on the employer's return in the case of the SEP and the elective employee contributions to the SIMPLE IRA would not have been included in gross income to begin with. The proposed (and now the final) regulations provided that an erroneous rollover contribution from a traditional IRA to a SIMPLE IRA (which are only permitted to accept contributions under salary reduction agreements) may be recharacterized.[82]. In addition, it seemed apparent, based on the fact that SEP and SIMPLE IRAs are IRAs under section 7701(a)(37) of the Code[83] and are, thus, covered by the literal language of section 408A(d)(6) of the Code, that the conversion of a SEP or SIMPLE IRA could be recharacterized. Nevertheless, the proposed regulations did not address the issue. The final regulations, however, do make it explicit that the conversion of an amount from a SEP or SIMPLE IRA to a Roth IRA may be recontributed to the same or a different SEP or SIMPLE IRA.[84]

So-called "conduit IRAs" represent an exception to the prohibition on rollovers from IRAs to section 401(a) or 403(a) qualified plans or section 403(b) annuities. Amounts may be rolled over from a qualified plan to an IRA and subsequently back to a qualified plan, provided the only amounts in the intervening IRA are attributable to rollovers from qualified plans. The same rule applies to section 403(b) plans.[85] The preamble to the regulations clarifies that a conduit IRA that is converted to a Roth, but then converted back to a traditional IRA will redeem its status as a conduit IRA because the effect of the recharacterization is that of a transfer directly from one conduit IRA to another conduit IRA.

Although individuals should generally elect out of 10% withholding under section 3405(b) of the Code upon a conversion to move more money into the Roth IRA, it is also advisable to do so in anticipation of a possible recharacterization. In the event of a recharacterization, the 10% withheld on the conversion is likely to be recoverable only against other taxes owed on the individual's return. The custodian will be unwilling to recontribute the 10% withheld to the traditional IRA if it has been forwarded to the Treasury. If, however, the custodian is willing to return the 10% withheld, the policy behind section 408A(d)(6) of the Code supports recontributing it to the traditional IRA as part of the recharacterization—even though technically the 10% withheld was not converted. Nevertheless, whether the 10% is contributed by the custodian or by the individual from fresh funds, no earnings will have accrued on the 10% withheld from the time of the conversion to the recontribution to the traditional IRA.

The regulations provide that the recharacterization must be made, as mentioned, by the extended due date of the return "for the taxable year for which the contribution was made to the FIRST IRA," e.g., the Roth conversion. The same provision of the regulations also provides that where a rollover contribution to a Roth IRA occurs in the year following the rollover distribution, the conversion will be treated as occurring in the year of the rollover *distribution.*[86] For other purposes in the regulations, however, where a rollover conversion straddles two years, the conversion is deemed to occur in the year of the rollover *contribution.*[87] At least for 1998 conversions, treating the rollover *distribution* date as the conversion date coordinates the recharacterization provision with the generous one-time exception provided under the regulations that qualifies rollover *distributions* that occur in 1998 for the four-year spread—even though the rollover contribution to the Roth IRA occurs within the 60-day window in 1999.[88]

Admittedly, the bulk of conversions are likely to have occurred in 1998 to take advantage of the four-year spread and a minority of the conversions in any year are likely to be two-year rollovers, but, where two-year conversions do occur subsequent to 1998, the recharacterization provision could cause confusion. For example, if a rollover distribution occurs in 1999 and the rollover contribution occurs 60 days later during 2000, the owner would be justified in believing that, because the conversion is treated as occurring in 2000 for other purposes, he or she has until the extended due date of the 2000 return to reverse a failed conversion. In fact, the con-

[81] See Treasury regulation section 1.408A–5 A–5.
[82] See Treasury regulation section 1.408A–5 A–4.
[83] See sections 408(k) and (p) of the Code.
[84] See Treasury regulation section 1.408A–5 A–5.
[85] See section 408(d)(3)(A) of the Code.
[86] See Treasury regulation section 1.408A–5 A–1(b).
[87] See, e.g., Treasury regulation section 1.408A–6 A–2 and A–5(c).
[88] See Treasury regulation section 1.408A–4 A–8.

version must be reversed by the extended due date of the 1999 return. It should be recalled that the modified AGI limit and the joint return requirement apply for the year of the rollover distribution where the conversion straddles two years,[89] but the existence of other provisions that are consistent with this exception adds to the potential for confusion. A helpful simplicity would have been created had the IRS been able to treat two-year conversions consistently. Treating the year of the rollover distribution as determinative would not only have been helpful in making the four year-spread available for 1998 distributions, but it would have eliminated a trap that has been created in the measurement of the five-year holding periods for qualified distributions and conversion contributions (see *Qualified Distributions,* below).

If, after the initial regular or conversion contribution is made to a Roth IRA (traditional IRA)—the FIRST IRA—there are one or more intervening transfers to other Roth IRAs (traditional IRAs) before the recharacterization or reversal transfer is made to the traditional IRA (Roth IRA)—the SECOND IRA—then the intervening transfers will be ignored. The individual may elect to treat the recharacterization transfer to the SECOND IRA as occurring on the date that the initial contribution to the FIRST IRA occurred and all the earnings from the date of the initial transfer would be credited to the SECOND IRA.[90]

Recharacterizations, even where limited to one a year, will create significant complexity for plan trustees. They must remember for information reporting purposes that the income or losses of the FIRST IRA will be treated as earned or incurred in the SECOND IRA, which is the IRA recharacterized as having received the contribution originally. If the first transfer was not kept entirely separate, then the earnings must be apportioned—an exercise for which the IRS has provided minimal guidance. Where two trustees are involved, the need for information sharing adds to the complexity.

[Due to the length of the attachment, it is being partially printed and the full attachment is being retained in the Committee files. If anyone wants a copy of the statement with the full attachment, please contact James O'Connor, America's Community Bankers, 202/857–3100.]

Statement of American Bankers Association

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on reducing the tax burden including pension reforms, health care incentives, long-term care incentives, estate and gift tax relief, and savings incentives.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks and thrifts—makes ABA the largest banking trade association in the country.

There are several proposals to reduce the tax burden on individuals and businesses that are of interest to banking institutions. The most significant proposals are set out more fully below.

INDIVIDUAL RETIREMENT ACCOUNTS

Inadequate personal savings is one of the most important long-term issues facing taxpayers in the coming years. Savings promote capital formation, which is essential for job creation, opportunity and economic growth. The banking industry fully supports continued efforts to encourage retirement savings and to strengthen IRAs. The primary appeal of the IRA concept to individuals is based upon its tax advantages, which are often viewed as a supplement to savings, making the IRA an appealing product for an individual's long-term savings growth. Individuals concerned about the availability of retirement funds can appropriately complement social security and other retirement savings vehicles with IRAs. Also, the tax penalties that accompany early withdrawals operate as an additional incentive to save for the long-term.

We commend Representatives Phil Crane (R–IL) [H.R. 1311, the "IRA Charitable Rollover Incentive Act of 1999"]; Bill Thomas (R–CA) [H.R. 1546, "the Retirement Savings Opportunity Act of 1999"]; Richard Neal (D–MA) [H.R. 1311, the "IRA Charitable Rollover Incentive Act of 1999"] and Jennifer Dunn (R–WA) [H.R. 1084,

[89] See Treasury regulation section 1.408A–4 A–2(a) and (b).
[90] See Treasury regulation section 1.408A–5 A–7.

the "Lifetime Tax Relief Act of 1999"] for introduction of legislation that would enhance IRAs and encourage retirement savings.

We urge you to include provisions enhancing IRAs in the next tax legislation enacted.

ESTATE TAX REFORM

The financial services industry has been involved in estate administration for many years. As a consequence, bankers have seen many times how families struggle to pay the taxes due when a death occurs, particularly when such death is unexpected. Some families encounter more than their fair share of obstacles when confronted with the required payment of a large death tax bill after the death of a loved one. The payment of death taxes with respect to a small business owner or farmer may be particularly difficult due to a lack of liquid assets in the estate. Indeed, the death tax will impact more taxpayers in the future as the value of estates increase as a result the continued strong growth of the equities market and the increase in the proportion of senior citizens to the general population.

The ABA strongly supports broad-based estate tax relief in order to allow small family business owners and family farmers to keep their businesses in the family. Any proposed tax law change should not increase complexity nor the time and effort expended by taxpayers in compliance. In this regard, we urge you to increase the unified credit or, in the alternative, to significantly reduce the current estate tax rates. However, we would oppose any proposal to eliminate both the estate and gift tax system and eliminate the step-up in basis rules for inherited property, as provided in certain Senate legislation (S. 1128, "the Estate Tax Elimination Act of 1999," introduced by Senator Jon Kyl (R–AZ)).

Bank trust departments, which often serve as executors to estates, are concerned that S. 1128 would place the burden of establishing the carryover basis on the executor. Determining the carryover basis would be extremely difficult if not virtually impossible in that, unlike property transferred in connection with a divorce or gift, the original owner would not be available for consultation. Also, records establishing the original purchase price of inherited property might not be available.

We urge you to include broad-based death tax relief in the next tax legislation enacted.

REDUCTION OF INCOME TAX RATES FOR TRUSTS AND ESTATES

The current rate structure complicates the decision-making process of fiduciaries to trusts and estates such as bank trust departments. A fiduciary may face possible criticism and subsequent litigation whenever a decision is made to accumulate funds within the estate or trust rather than distribute them. There are many legitimate reasons to accumulate assets within the estate or trust, such as payment of debts (including estate and inheritance taxes); provision of future education benefits to minor children; or care of surviving spouses, orphans, elderly parents, the mentally or physically disabled, or accident victims. High income tax rates for trusts and estates may also have an impact on investment decisions. One of the factors a prudent fiduciary takes into consideration when choosing a particular investment portfolio is the income tax consequence. Due to the compressed tax rates, a fiduciary may choose to invest trust or estate assets in tax-exempt income generating investments. This excludes investment choices such as equity mutual funds. Whatever decision the bank trust department makes may subject them to potential second-guessing by beneficiaries.

The ABA supports legislation that would provide that trusts and estates should be taxed at the same rates as individual taxpayers.

SHORT-TERM CAPITAL GAINS DISTRIBUTED BY MUTUAL FUNDS

The use of mutual funds as investment options for trust accounts is increasing every year. When a trust is invested in a mutual fund, it is not clear how dividends payable out of the short-term capital gains of a mutual fund are to be treated for tax purposes. The Internal Revenue Code requires the mutual fund to classify such sums as ordinary dividends. However, the short-term capital gains nature of such sums have caused banks in certain states to allocate them to principal by direction of the trust instrument or state law. Further questions arise as to whether this income, when allocated to principal, should be excluded from distributable net income (DNI) under Internal Revenue Code Section 643(a)(3) as gains from the sale of capital assets allocated to principal, and not paid or required to be distributed to beneficiaries. Another way to treat these sums is to include them in DNI as ordinary dividend income and make them potentially taxable to the trust income beneficiary under the rules of Section 652 for simple trusts and Section 662 for complex trusts.

Due to the lack of certainty in the law and regulations, the banking industry differs with respect to its handling of the treatment of such dividends and their includability in DNI. A similar issue obtains with respect to market value discount and currency gains, both of which are allocated to principal but taxable as ordinary income. These items are the result of bifurcating capital gains between income that is taxed as capital gain and income that is taxable as ordinary income.

We believe that Section 643 should be modified to specifically exclude such gains, taxable as ordinary income, from DNI. Such action would simplify the Code and reduce confusion.

MODIFICATION OF GENERATION SKIPPING TRANSFER TAX

Under current law, missed allocations of generation skipping transfer (GST) exemption create significant potential GST tax liability and no relief is available. The ABA supports legislation that would allow the IRS to grant relief to taxpayers who inadvertently fail to allocate GST exemption; allow validation of certain technically flawed exemption allocations; allow retroactive allocation of GST exemption in cases of unnatural order of death; automatically allocate a GST exemption to certain transfers; and permit division of trusts to allow taxpayers to maximize the benefit of the exemption without overly complex planning and drafting.

In this connection, we commend Rep. Jim McCrery (R–LA) for the introduction of H.R. 2158, the "Generation-Skipping Transfer Tax Amendments Act of 1999" and urge its inclusion in the next tax legislation enacted.

EMPLOYEE BENEFITS

The American Bankers Association supports long-term savings for retirement. Providing pension coverage to a greater number of workers will substantially enhance the retirement security of American families. The ABA supports initiatives that focus specifically on the need to make it easier and less expensive for small businesses to start retirement plans. We also support increased pension portability. Current law rules should be modified to facilitate transfer of employee retirement savings from job to job.

Finally, the overly complex rules governing retirement plans should be simplified to reduce costs and administrative barriers that keep employers out of the system, interfere with business transactions necessary to stay competitive in today's economic environment, and inhibit the efficient operation of plans sponsored voluntarily by employers for their employees.

We urge you to include such provisions in the next tax legislation enacted.

ELIMINATION OF 2% FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS IN CONNECTION WITH IRREVOCABLE TRUSTS

The ABA supports enactment of legislation that would Internal Revenue Code Section 67(e) to exclude irrevocable trusts from the 2% rule calculations. This would aid in administration of trusts and estates, as well as continue the efforts to further simplify the Code.

CONCLUSION

We appreciate having this opportunity to present our views on these issues. We look forward to working with you in the further development of solutions to our above-mentioned concerns.

AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES
(AFSCME) ET AL.
June 16, 1999

The Honorable Bill Archer
Chairman, House Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Re: *Support for Public Pension Provisions in HR 1102*

Dear Mr. Chairman:

The national organizations listed, representing state and local governments, public employee unions, public retirement systems, and millions of public employees, retirees, and beneficiaries, support public pension provisions contained in the bipartisan Comprehensive Retirement Security and Pension Reform Act (H.R. 1102) sponsored by Representatives Rob Portman, Ben Cardin, and many other members of Congress. This proposal would strengthen the retirement savings programs of public employers and their employees throughout the country. We are writing to urge your support for this important legislation.

The Comprehensive Retirement Security and Pension Reform Act would remove existing barriers between various types of retirement savings plans so that employees may have a better opportunity to manage and preserve their retirement savings when they switch jobs. The legislation would enhance existing portability in public sector defined benefit plans, and would allow workers to take all their deferred compensation and defined contribution savings with them when they change jobs. H.R. 1102 would additionally provide greater clarity, flexibility and equity to the tax treatment of benefits and contributions under governmental deferred compensation plans. Finally, it would simplify the administration of and stimulate increased savings in retirement plans by restoring benefit and compensation limits that have not been adjusted for inflation and are generally lower than they were fifteen years ago; repealing compensation-based limits that unfairly curtail the retirement savings of relatively non-highly paid workers; and allowing those approaching retirement to increase their retirement savings.

All of these provisions would help employees build their retirement savings, especially those who have worked among various public, non-profit and private institutions. Our organizations appreciate the support that you have shown on past public pension issues and are hopeful you will have similar interest in this comprehensive, bipartisan legislation. We ask that you please include these proposals in pending tax legislation before your Committee.

If you have any questions or need additional information, please contact the following members of our organizations:

Ed Jayne, American Federation of State, County and Municipal Employees
Ned Gans, College and University Personnel Association
Tim Richardson, Fraternal Order of Police
Tom Owens, Government Finance Officers Association
Chris Donnellan, International Brotherhood of Police Oganizations/National Association of Government Employees
Barry Kasinitz, International Association of Fire Fighters
Michael Lawson, International City/County Management Association
Tina Ott, International Personnel Management Association
Kimberly Nolf, International Union of Police Associations
Neil Bomberg, National Association of Counties
Susan White, National Association of Government Deferred Compensation Administrators
Bob Scully, National Association of Police Organizations
Jeannine Markoe Raymond, National Association of State Retirement Administrators
Jennifer Balsam, National Association of Towns and Townships
Ed Braman, National Conference on Public Employee Retirement Systems
Gerri Madrid, National Conference of State Legislatures
Cindie Moore, National Council on Teacher Retirement
David Bryant, National Education Association
Frank Shafroth, National League of Cities
Roger Dahl, National Public Employer Labor Relations Association
Clint Highfill, Service Employees International Union
Larry Jones, United States Conference of Mayors

Statement of AMR Corporation, Fort Worth, Texas

Introduction and Overview

Employer-sponsored defined benefit retirement plans play an integral role in guaranteeing retirement security. Yet arbitrary and onerous regulations can encourage certain employers to abandon such plans. This testimony outlines the comments of AMR Corporation on one aspect of how the Internal Revenue Code of 1986 (the "Code"), as amended, has been interpreted to impose unfair rules on the sponsors of defined benefit retirement plans permitting lump sum payments for retiring employees.

Under the Code, "qualified" pension plans must offer a lifetime stream of monthly payments to plan participants, commencing upon retirement. Many pension plans permit participants to receive the value of this lifetime income stream in a single lump sum payment. In determining the "present value" of the lifetime income stream that is being cashed out, the period over which payments are expected to be made (the period ending with the assumed date of death) and the rate at which funds are expected to grow (the assumed interest rate) are necessary assumptions. The interest rate and mortality assumptions are therefore critical in calculating the lump sum value of lifetime benefits.

The Retirement Protection Act of 1994 (the "RPA") amended section 417(e) of the Internal Revenue Code to specify an interest rate that must be used to convert a pension to a single lump sum. The RPA also authorizes the Secretary of the Treasury to prescribe a mortality table for use in calculating lump sums under section 417(e) of the Code. We perceive no problem with the current statutory language itself, only with its implementation by the Internal Revenue Service.

The Internal Revenue Service has prescribed a mortality table for use by retirement plans. We have no objection to the table itself. However, we are concerned with the requirement that the table is to be used together with the mandatory assumption that half of the participants covered by the plan are male and half are female.

The requirement that a plan must assume that half its participants are male and half are female is highly questionable. The participation in many plans is dominated by one gender. It is an accepted scientific fact that females, as a class, have a longer life expectancy than males, as a class. Prescribing an artificial "gender mix," therefore, artificially and inaccurately enlarges or contracts the true average life expectancy of the work force covered by the pension plan unless the plan's gender mix is actually in balance. Assumed life expectancy is a major factor in calculating the amount of a lump sum distribution and in funding plans, regardless of whether a lump sum distribution benefit is offered.

These regulations, which appear at Treas. Reg. Section 1.417(e)–1(d)(2) (the regulations) (effective April 3, 1998), do twist actuarial reality by arbitrarily imposing a mandatory gender neutral mortality table on pension plans that permit lump sum payments. A directly relevant revenue ruling, Rev. Rul. 95–6, 1995–1 C.B. 80, 95 TNT 2–1, contains provisions that operate in tandem with the regulations. Under these rules, regardless of whether the participants in a qualified defined benefit pension plan are 90 percent female or 1 percent female, all lump sum payments must be calculated using a mortality table that assumes the plan population is 50 percent female and 50 percent male. The IRS has essentially imposed a requirement that a pension plan comprised almost entirely of men must pretend that half its covered participants are women when it calculates its pension payments. These regulations give employers of work forces that are gender-imbalanced one more reason to abandon their defined benefit plans, or not to adopt them. We anticipate that this issue will raise more concern when companies with such plans realize that by 2000 all their lump sum distributions will have to be calculated based on this arbitrary gender assumption.

The legislative history accompanying the 1993 law mandating that Treasury create appropriate mortality tables gives no indication whatsoever that Treasury should issue such an arbitrary rule. If Treasury and the IRS are unwilling to change their rules to reflect actuarial reality, we hope that Congress will amend this law to mandate that Treasury utilize gender factors reflecting reality in those benefit plans where participant gender ratios are particularly unbalanced.

THE PROBLEM

A lump sum distribution from a qualified defined benefit pension plan to a participant is designed to be the "actuarial equivalent" of the payments that would otherwise be made during that participant's lifetime following retirement (or over the joint lifetime of the participant and the participant's spouse or other designated annuitant). To fund this lifetime income, a plan can use assumptions based on the expected lifetimes of its participants and can recognize, for example, that the covered participant population is 80 percent female and 20 percent male. The assumed mortality rates of participants is obviously a major factor in funding pension benefits, and it is a universally-accepted and well-documented fact that females will on average out-live males of the same age.

In contrast, if lifetime benefits are paid out in a lump sum, actuarial reality as described above for funding plans is ignored under current Internal Revenue Service rules. To determine the amount of lump sum payments, the regulations and Rev. Rul. 95–6 require plans to use a mortality table that assumes half the covered participant population is male and half is female. In the example given above (80 percent female and 20 percent male), the mandated 50/50 assumption artificially shortens the expected lifetimes of plan participants who are female, at least in comparison with the actual gender factors that can be used in the plan's funding. Nothing in the statute, which simply requires a "realistic" mortality table without reference to gender, mandates this arbitrary result.

Looking at this result from another perspective, the greater the gender disparity in favor of males, the more likely the plan will be underfunded if benefits are regularly paid in the form of a lump sum. Conversely, the greater the disparity in favor of females, the more the plan will become overfunded because expected lifetimes are artificially reduced.

CURRENT LAW

The Retirement Protection Act of 1994, enacted as part of the General Agreement on Trade and Tariffs, amended section 417(e) of the Code, as well as other sections of the Code and the Employee Retirement Income Security Act of 1974, as amended. GATT made two significant changes affecting the calculation of minimum lump sum payments. First, the statute redefined the applicable interest rate. Second, the legislation authorized the Treasury Secretary to prescribe a mortality table for use in calculating the present value of qualified plan benefits. Nothing in the legislative history of GATT indicates that Congress intended to preset a particular gender blend version of GAM 83.

Less than two months after passage of GATT, the Internal Revenue Service quickly published a mortality table in Rev. Rul. 95–6 for use under section 417(e). As provided in the statute, the Service's table uses the current prevailing commissioner's standard table for group annuities, or the 1983 GAM Table, which is a sex-distinct table (GAM 83). However, the ruling requires a 50/50 mandatory gender split assumption.

As mentioned above, the Secretary issued final regulations on both the new interest rate mortality table assumptions, in April of 1998. The regulations provide specific guidance on how the interest rate provisions are to be implemented. In contrast, for the applicable mortality table, the regulations provide only that the table is to be "prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin." Treas. Reg. Section 1.417(e)-I(d)(2). Treasury's approach of publishing the table required by the statute in a revenue ruling, instead of in the regulations, effectively precluded needed public comment on the 50/50 mandatory gender split that would have otherwise been required under the Administrative Procedures Act.

The adverse impact of the regulations will be felt particularly in industries where plans are collectively bargained. These plans, presumably for historical reasons, cover work forces that are frequently heavily skewed by gender. Collectively bargained workforces that are dominated by females include flight attendants and skilled nurses. Conversely, such workforces dominated by males consist of, for example, heavy construction, road building, pilots, long-haul trucking, movers of household goods, oil and gas, mining, and forestry workers. Accordingly, this arbitrary regulatory fiat will work to *overfund* pensions in industries where rates of female plan participation are particularly high and will work to *underfund* pensions where rates of male participation are high.

Rev. Rul. 95–6 hardly levels the playing field between annuities and lump sums. Male employees in male-dominated plan populations will be strongly encouraged to take their benefits in a lump sum in order to take advantage of the windfall, possibly exposing their retirement security to the increased risk of dissipation of their retirement "nest egg." Female employees in female dominated plans will receive less than they would if the plan assumptions reflected reality of workforce participation by gender.

EFFECT OF A 50/50 MORTALITY TABLE

The Service's 50/50-gender blend table has an unintended and inequitable effect on the level of funding and on the calculation of the present value of lump sum payments. As previously discussed, the primary focus of GATT was on reducing underfunding of pension plans. Accordingly, GATT's applicable mortality table was designed to prevent plan sponsors from making assumptions that placed plans at risk by minimized funding obligations. The 50/50 mortality table assumptions negate that goal by reducing a plan's ability to provide an accurate and adequate funding level. The 50/50 assumption, which can be objectively inaccurate, requires plan administrators to calculate actuarially inaccurate present values of lump sum payments, at least where plan population by gender is unbalanced.

For example, if an individual would receive a $1,000 lump sum payment at retirement based on GAM 83 using gender specific mortality, the following table presents the adjusted lump sum amount that would be paid to that individual using the 50/50 blended table:

Effect of Blended Mortality Table on Gender Specific Lump Sum of $1,000

Discount Rate: 7.0 percent

Age	Male	Female
55	1,042	955
60	1,053	944
65	1,068	929

This table shows that an age 60 male retiree receives a $53 windfall under the 50/50-blended table and an age 60 female retiree receives a $56 shortfall.

PROPOSED AMENDMENT

Congress should rectify this inaccurate treatment by amending the Code to include a rule addressing use of the required mortality table for those plans which contain a lump sum distribution option and which cover populations that are primarily male or primarily female. For example, the Code could be amended to include a proposal that would provide an alternative rule for determining the present value of a permitted lump sum payment if 80 percent or more of a plan's covered participant population is comprised of a single gender. In such cases, the plan would be permitted an election to utilize Treasury's applicable mortality table with the assumption that the dominant gender comprises 80 percent, and the minority gender comprises 20 percent, of the plan's covered participant population. In order to keep the proposal simple, the rule could provide that, if in any subsequent plan year the plan did not satisfy the 80 percent test then, in that and all successive plan years, the plan sponsor could not make such an election.

Statement of Associated General Contractors of America

Thank you Chairman Bill Archer for holding a hearing this morning on the effect of the death (estate) tax on family-owned construction companies. AGC is pleased to submit testimony today because elimination of the death tax is our top legislative priority for the 106th Congress. 94% of AGC members are closely-held businesses—often family-owned—and planning for and paying death taxes is an onerous burden our members will have to face at some point in the life of their company.

You'll notice throughout this testimony that we consistently refer to the estate tax as the "death tax." We prefer to call it the "death tax" for two reasons: 1) death of the owner of a company is the event that triggers the tax; and 2) at a rate of 37% to 55% on all company assets, this tax kills small businesses and kills jobs!

AGC is the nation's largest and oldest construction trade organization, founded in 1918. AGC represents more than 33,000 firms, including 7,200 of America's leading general contractors, and 12,000 specialty-contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, and site preparation/utilities installation for housing developments.

EFFECT OF DEATH TAXES ON CONSTRUCTION COMPANIES

Business continuity—the passing of years of hard work to the next generation—is a great concern to family-owned construction companies. Succession planning is long and difficult. Owners are forced to answer difficult questions about the future of the company they have often worked all their life to grow. Who will run the business when I'm gone? What does my family think should happen? How will ownership be transferred? These are just a few of the questions a contractor must address when undertaking succession planning.

As difficult as succession planning can be, it gets even worse when the owner realizes that up to 55% of his or her company can be lost to death taxes. When the owner of a construction company dies, his or her estate is subject to federal and state death taxes. The total value of the estate includes the value of the family business along with other assets such as homes, cash, stocks, and bonds. At a minimum, an estate over $650,000 (gradually increased to $1 million by 2006) will be subject to a federal death tax rate of 37% and an estate over $3 million will be taxed at an astronomical federal rate of 55%. This tax is on top of not only the state death tax but also the income, business, and capital gains taxes that have been paid over an individual's lifetime. It is not surprising, then, that more than 70% of family businesses do not succeed to the second generation and 87% do not survive to the third generation.

The construction industry is capital intensive, requiring large investments in heavy equipment. One single critical company asset can cost more than the amount ($650,000) of the unified credit. For instance, a 150-ton crane used in bridge construction can cost more than $1 million. A scraper can cost $700,000 and a large bulldozer can cost more than $800,000.

Most family-owned construction firms invest a significant portion of their after-tax profits in equipment, facilities and working capital. This is necessary for these firms to increase their net worth, create jobs and continue to be bonded for larger projects. Because of these assets, the construction industry is especially vulnerable to the devastating effect of the death tax.

Those family-owned construction companies that do survive after death taxes have spent thousands, sometimes millions, of dollars to plan for and pay death taxes. Of AGC firms involved in estate planning, 63% purchase life insurance, 44% have buy/sell agreements and 29% provide lifetime gifts of stock.

Last year, Richard Forrestel, a CPA and Treasurer for Cold Spring Construction in Akron, New York, testified succinctly before this Committee on what death tax planning has cost his company:

> "We spend in excess of $100,000 a year in insurance costs and accounting fees to ensure that we have the capital to pay the death tax and transfer our business from one generation to the next. We have diverted enormous amounts of capital and management time to this process. We ought to be buying bulldozers and backhoes built in Peoria, Illinois rather than wasting capital on intangible life insurance policies."

In sum, AGC believes that all the resources spent planning for and paying the death tax should be used more productively to grow businesses and create jobs.

CONSTRUCTION JOB LOSSES

The death tax not only affects the business owner, but also his or her employees. While the death tax rate on a company is 37% to 55%, for the worker who loses a job because of death taxes the rate is in effect an agonizing 100%! AGC's family-owned firms employ on average 40 persons and have created on average 12 new jobs each in the last five years. The death tax, however, can destroy these jobs because firms are often forced to sell, downsize or liquidate to pay this onerous tax. On average, 46 workers lose their jobs every time a family-owned business closes. And every time an owner foregoes the purchase of new equipment because resources have been diverted to pay death taxes, the workers who use and build that equipment are impacted.

Also, remember the effect these family-owned businesses have on their immediate community. Family-owned businesses not only offer jobs, but they are a vital part of every community providing specialized services, supporting local charities, and returning earnings back to the local economy.

ECONOMIC EFFECTS OF THE DEATH TAX

A most frustrating aspect of death taxation is that after all the countless hours and financial resources spent preparing for and paying the tax, it raises almost no revenue for the federal government! Annual death tax receipts total approximately $23 billion, less than 1.4% of total tax revenue.

Furthermore, the Congressional Joint Economic Committee released a report last year on the death tax that found that this tax "raises very little, if any, net revenue for the federal government." The JEC also concluded that the tax results in losses under the income tax that are roughly the same size as the death tax revenue.

LEGISLATION SUPPORTED BY AGC

AGC appreciates the efforts made by Congress in lowering the death tax as part of the Taxpayer Relief Act of 1997. However, Congress needs to do much more than simply increase the unified credit to help the growing number of family-owned businesses facing the death tax. The construction industry urges Congress to focus on eliminating death tax rates. As stated earlier, the construction industry is capital intensive and even the smallest contractors have lifetime assets that easily exceed the unified credit amount.

In the House, we strongly support H.R. 8, introduced by Reps. Jennifer Dunn and John Tanner, that calls for gradual elimination of the death tax by 5% per year over a period of ten years. We also support H.R. 86, introduced by Rep. Chris Cox, that calls for full and immediate repeal of this tax. We urge you to include legislation eliminating the death tax in any upcoming tax legislation.

SUMMARY

The death tax has become an American nightmare at the end of the American dream for family-owned construction companies. Construction company owners work hard to grow their business. They create jobs for people in their community. They pay federal and state taxes throughout the life of their company. But then, when they die, the federal government steps in and takes over half of their company. It is unthinkable in a time of surplus that our government imposes a tax that raises so little revenue while it devastates businesses and kills jobs. AGC urges you to pass legislation to eliminate this terrible tax.

Thank you for the opportunity to present testimony this morning.

Statement of Certified Financial Planner Board of Standards, Denver, Colorado

The Certified Financial Planner Board of Standards, Inc. is submitting this testimony to the United States House of Representatives Committee on Ways and Means for inclusion in the written record of the June 16, 1999 hearing before the Committee on Enhancing Retirement and Health Security.

The Certified Financial Planner Board of Standards, Inc., known as the CFP Board, is pleased to provide information concerning Americans' financial futures for the United States House of Representatives, Committee on Ways and Means. The CFP Board is the professional regulatory organization for over 34,000 CFP marks holders or licensees. The CFP Board was formed in 1985 to benefit the public by fostering professional standards in personal financial planning.

The CFP Board wants the Committee to be aware of a very serious problem in this country. Americans are not saving *nearly* enough for retirement. They are not investing properly, most of them do not have any kind of financial plan for their retirement years, they do not understand the differences between managing money before and after retirement, and they are very uncomfortable with making the plans for their financial futures. So far, the solutions Congress has created have not addressed the situation.

One can not read a paper or magazine, hear the radio, or watch the television news without seeing something about the retirement crisis facing this country. A 1997 Consumer Federation of American and NationsBank survey found only one in three savers has a comprehensive retirement plan. In many ways, it is fair to say financially, this is a nation at risk. Many Americans are finally starting to realize their future is in their own hands. In a self-directed, defined contribution plan world, they need to be able to properly plan for their financial futures since government sources are not nearly going to cover all of our expenses in retirement.

The CFP Board's September 1998 testimony before the Department of Labor's ERISA Advisory Council Working Group on Small Business provided the results of a 1998 survey of CFP marks licensees. The survey revealed 67% of CFP licensees' prospective clients consider their employer's retirement plans as their primary source for funding retirement goals. However, CFP licensees report only a quarter of their prospective clients are contributing the maximum amount to their pension plans. These figures are even more disturbing when we realize that those seeking financial planning advice are more aware of the need for retirement than the general population.

The state of Americans' financial planning is not surprising. Over the past 20 years, this country has undertaken a massive transfer of financial responsibility from professional pension plan managers to everyday workers. Retirement planning has moved away from the old defined benefit pension plans that required absolutely no input from participants, provided a guaranteed monthly income for life and were managed by highly trained professionals. Now, those plans are largely a variety of self-directed defined contribution plans, such as the 401(k), that require participants to manage their own accounts. Essentially, American workers have become their own pension plan managers.

The problem is that very few American workers have ever had any education or training in retirement or financial planning. Securities and Exchange Commission Chairman Arthur Levitt in an April 1999 speech stated, "The plain truth is that we are in the midst of a financial literacy crisis. Too many people don't know how to determine saving and investment objectives or their tolerance for risk. Too many people don't know how to choose an investment, or an investment professional, or where to turn for help."

As an educational resource to the American Institute of Certified Public Accountant's (AICPA) Retirement Security through Financial Planning Coalition, the CFP Board strongly believes the retirement education proposals contained in section 520 of H.R. 1102 (Portman-Cardin) and Section 503 of S. 741 (Graham-Grassley) will encourage American workers to plan and save for their financial futures. However, a greater service could be done for American workers if the provisions went beyond simply retirement and included financial planning.

Financial planning is the process of meeting life goals through the proper management of personal finances. Life goals can include buying a home, funding a child's education, passing along a family business, or planning for the years after retirement. Financial planning provides direction and meaning for financial decisions. It allows one to understand how each financial decision affects other areas of personal finances. For example, buying a particular investment product might help pay off a mortgage faster, or it may delay retirement significantly. By reviewing each financial decision as part of a whole, one can consider short and long-term effects on life goals. One can also adapt more easily to life changes and feel more secure about reaching life goals.

In their 1997 9th Annual Retirement Planning Survey, Merrill Lynch, Inc. found people with financial plans feel more confident about their investment skills and ability to achieve their financial goals. Those with a written plan prepared by a professional are most confident. Half of people who have professionally prepared financial plans and 44% of those with self-prepared plans are "very confident" they will realize their financial goals. Less than a third of the people with no plans feel this confident, and 20% are not very or not at all confident they will realize their goals. People who have financial plans are significantly more likely to have a written budget and to put money into savings before paying other expenses (41% of planners put money in savings first then pay bills while only 14% of people who have no plans did). These figures demonstrate the urgent need for Americans to have the opportunities and incentives to develop plans for their financial futures.

The CFP Board believes if the proposals contained in section 520 of H.R. 1102 and Section 503 of S. 741 become law, the nation will be making an investment in the retirement security of the American worker. These two proposals are a step though in achieving retirement security through financial planning. There are many other steps and reaching them all will require commitment. As Peter Druker said,

> "Unless commitment is made, there are only promises and hopes... but no plans."

If Congress wants to help Americans reach their financial goals and not simply make promises to them and raise their hopes, it must commit to helping them plan for the future.

Statement of Committee To Preserve Private Employee Ownership

INTRODUCTION

This statement is submitted on behalf of the Committee to Preserve Private Employee Ownership ("CPPEO"), which is a separately funded and chartered committee of the S Corporation Association. To date, 34 employers have joined CPPEO and more than 45,000 employees across the country are represented by CPPEO companies.

CPPEO welcomes the opportunity to submit a statement to the Ways and Means Committee for the written record regarding the goal of enhancing Americans' retirement security. CPPEO wishes to bring to the Committee's attention the proposal in the Administration's Fiscal Year 2000 Budget that would subject the income of S corporation ESOPs to the unrelated business income tax ("UBIT"). This proposal is inconsistent with the goal of enhancing Americans' retirement savings and cannot be reconciled with the Administration's own stated goal of enhancing retirement savings, as reflected in the 17 revenue proposals included by the Administration in its Fiscal Year 2000 Budget to promote expanded retirement savings, security, and portability. The Administration's proposal would effectively repeal key provisions in the Taxpayer Relief Act of 1997 (the "1997 Act")[1] that allowed S corporations to create ESOPs in order to promote employee stock ownership and employee retirement savings for S corporation employees. CPPEO urges the Committee to reject the Administration's S corporation ESOP proposal and other proposals which would inhibit the creation or the viability of S corporation ESOPs, and continue to allow S corporations to have ESOP shareholders as contemplated in the 1997 Act. Only by retaining the fundamental policies of the 1997 Act can the Committee continue to preserve and promote retirement savings for the hundreds of thousands of S corporation employees in the United States.

LEGISLATIVE HISTORY OF S CORPORATION ESOPS

In the early 1990s, efforts began to enact legislation that would allow S corporation employees to enjoy the benefits of employee stock ownership that were already conferred on C corporation employees. Finally, in 1996, Congress included a provi-

[1] P.L. 105–34.

sion in the Small Business Jobs Protection Act of 1996 (the "1996 Act,")[2] that allowed S corporations to have ESOP shareholders, effective for taxable years beginning after December 31, 1997. This provision, which was added just prior to enactment, established Congress' desire to see S corporation ESOPs established, but did not result in a viable method to allow S corporation ESOPs to be created or sustained.

Specifically, a 39.6 percent tax (the unrelated business income tax of Internal Revenue Code section 511,[3] or "UBIT") was imposed on employees' retirement accounts with respect to the ESOP's share of the income of the sponsoring S corporation and any gain realized by the ESOP when it sold the stock of the sponsoring S corporation. The imposition of UBIT on S corporation ESOPs meant that the same income was being taxed twice, once to employees' ESOP accounts and a second time to the employees' distributions from the ESOP. Accordingly, owning S corporation stock through an ESOP would subject employees to double tax on their benefits, while individuals holding S corporation stock directly would be subject to only a single level of tax.

The 1996 Act had another defect that made ESOPs an impractical choice for providing employee retirement benefits to S corporation employees—the right of ESOP participants to demand their distributions in the form of employer securities. By law, S corporations cannot have more than 75 shareholders and cannot have IRAs or certain other qualified retirement plans as shareholders. Therefore, S corporations generally could not adopt ESOPs without taking the risk that the future actions of an ESOP participant—such as rolling over his or her stock into an IRA—could nullify the corporation's election of S corporation status.

Moreover, the 1996 Act did not provide S corporation ESOPs with the incentives that are provided to encourage C corporation ESOPs. For example, under section 1042, shareholders that sell employer stock to a C corporation ESOP are allowed to defer the recognition of gain from such sale, while S corporation shareholders cannot do so. In addition, under section 404(a)(9), C corporations are allowed to make additional deductible contributions that are used by an ESOP to repay the principal and interest on loans incurred by the ESOP to purchase employer stock, though this is also not permissible for S corporations. C corporations are also allowed deductions under section 404(k)—deductions for which S corporations are ineligible—for dividends paid to an ESOP that are used either to make distributions to participants or to repay loans incurred by the ESOP to purchase employer stock. In addition, as a practical matter, S corporation ESOP participants are unable to use the "net unrealized appreciation" exclusion in section 402(e)(4) because this benefit applies only to the distributing of employer stock, which S corporations cannot do.

In the 1997 Act, Congress reaffirmed its policy goal of making viable ESOPs available to the employees of S corporations and addressed the problems with the ESOP provisions in the 1996 Act. Recognizing that S and C corporations are fundamentally different entities, Congress did not provide S corporation ESOPs with all the advantages and incentives provided to C corporation ESOPs (such as the favorable tax treatment for shareholders selling stock to the ESOP and increased deductions and contribution limits for the sponsoring employer discussed above), but it did fix the critical problems. The double tax on S corporation stock held by an ESOP was eliminated by exempting income attributable to S corporation stock held by the ESOP from UBIT. Thus, only one level of tax was to be imposed, and it would be on the ESOP participant when he or she received a distribution from the ESOP. S corporation ESOPs also were given the right to distribute cash to participants in lieu of S corporation stock in order to avoid the problems of potentially ineligible S corporation shareholders and the numerical limit on S corporation shareholders.

While in 1997 it was clear that a key feature of the legislation was that S corporation ESOPs would not have the same incentives afforded to C corporation ESOPs, Congress provided different, but comparable benefits to S corporation ESOPs.

First, the income of S corporation ESOPs under the 1997 Act is subject to only a single level of tax. This is a fundamental characteristic of the taxation of S corporations and their shareholders. As Assistant Secretary of Treasury Donald Lubick commented in testimony to this Committee in March of this year, no one, including the Administration, disputes that only one level of tax should be imposed on S corporations and their shareholders.

The second benefit provided to S corporation ESOPs is that the one level of tax is *deferred* until benefits are distributed to ESOP participants. Considerable thought was given in 1997 relating to whether this deferral tax was appropriate. Various

---

[2] P.L. 104–188.

[3] All "section" references are to the Internal Revenue Code of 1986, as amended.

ways of taxing S corporation ESOPs and their participants were considered in 1997, including ways essentially the same as the Administration's proposal, and were rejected by Congress as being too complex, burdensome, and unworkable. In order to achieve a workable S corporation ESOP tax regime with incentives that were roughly commensurate with those available to C corporation ESOPs, Congress determined that the deferral of the one level of tax, in lieu of the special incentives afforded to C corporation ESOPs, was appropriate. The Administration's proposal and others which have followed simply reject this determination just 18 months after Congress acted.

The Administration's S Corporation ESOP Proposal Would Undermine Congressional Retirement Savings Policy

The Administration's S corporation ESOP proposal would undermine the Congressional policy of allowing S corporations to establish ESOPs for their employees principally because it will not only end deferral, but also will reinstate double taxation. The Administration's proposal to allow a deduction to the ESOP for distributions to participants would effectively create double taxation.

S corporation ESOPs would be required to pay UBIT for all the years that they hold S corporation stock, but would not be allowed any way to recover those taxes until distributions are made to participants. The rules limiting the timing of distributions by an ESOP to its employee participants, like the rules for all qualified retirement plans, are designed to encourage long-term retirement savings and are intended to produce the result that distributions to an employee will occur many years, even decades, after the employee first becomes a participant in the ESOP. A 2-year carryback and a 20-year carryforward of excess deductions, as is suggested by the Administration's proposal, will not ensure that the taxes paid by the ESOP over many years, even decades, will be recovered. Thus, there is no assurance that a future deduction will prevent double taxation of employee benefits. Moreover, it would encourage ESOP's to make distributions earlier, rather than later—a practice that is wholly inconsistent with Congress' intent to create ESOPs as long-term vehicles for earnings and retirement security. Most telling though, is that the *estimated revenue to be raised by the Administration's proposal is the same as the revenue cost of the 1997 Act, demonstrating that the Administration's proposal is simply an attempt to repeal the provisions of the 1997 Act and is not aimed at preventing what it claims are unintended uses of current law.*

The Administration's proposed scheme and other similar proposals for eliminating tax deferral have another substantial defect. That is, any tax refunds to the ESOP for the tax deductions allowed to the ESOP cannot be fairly allocated and paid to the employee participants. Assume, for the sake of illustration, that employees A and B are the participants in an S corporation ESOP, each owning an equal number of shares of S corporation stock through the ESOP. A and B work for the next 20 years and the ESOP pays tax on the income of the S corporation attributable to their shares of stock. Then A decides to retire and the ESOP sells the shares of stock in A's account to the S corporation and pays A the proceeds. The ESOP receives a deduction for the distribution to A and is able to reduce its UBIT liability for the year it makes a distribution to A. In this example, there would be no way the ESOP could use the full amount of the deduction for the year it makes a distribution to A, nor would it be able to fully use the excess amount when it carries the excess deduction back two years. Thus, the ESOP would not be able to realize the full benefit of the deduction, which was intended to allow the ESOP to recoup the taxes it paid over the past 20 years with respect to the stock in A's account and, presumably, give A that benefit to offset the second level of taxes A will pay. By the time the ESOP realizes all the benefits of the deduction, A will have long ceased to be a participant in the ESOP and those benefits will be allocated to the remaining participant, B.

In addition, it is not clear how the ESOP could properly allocate the benefits that it can immediately realize. The deduction is allowed for distributions to participants. After the proceeds from the sale of the stock in A's account are distributed to A, A ceases to be a participant. The ESOP cannot make any additional allocations or distributions to A. As the sole remaining participant, B will receive the benefit of those deductions.

The Administration's proposal also resurrects a problem under ERISA that the 1997 Act eliminated. The imposition of UBIT on S corporation ESOPs raises concerns about fiduciary obligations under ERISA for potential ESOP plan sponsors and trustees. The potential for double taxation and the inequitable allocation of benefits among plan participants will make the establishment of S corporation ESOPs unpalatable to anyone who would be subject to ERISA. In addition, qualified plan trustees typically avoid investments that give rise to UBIT because it obligates the trustee to file a federal income tax return for the plan's UBIT liability. Under the Administration's proposal, the establishment of an S corporation ESOP would *necessarily* involve making investments that give rise to UBIT liability because ESOPs are *required* to invest primarily in employer securities. By making S corporation stock an unviable investment for ESOPs, the Administration's proposal and others like it would prevail against the establishment of many of these retirement savings programs. This clearly contradicts Congress' intent.

The Administration's proposal and others attempt to characterize the treatment of S corporation ESOPs as a corporate tax shelter. These proposals, however, fail to note that the beneficiaries of S corporation ESOPs are the *employees,* not the S corporation. Moreover, in testimony before this Committee, Assistant Secretary Lubick made it clear that the Administration's only concern is that there may be attempts by some persons to use the S corporation ESOP provisions as a device to gain tax deferral rather than to provide retirement savings benefits to employees. Current law was enacted to do just what it is doing—encouraging employee ownership of S corporations. *Indeed, advocating the repeal of a successful retirement program—just 18 months after its enactment directly contradicts the Administration's stated objective of increasing retirement savings, as reflected in the 17 retirement savings proposals included in its Fiscal Year 2000 budget.*

CPPEO's S Corporation ESOP Anti-Abuse Proposal

CPPEO and other organizations have, in response to a request from Ways and Means Committee staff, developed an anti-abuse rule that addresses the issue of potential misuses of S corporation ESOPs while preserving the ability of S corporation employees to be owners of their companies through ESOPs and accrue long-term retirement savings. The joint proposal is narrowly targeted to penalize only the persons who might otherwise misuse the ESOP for their own advantage, or the advantage of members of their families, rather than for the benefit of S corporation employees. To this end, CPPEO proposes that such an anti-abuse rule apply to persons who *control* an S corporation which has misused its ESOP and who are consequently *responsible* for the misuse of the ESOP to defer tax on their income from the S corporation.[4] Accordingly, persons who individually benefit from the deferral of a substantial portion of the S corporation's income and who collectively have control of the S corporation would be denied the retirement benefits of an S corporation ESOP. The penalty for such persons' misuse of an S corporation ESOP to gain deferral of tax on S corporation income would be the loss of tax deferral for such persons and *not the disqualification of or tax on, the ESOP*. Disqualification of, or tax on, the ESOP would unfairly harm the retirement savings of non-controlling S corporation employees, the intended beneficiaries of the S corporation ESOP provisions, whose interests in the ESOP reflect the allocation of retirement benefits in accordance with the requirements that apply to qualified retirement plans.

The anti-abuse provision described above preserves the use of S corporation ESOPs to provide retirement benefits to S corporation employees as Congress intended, and explicitly prevents the misuse of S corporation ESOPs by those persons who, through their control of the S corporation, might otherwise seek to use an ESOP simply to defer tax on the S corporation income of themselves and their families rather than provide retirement savings benefits to their S corporation employees.

CONCLUSION

Current law is working to encourage employee ownership of S corporations and promote employee retirement savings, exactly as it was intended to work when Congress amended the ESOP rules for S corporations in the 1997 Act. Accordingly, CPPEO urges the Committee to reject the Administration's S corporation ESOP tax proposal because of the great danger it poses to the retirement security of S corporation owners who do or can now rely on ESOPs as a major (or only) source of retirement savings. The tax and retirement policies reflected in the 1997 Act, resolved just a few months ago, should not now be undone. The targeted anti-abuse legisla-

[4] To implement this approach, CPPEO urges that Congress enact an amendment to section 1361 to provide that controlling 20-percent employee-owners would be taxed currently on S corporation income attributable to S corporation stock held by them through the ESOP, and on S corporation income attributable to their holdings of "synthetic equity" (such as options, restricted shares, stock appreciation rights, or similar instruments) in the S corporation. In this manner, the benefit of tax deferral on S corporation income attributable to the use of an ESOP would be denied to the controlling shareholders who improperly employ the ESOP (alone or in combination with synthetic equity) to gain such tax deferral for themselves or their families, but would not be denied to non-controlling employees who participate in the ESOP.

tion supported by CPPEO is the appropriate response to any concerns that S corporation ESOPs could be used for unintended purposes.

Statement of J. Michael Keeling, President, ESOP Association

Chair Archer, ranking member Rangel, and members of the Committee, I am Michael Keeling, President of The ESOP Association, a national trade association based in Washington, D.C., with over 2,100 members nationwide, two-thirds of which are corporate sponsors of Employee Stock Ownership Plans, or ESOPs, and other members are either providing services to ESOP company sponsors, considering installing an ESOP, or affiliated with an educational, or non-profit institution.

We come today because the press release announcement for today's hearings set forth that the subject matter for review is "Enhancing Retirement and Health Security."

I come with this statement to you on behalf of The ESOP Association to urge the Committee, at its very first opportunity, which will hopefully be during your consideration of a 1999 tax relief bill pursuant to the Congressional FY 2000 budget resolution, to adopt an expansion of the current law pertaining to the deduction of dividends paid on ESOP stock.

Before describing what the change is that we want, and why it is good retirement savings, and good employee ownership policy, permit me to indicate to you the widespread support for the proposal among members of this Committee, members of the House, members of the Senate, and private sector employers and groups that represent those employers.

To note, the proposal we urge you to adopt is Section 510 of H.R. 1102, "The Comprehensive Retirement Security and Pension Reform Act of 1999," introduced primarily by Congressmen Portman, and Cardin of your Committee. Although their list of co-sponsors grows daily, the latest from the world wide web indicates 23 members of Ways and Means are sponsors, along with 81 members of the House. Just last Thursday, June 10th, your colleague and senior member of the House Committee on Education and the Workforce, Cass Ballenger introduced H.R. 2124, "The ESOP Promotion Act of 1999," and Section 2 is the same as Section 510. Your colleagues Congresswomen Nancy Johnson and Karen Thurman, and Congressmen Levin and Ramstad joined as original co-sponsors of Mr. Ballenger's pro-ESOP bill. (The provision we are discussing will be referred to as Section 510, as a shorthand reference.)

Section 510 is included in Senate bills S.1132, "The ESOP Dividend Reinvestment and Participant Security Act," by Senators Breaux and Hatch, and S. 741, "The Pension Coverage and Portability Act," primarily by Senators Grassley and Graham of Florida. Both have attracted bi-partisan Senate support.

But the proposal contained in Section 510 did not crop up at the last minute for inclusion in these bills promoting either retirement savings or employee ownership—this proposal was born in 1997, with the introduction by Breaux and Hatch of the 1997 ESOP Promotion Act, and was duplicated by Congressman Ballenger in H.R. 1592, which had 8 members of Ways and Means as co-sponsors. These two ESOP promotion bills, introduced in the second quarter of 1997, soon had their provision on dividend reinvestment included in the 1998 version of the Portman-Cardin, and Grassley-Gramm.

The history gets even better Chair Archer, because the Oversight Subcommittee of Ways and Means focused on this provision at its May 5, 1998, hearings, when Mrs Johnson was chair of the Subcommittee, as it reviewed our pension laws, and how to make them more palatable to increasing retirement savings.

At that hearing, members of the Subcommittee heard testimony from the private sector, from Mr. Ballenger, and from trade groups endorsing the expansion of the deduction for dividends paid on ESOP stock.

In fact, on October 20, 1998, then Chair of the Oversight Congresswoman Johnson wrote to you an interim report from the Subcommittee based on its series of hearings and said, among other things, as an interim recommendation that "The rules applicable to the deductibility of the dividends which an employer pays with respect to ESOP stock should be addressed and an expansion of the ESOP option should be explored."

Now, the next few weeks before your final decision on the provisions of the 1999 tax relief bill for provisions to enhance retirement savings is the time to make last year's interim recommendation a permanent pro-savings, pro-employee ownership recommendation.

Now you should explore the questions, "What is Section 510 and how will enactment of section 510, as so many have recommended enhance retirement savings?"

The ESOP Association strongly believes that the answer to these questions will persuade this Committee to adopt Section 510 as part of a 1999 tax relief bill.

So, let us answer the questions set forth above:

What is Section 510? To answer the question, we first have to understand current law pertaining to dividends paid on stock in an ESOP. (Note, an ESOP is a tax-qualified defined contribution plan that must be primarily invested in employer securities that may borrow money to acquire employer securities. In other words, it is an ERISA plan that is akin to a tax-qualified profit sharing plan. An ESOP must comply with all the laws, regulations, and regulatory guidance pertaining to ERISA plans, plus many unique, Congressionally sanctioned incentives and restrictions to ensure ESOPs are both "ownership" plans, and secure "ERISA" plans.)

Internal Revenue Code Section 404(k) provides that dividends paid on ESOP stock are tax deductible if they are passed through in cash to the employee participants in the ESOP, or if they are used to pay the debt incurred by the ESOP in acquiring its employer securities, and the employees receive stock equal in value to the dividends. This section of the Code was added to the tax code in 1984, and modified in 1986, and in 1989.

Section 510 provides that if a sponsor of an ESOP pays dividends on ESOP stock that may be passed through the ESOP in cash to the employee, and the employee in turn has indicated that he or she would like the dividends "reinvested" in the sponsor's dividend reinvestment program, the sponsor can still take the Section 404(k) deduction.

Now, to the second question asked above—Why would Mr. Portman, Mr. Cardin, Mr. Ballenger, Mrs. Johnson, et al want to have this proposal considered? Well the reason is simple, but typical of most of our tax law, we have to be careful to make the simple explanation understandable.

The IRS has taken the position that when the employee voluntarily authorizes his or her dividends on his or her ESOP stock to be reinvested in the ESOP sponsor's dividend reinvestment program, the value of the dividends is not tax deductible for the ESOP sponsor.

Let me repeat what I just said—if the employee wants to reinvest his or her dividends on ESOP stock in more stock to be held in the ESOP or a co-ordinated 401(k) plan in order to have more savings, the IRS says, "No tax deduction." Think about it, the IRS is saying, "spend the money now, do not save it for the future," or at least that is the impact of the position.

But the situation in the real world gets even worse in the view of ESOP advocates, as there is a way for the plan sponsor to keep its tax deduction and for the employee to save more by keeping his or her dividends in a 401(k) plan. But this way is convoluted to a great extent, requiring the creation of some legal fictions that serve no purpose except to make life more complex and expensive for the sponsor of the ESOP and 401(k) plan.

Again, here is the explanation. There is a technique that the IRS has blessed in several letter rulings back in 1993 and 1994 that is called the 401(k) switchback. Getting a switchback program set up involves quite a bit of rigmarole, and I am not going to pretend that what follows is a perfect explanation of the technique.

In brief, under a suitable program, an ESOP participant is allowed to make an additional pre-tax deferral to the 401(k) plan equal to the amount of the ESOP dividends passed through to her or him. The plan sponsor then pays the ESOP dividends to the company payroll office, and there is a chain of paper that has established an agency relationship between the ESOP participant and the payroll office. (This is done by signing forms, etc. etc.)

If the ESOP participant elects the additional 401(k) deferral equal to her or his ESOP dividends, his or her paycheck would reflect the ESOP dividend amount and the additional pre-tax deferral to her or his 401(k) account. The paycheck has gone neither up or down for his or her personal tax situation.

Now an employee can elect not to make an additional 401(k) deferral, and thus have his or her dividend paid, and have personal tax liability on the amount.

As noted the IRS has held that the plan sponsor does not lose the ESOP dividend deduction in a switchback scheme as broadly outlined above if the dividends are first paid to the payroll office, and the employee has entered into a written agency agreement with the payroll office.

One expert in designing these 401(k) Switchback programs writes,

> "Because the dividend pass-through/401(k) switchback feature involves a considerable amount of work to implement with regard to treasury and payroll procedures (including software programming changes), the company will want to carefully assess the anticipated value of the program both in terms of the expected dividend deduction and enhanced employee owner-

ship values." Duncan E. Harwood, Arthur Anderson Consulting, LLP, "Dividend Pass-Through: Providing Flexibility," Proceedings Book, *The 1995 Two Day ESOP Deal,* Las Vegas, Nevada, page 158, The ESOP Association.

In short, Section 510 is to simplify encouraging people to save their dividends paid on ESOP stock in a manner that encourages the corporation to pay dividends in an employee owner arrangement, compared to accomplishing the same thing in a convoluted way.

Now, lets turn to the third question set forth at the beginning of this statement. Please remember the answer to this question would go a long way in determining whether the Congress will want to make Section 510 law.

The answer to this question should be self-evident. The current IRS position is anti-savings and anti-simple. To encourage saving the dividends on ESOPs in a tax-qualified ERSIA plan in a manner that is simple and easy to understand, Section 510 should become law.

Otherwise, we can all accept the IRS position that in order to encourage the savings of the ESOP dividends the plan sponsor should engage in some mumbo-jumbo involving the payroll office being an agent for employees who just happen to figure out how to increase their 401(k) elective deferrals and who tell their "agent" to put their dividends in the 401(k) plan.

In conclusion Chair Archer, the ESOP and employee ownership community, in allegiance of sponsors of 401(k) plans and dividend reinvestment plans, believe that your focus on enhancing retirement savings will lead you and your colleagues to conclude that Congress should enact Section 510.

And, let me pledge that the ESOP community will work with you, your colleagues, Committee staff, the staff of the Joint Tax Committee, and Treasury staff, to ensure that any legislative action on Section 510 meets its intent to be a fair and reasonable provision of law, both in terms of application and revenue impact, that promotes savings, and employee ownership.

Again, I thank you for your leadership in the area of retirement savings.

Statement of ESOP Coalition, Somerset, New Jersey

This written statement is submitted on behalf of the ESOP Coalition, an informal organization of more than 30 large and small corporations doing business in the communications, banking, oil and gas, utilities, manufacturing, automobile, retail, and insurance industries. Our work is also supported by many trade associations, including the Association of Private Pension and Welfare Plans (APPWP); the ERISA Industry Committee (ERIC); the ESOP Association; the Financial Executives Institute (FEI); the National Association of Manufacturers (NAM); and the U.S. Chamber of Commerce.

The ESOP Coalition commends the Committee and its Chair for their proactive role in addressing the vital issues now facing this country in securing important retirement protections for our workers and retirees. With record numbers of workers on the verge of retirement, and many young people entering the workforce and commencing participation in their employer's retirement programs for the first time, it is more important than ever before that our nation's employees understand their own roles and responsibilities in saving for the years when they no longer will be working and that our laws and policies encourage this discipline where possible.

One proposal currently before this Congress would accomplish the worthwhile goal of enhancing retirement security while at the same time strengthening the very backbone of the American economy: a worker's commitment to his or her employer. This provision would further these diverse goals by allowing employees to retain in the plan dividends paid on employer stock held in an employee stock ownership plan (an "ESOP") without causing the employer to lose the deduction for these ESOP dividends.

Current law affirms the importance of fostering employee ownership in the company by permitting an employer to deduct the dividends paid on employer stock held in an ESOP. This deduction is given (under § 404(k) of the Internal Revenue Code), however, only if the dividends are used to pay off the loan held by a leveraged ESOP or the dividends are paid in cash to the ESOP participants. *No deduction is generally available for dividends that the employee would wish to retain in the ESOP rather than consume immediately.* Although one Internal Revenue Service "solution" exists whereby some workers are able to reinvest some dividends in a 401(k)/ESOP, this approach is neither practical nor efficient and often is not available to all participants in the ESOP. In addition, many employees receive no benefit from this approach because the reinvested dividends offset the elective deferrals they might otherwise make to their 401(k) plan rather than being treated—like all other dividends and interest—as earnings under the plan.

Thus, current law not only discourages the reinvestment of ESOP dividends, it also deprives employees of an efficient means of steadily accumulating an ever-growing ownership interest in the employer and greater retirement income. A simple change to § 404(k) of the Code would correct this anomaly by giving employees the additional choice of retaining their dividends in the ESOP instead of receiving the dividends in cash.

Many in Congress have recognized the desirability of amending § 404(k) of the Code to encourage the retention of dividends in an ESOP. In particular, we applaud Rep. Rob Portman (R–OH) and Rep. Benjamin Cardin (D–MD) and many other Members for supporting this provision in H.R. 1102, "The Comprehensive Retirement Security and Pension Reform Act of 1999," as well as Rep. Cass Ballenger (R–NC) for introducing the "ESOP Promotion Act of 1999," which also contains this change. This provision also has been included in comparable bipartisan pension reform bills in the U.S. Senate.

Employees today appreciate that their retirement years will be vastly more comfortable if they systematically set aside the money that will sustain them during their post-working years and not allow the dissipation of any of their hard-earned savings through periodic dividend pay-outs. Promotion of the reinvestment of ESOP dividends is sound tax policy—not only because it stems the "leakage" of retirement savings, but also because it furthers one of the primary purposes of an ESOP, encouraging employees to participate more fully in their employer's growth. Thus, this provision fosters employee responsibility and productivity while simultaneously building retirement security.[1]

The ESOP Coalition commends the Committee and its Chair for their important work in addressing the issues of retirement security and urges that this provision to encourage the reinvestment of ESOP dividends be accorded a top priority in Congressional efforts to secure comprehensive pension reform.

Statement of Financial Planning Coalition

This Statement is being submitted to the Ways and Means Committee of the United States House of Representatives by the Financial Planning Coalition for inclusion in the written record of the June 16, 1999, hearing before the Committee on Enhancing Retirement and Health Security. The members of the Financial Planning Coalition are the American Institute of Certified Public Accountants, the Consumer Federation of America, the Institute of Certified Financial Planners, the International Association for Financial Planning, the Investment Counsel Association of America, and the Society of Financial Service Professionals. The Certified Financial Planner Board of Standards, Inc. is an educational consultant to the Coalition.[1]

[1] For a discussion of the evidence supporting the finding that employee ownership improves the performance of publicly traded corporations, see "Unleashing the Power of Employee Ownership," a July 1998 Research Report by Hewitt Associates LLC.

[1] The American Institute of Certified Public Accountants is the national professional association of CPAs in the United States with more than 330,000 members in public practice, business and industry, government and education.

The Consumer Federation of America is a non-profit association of some 260 pro-consumer groups. It was founded in 1968 to advance the consumer interest through advocacy and education.

The Institute of Certified Financial Planners is a professional membership association that exclusively serves Certified Financial Planner licensees.

The International Association for Financial Planning is the largest and oldest membership association representing the financial planning community, with 123 companies as members of the Broker-Dealer Division and over 17,000 individual members nationwide.

The Investment Counsel Association of America is a national not-for-profit association that exclusively represents SEC-registered investment advisors.

The Society of Financial Service Professionals was formerly known as the American Society of CLU & ChFC. Founded in 1928, it is composed of 32,000 members who are dedicated to serving the financial needs of individuals, families, and businesses.

The Certified Financial Planner Board of Standards, Inc. is a non-profit professional regulatory agency that was founded in 1985. It owns and sets the standards for using the CFP certification mark and the marks CFP and Certified Financial Planner.

BACKGROUND

The convergence of the growing complexity in the financial marketplace, and the shifting of a significant portion of financial and investment decision making from professionals to the American public has created a significant need for financial planning services to be more easily accessible. Financial planning services must include both education and individual professional assistance to help lead individuals through the financial marketplace. The use of education and financial planning assistance will help Americans to effectively manage their finances in ways that allow them to provide for their families today and have a secure and comfortable retirement.

THE CHANGING MARKETPLACE

The financial world that Americans are living in has become increasingly complex. Because of dramatic changes in the way pensions are funded, as well as a growing reliance on personal savings to fund retirement and other major life goals, individuals increasingly make retirement and financial planning decisions that were once made for them by professionals. Even for those who are financially sophisticated, the determination of how much money must be saved for each individual's varied future needs, especially for retirement, and how that money should be invested is difficult. For those who are not financially sophisticated, the complexity of the decisions that must be made and the myriad choices that are available make these decisions truly daunting.

Perhaps the most important change is the sea change in the type of retirement plans of the American worker in the last 20 years. In 1975, sixty eight percent of pension plans were defined benefit plans.[1] These plans defined the amount of the benefit the worker would receive upon retirement very simply—the worker would get a check for a specific amount every month for the rest of his/her life. The worker did not have to make any decisions regarding the amount of money that must be saved for retirement or how to invest the money.

By 1994, fifty percent of pension payments were made from defined contribution plans.[2] These plans generally require the worker to determine how much to save for retirement and how to invest the money. Cash balance plans are also becoming very popular. They give the employee the flexibility of having a portable pension—one that goes with the worker when there is a change in employers—but they also often require the worker to make investment decisions when there is a change in employers.

Also, workers today change jobs much more often than in previous years, either due to greater opportunities existing in a tight labor market, or due to layoffs accompanying consolidation and downsizing. Changing jobs potentially dilutes a worker's retirement benefits because the worker leaves a position before benefits have vested and/or because some pension provisions disfavor leaving early in a career (e.g. the pension benefit is calculated as a percentage of an employee's top three years of salary).

Another factor has added to the complexity of managing investments and retirement funds. The number and type of investment options has skyrocketed in the last 20 years. Not only have whole new classes of investments been made available, such as Roth IRAs and the complex world of derivatives, but within each type of investment the number of choices has increased exponentially. For example, in 1983, just 15 years ago, there were 1,026 mutual funds to choose from. In 1998, there were 7,314.[3]

Because of these changes, the ability of each American to retire in comfort increasingly depends on his or her proficiency in making sound investment decisions. And sound investment decisions encompass how much to save for various needs and how to invest the money that is saved. Even for the relatively sophisticated, making the mathematical calculation to determine how much we need to save in order to have a specific income at retirement is not an easy calculation. Seventy-five percent of American workers do not know how much money they will need to reach their retirement goals.[4]

---

[1] Employee Benefit Research Institute Databook on Employee Benefits, 4th Edition.
[2] *Id.*
[3] 1999 Mutual Fund Fact Book, 39th Ed., pub. By the Investment Company Institute.
[4] Yakoboski and Dickemper, Increased Saving but Little Planning: Results of 1997 Retirement Confidence Survey, Employee Benefit Research Institute Brief (Nov. 1997).

Yet there is a crisis in savings at the very time that savings is becoming crucial to the long term well being of the American public.[5] The personal savings rate in this country has fallen to a minus 0.7%.[6] In a 1998 survey taken by the Employee Benefit Research Institute, thirty six percent of those surveyed had no money saved for retirement (a summary of the survey is attached).[7] These statistics underscore the need to educate Americans about the need for retirement planning.

EFFECT OF FINANCIAL PLANNING

We believe that the cornerstone of retirement income security is proper financial planning and education (attached is a copy of a letter sent to all Members of the Ways and Means Committee by the Coalition). This was a finding of the 1998 National Summit on Retirement Savings that was held in Washington, D.C. The consensus of the delegates attending the Summit was that the overall solution to the savings crisis is education, provided from qualified sources, and made available to current workers and retirees over an extended period of time. This Summit was mandated by the SAVERS Act and co-hosted by the Administration and Congressional leadership. A 1997 survey by the Consumer Federation of America and NationsBank (now Bank of America) confirms this finding (a copy of the survey is attached). The survey found that savers with financial plans report twice as much savings and investment as do savers with comparable incomes, but without plans.

THE COMPREHENSIVE RETIREMENT SECURITY AND PENSION REFORM ACT—H.R. 1102

The Comprehensive Retirement Security and Pension Reform Act was introduced this year by Congressmen Rob Portman (R–OH) and Benjamin Cardin (D–MD) and had a total of 98 co-sponsors on June 28, 1999. Section 520 of the bill contains an important first step in making financial planning available to American workers.

Section 520 of this bill does two things. First, it clarifies that the provision of retirement planning services by an employer to employees is a de minimis fringe benefit under Section 132 of the Internal Revenue Code. This is a clarification of existing law. It is clear under current law that it is a de minimis fringe benefit when an employer provides a seminar to a group of employees to provide information about the employer's pension plan. However, it begins to fall into a gray area when the employer adds the availability of a one-on-one meeting for an employee to discuss his/her personal situation, especially when the discussion goes beyond the application of the employer's pension plan and encompasses other aspects of the employee's financial situation.

It is critical that this area be clarified. Retirement planning cannot be done in a vacuum. One of the key questions to be answered is how much money can and should be saved for retirement purposes. Included in this determination must be the consideration of what other assets may be available at retirement, including from sources such as Social Security and a spouse's pension. But that is only the first step. The individual must also determine how much money is currently available to save for retirement. And this can only be determined by looking at the employee's entire financial situation, determining what other needs exist and how much money can and should be allocated for those needs. Examples of some other critical financial needs that must be factored into this calculation are education savings for children and provision to help care for elderly parents.

The second part of Section 520 would allow the employer to create an employee benefit plan for its employees regarding retirement planning that is similar to a "cafeteria plan." This would allow the employer to offer retirement planning or, in lieu of the planning, additional salary. If the retirement planning service is chosen, there would be no income imputed to the employee by reason of taking the service instead of the salary.

These retirement planning benefits would have to be offered on a non-discriminatory basis. This would ensure that the rank and file employee, not just the highly compensated employee, would have access to the benefit.

Enactment of Section 520 will provide a concrete first step to help Americans achieve retirement security. This is a first step because it will only reach a limited number of people. Not all employers will offer these benefits to their employees. Large employers will be more likely to offer such benefits than will small employers. And self-employed individuals, independent contractors, and part time employees

---

[5] The SAVER Act (P.L. 105–92 (1997)) (passed unanimously by Congress) noted that we have a crisis of savings in this country.

[6] Advisory from the Committee on Ways and Means of the United States House of Representatives, No. FC–10, June 2, 1999.

[7] 1998 Retirement Confidence Survey by the Employee Benefit Research Institute.

who do not receive a full range of benefits will not receive these or other retirement planning services.

CONCLUSION

Financial planning and education has become a critical element of every American's ability to live and retire in comfort. Not only do people save more, but they save smarter when they have the proper education and tools. Unfortunately, the provision of education and financial planning tools is trailing the changes in the marketplace that are making them necessary.

Section 520 of H.R. 1102 is a good starting point in the move to make financial planning services and education available to all Americans. If Section 520 is enacted, a substantial number of Americans will have access to financial planning services that were previously unavailable. And the provision of these retirement planning and education services will prove their worth when they cause a substantial number of workers begin to save for retirement that have not done so yet, and cause workers who are saving for retirement to save more and to invest it more wisely. Section 520 offers a foundation upon which other efforts to increase American's access to financial planning services can be built.

May 24, 1999

The Honorable Bill Archer
U.S. House of Representatives
Longworth House Office Bldg.
Washington, DC 20515–0001

Re: RETIREMENT PLANNING IS CRITICAL TO ENSURE THE FUTURE SECURITY OF THE AMERICAN WORKER

Dear Representative Archer:

We are writing to ask you to support legislative endeavors which would make retirement planning more available to the American workforce. A proposal contained in both H.R. 1102 and S.741 would make it clear that the value of employer provided retirement planning assistance is not a taxable fringe benefit to an employee.[1]

The ability of each American to retire in comfort increasingly depends on his or her proficiency in making sound investment decisions. This means that the cornerstone of retirement income security is proper financial planning and education.[2] Recent surveys and studies have underscored the critical need for retirement planning education among today's workers.

Only one in three savers has a comprehensive retirement plan.[3]

75% of America's workers do not know how much they will need to reach their retirement goals.[4]

36% of those surveyed have no money saved for retirement.[5]

Of all workers, only 39% received employer provided educational material about retirement planning.[6]

Evidence also exists that retirement education is a key element in ensuring retirement security for workers:

---

[1] Sec. 520 and Sec. 503 respectively of H.R. 1102, *the Comprehensive Retirement security and pension Reform Act (the Portman-Cardin bill) and S. 741, Pension Coverage and Portability Act (the Grassley-Graham bill).*

[2] The SAVER Act (P.L. 105–92 (1997)) (passed unanimously by both houses of Congress) noted that we have a crisis of savings in this country. A summit was mandated by this law to establish recommendations to encourage savings. One of the main findings of the 1998 National Summit on Retirement Savings (co-hosted by the Administration and Congressional leadership) was that employers must be urged to "educate employees about the importance of retirement savings."

[3] 1997 Survey of Consumer Federation of America and NationsBank (now Bank of America).

[4] Yakoboski and Dickemper, Increased Saving but Little Planning: Results of 1997 Retirement Confidence Survey, Employee Benefit Research Institute Brief (Nov. 1997). (hereinafter cited as the Yakoboski study).

[5] 1998 Retirement Confidence Survey by the Employee Benefit Research Institute. (Hereinafter cited as the Retirement Confidence Survey).

[6] Retirement Confidence Survey.

Savers with financial plans report twice as much savings and investments as do savers without plans.[7]

81% of workers who received retirement education have money earmarked for retirement in an account.[8]

These findings are both alarming and encouraging. It means that many of today's workers will reach and are reaching retirement age with too little income for retirement. These findings also provide hope. The studies show that those individuals that receive retirement education significantly increase their savings and investments. If we are to encourage national savings, we must encourage education to empower each American to make the most of his or her investment choices. Retirement planning services provided by employers to their employees must be encouraged and promoted but—should not be taxed!

Sincerely,

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC. (AS AN EDUCATION CONSULTANT TO THE AICPA)
CONSUMER FEDERATION OF AMERICA
INSTITUTE OF CERTIFIED FINANCIAL PLANNERS
INVESTMENT COMPANY INSTITUTE
INVESTMENT COUNSEL ASSOCIATION OF AMERICA
SECURITIES INDUSTRY ASSOCIATION

May 24, 1999

The Honorable Xavier Becerra
U.S. House of Representatives
Longworth House Office Bldg.
Washington, DC 20515–0001

Dear Representative Becerra:

Re: RETIREMENT PLANNING IS CRITICAL TO ENSURE THE FUTURE SECURITY OF THE AMERICAN WORKER

We are writing to ask you to support legislative endeavors which would make retirement planning more available to the American workforce. A proposal contained in both H.R. 1102 and S.741 would make it clear that the value of employer provided retirement planning assistance is not a taxable fringe benefit to an employee.[1]

The ability of each American to retire in comfort increasingly depends on his or her proficiency in making sound investment decisions. This means that the cornerstone of retirement income security is proper financial planning and education.[2] Recent surveys and studies have underscored the critical need for retirement planning education among today's workers.

Only one in three savers has a comprehensive retirement plan.[3]

75% of America's workers do not know how much they will need to reach their retirement goals.[4]

---

[7] 1997 Survey by Consumer Federation of America.

[8] Retirement Confidence Survey.

[1] Sec. 520 and Sec. 503 respectively of H.R. 1102, the Comprehensive Retirement security and pension Reform Act (the Portman-Cardin bill) and S. 741, *Pension Coverage and Portability Act* (the Grassley-Graham bill).

[2] The SAVER Act (P.L. 105–92 (1997)) (passed unanimously by both houses of Congress) noted that we have a crisis of savings in this country. A summit was mandated by this law to establish recommendations to encourage savings. One of the main findings of the 1998 National Summit on Retirement Savings (co-hosted by the Administration and Congressional leadership) was that employers must be urged to "educate employees about the importance of retirement savings."

[3] 1997 Survey of Consumer Federation of America and NationsBank (now Bank of America).

[4] Yakoboski and Dickemper, Increased Saving but Little Planning: Results of 1997 Retirement Confidence Survey, Employee Benefit Research Institute Brief (Nov. 1997). (hereinafter cited as the Yakoboski study).

36% of those surveyed have no money saved for retirement.[5]

Of all workers, only 39% received employer provided educational material about retirement planning.[6]

Evidence also exists that retirement education is a key element in ensuring retirement security for workers:

Savers with financial plans report twice as much savings and investments as do savers without plans.[7]

81% of workers who received retirement education have money earmarked for retirement in an account.[8]

These findings are both alarming and encouraging. It means that many of today's workers will reach and are reaching retirement age with too little income for retirement. These findings also provide hope. The studies show that those individuals that receive retirement education significantly increase their savings and investments. If we are to encourage national savings, we must encourage education to empower each American to make the most of his or her investment choices. Retirement planning services provided by employers to their employees must be encouraged and promoted but—should not be taxed!

Sincerely,

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC. (AS AN EDUCATION CONSULTANT TO THE AICPA)
CONSUMER FEDERATION OF AMERICA
INSTITUTE OF CERTIFIED FINANCIAL PLANNERS
INVESTMENT COMPANY INSTITUTE
INVESTMENT COUNSEL ASSOCIATION OF AMERICA
SECURITIES INDUSTRY ASSOCIATION

[Additional attachments are being retained in the Committee files.]

Statement of Food Marketing Institute

Thank you, Chairman Archer, for holding a hearing on proposals to reduce the tax burden on personal savings. We particularly wish to focus on the effect of the estate tax on family-owned businesses. The Food Marketing Institute (FMI)—Your Neighborhood Supermarkets is pleased to submit testimony today because elimination of the estate and gift tax is our top legislative tax priority for the 106th Congress. About 1,000 of our members are family-owned supermarket companies. In fact, half of our members are one-store operators. Most of their money is tied up in assets-costly stores, refrigeration systems and thousands upon thousands of products. The burden of planning for and paying estate taxes is a critical issue for their companies.

The bricks and mortar to build a supermarket can cost $3 million alone, so most grocery store owners, even the smallest have personal assets taxed at the top marginal rate of 55%. This tax kills family businesses and affects local jobs. We also have less than 20 minority-owned grocers, most first-generation business owners-the first in their families to accumulate capital—who wonder if their children will be able to succeed them and participate in the great American economy. Our members are your constituents. Their customers, who visit supermarkets on an average of 2.2 times a week, depend on them not only for food shopping convenience, but also for local support in charity and community events. They are also significant employers in their local operating areas.

A small food retailer with one to three stores may have assets worth about $20 million. Rounding figures a bit, that creates an estate tax bill of about $10 million. With yearly profits of a penny on the dollar—the industry average—the owner has

[5] 1998 Retirement Confidence Survey by the Employee Benefit Research Institute. (Hereinafter cited as the Retirement Confidence Survey).
[6] Retirement Confidence Survey.
[7] 1997 Survey by Consumer Federation of America.
[8] Retirement Confidence Survey.

very little cash on hand. While some FMI members buy life insurance just to prepare for paying the tax, many cannot afford the premiums necessary to protect all of their assets.

The Food Marketing Institute (FMI) is a nonprofit association conducting programs in research, education, industry relations and public affairs on behalf of its 1,500 members including their subsidiaries—food retailers and wholesalers and their customers in the United States and around the world. FMI's domestic member companies operate approximately 21,000 retail food stores with a combined annual sales volume of $225 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 200 members from 60 countries.

FMI's President and CEO Tim Hammonds is the co-chairman of a unique coalition that was announced yesterday—Americans Against Unfair Family Taxation. What makes us unique is that we represent family-owned businesses throughout the United States. The coalition will give this issue a much higher profile through a national television and print advertising initiative and a series of local town meetings designed to inform the American people. National research already conducted shows that Americans believe a top 55% tax rate is too high and simply unfair.

Effect of the Estate Tax when a Supermarket Owner Dies

Supermarket succession, the passing of years of hard work on to the next generation is a top concern of family-owned supermarket retailers and wholesalers. Succession planning is long and difficult. Owners are forced to answer difficult questions about the future of a company they have worked their entire lives to create and grow. The transfer of ownership and the family dynamics are central questions in the decision to plan for the future of the business. The shocking reality is when the owner realizes that from 37% up to 55% of his or her company can be lost to estate and gift taxes. When the owner of a supermarket dies, the individual's estate is subject to federal and state death taxes. The tax not only covers the life savings of the one who passed away, abut also the home, land, pensions, life insurance, stocks and bonds, annuities, IRAs, 401K plans and the business assets, as well as anything else that has any economic value. The deceased has already paid income tax on that money. In addition to income taxes, they have paid and collected payroll taxes and employment taxes; many have paid capital gains taxes as well.

Food retailers and wholesalers run capital intensive businesses, requiring large investments in land, stores or shopping centers, refrigeration, point-of-sale equipment, large inventories of products, lighting, transportation, such as fleets of trucks, etc. One single asset of a company can be more than the amount of the $650,000 exemption or threshold for the unified credit. Owners of most family owned grocery stores plow their after-tax profits back into their stores in equipment, new consumer services, associates/jobs, remodeling and new store development. As mentioned earlier, the average profit of our industry is one penny on the dollar after taxes, so you can see why the supermarket industry is particularly vulnerable to the devastating effects of this tax.

Family-owned supermarkets that do survive after the principal owner's death have already spent thousands, and even more than $3 to $5 million, according to industry members surveyed, to simply plan for the eventuality of estate taxes. Most grocery stores involved in planning purchase life insurance, have buy/sell agreements or provide lifetime gifts of stock. FMI strongly believes that the resources spent planning for and paying the death tax could be used more productively to grow supermarkets, provide customers with value and create additional jobs in the economy.

It is hard to imagine a more onerous or unfair tax. When the owner dies, as much as she or he may have wanted to pass the business down to the children or cousins, the estate tax puts them in a deep financial hole. This is even before they get started. Some try to stay in business by taking out a loan with the Internal Revenue Service as their silent partner, skimming off a large portion of the profits every year, stifling job growth and business expansion. This option is extremely risky. The supermarket industry has never been more competitive than it is today. To survive, owners must use all available capital to upgrade their stores with new services and invest in technology to stay as efficient as possible. They need all of their slim profits, along with loans from banks and other sources, to remain competitive.

All too often, however, the estate tax forces them to close or sell the store. And the community loses an institution that may have supported the local economy for years. And the industry loses another independent operator, historically the source of greatest innovation in our business. The whole idea of the self-service supermarket, an American innovation, started with independent entrepreneurs in the 1930s.

ECONOMIC EFFECTS OF THE FEDERAL ESTATE TAX

The icing on the cake for FMI members is that after involved planning, which takes assets away from their business while they are alive; they are shocked to learn that the tax raises almost no revenue for the federal government.

The Joint Economic Committee of Congress released a "dynamic" report in December 1998, which found that this tax "raises very little, if any, net revenue for the federal government." The JEC also concluded that the estate tax results in losses under the income tax that are roughly the same size as the revenue brought in by the estate tax. Annual death tax receipts total approximately $23 billion, less than 1.4% of total tax revenue.

FMI believes Congress needs to do much more than simply increase the unified credit to help the growing number of family owned businesses facing high estate tax rates upon their deaths. The supermarket industry urges Congress to focus on eliminating these high tax rates. As mentioned earlier, raising the unified credit does little to ameliorate the ravaging effect of this tax. Closely held supermarkets and their wholesalers are capital intensive businesses, whose owners invest profits back into their business, but pay taxes at the personal rate. Lifetime assets easily exceed the unified credit amount of $650,000 (under current law, up to $1 million by 2006).

In the House of Representatives, we strongly support the bipartisan, leadership legislation, H.R. 8, introduced by Reps. Jennifer Dunn and John Tanner that calls for gradual elimination of the death tax by 5% per year over a period of 11 years. We also support H.R. 86, introduced by Rep. Chris Cox, which calls for full and immediate repeal of this tax. Versions of H.R. 8 have also been introduced in other tax packages, sponsored by Rep. Sam Johnson and Reps. Jennifer Dunn and Jerry Weller. We urge Congress to include legislation eliminating the estate and gift tax in any upcoming tax legislation.

SUMMARY

The federal estate tax has become a huge disincentive to continuing small family owned businesses. Take for instance, the two-store operator in the nation's heartland, who has built his business so he now employs 500 people, with 200 jobs added in just the last five years. The fair market value of his business is $10 to $20 million. He has spent between $600,000 and $1 million in succession planning, but he will have to sell all or part of the business when he dies to satisfy the estate tax. He believes his business will grow and expects to employ 700 people in his community in the next five years. All would lose their positions working for this small, but important market innovator, if he died.

Another supermarket operator has already spent just under $10 million in estate taxes, and the second generation has managed to hang on, by taking out a loan. This delayed the opening of a third store for almost five years and added a large debt payment. These funds otherwise could have been used to fund parts of his expansion instead of borrowing and adding cost to his operations. A few million dollars of the federal tax payment was deferred and debt taken on to pay back the federal tax over an allotted time period, so most of his profits are applied to the federal tax payments.

Supermarket owners pay federal and state taxes throughout the life of their company. When they die, the federal government steps in and takes up to half of the worth of the their company assets. It is unjust for our government to impose a tax that raises so little revenue while it devastates businesses and kills jobs. FMI urges you to pass legislation to eliminate this tax.

Thank you for the opportunity to present testimony this morning.

Statement of Investment Company Institute

The Investment Company Institute [1] is pleased to submit this statement to the House Committee on Ways and Means regarding retirement savings issues raised

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,576 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mu-

Continued

at its June 16 hearing. Most importantly, we would like to take this opportunity to indicate our strong support for many of the provisions of H.R. 1102, the "Comprehensive Retirement Security and Pension Reform Act of 1999" and H.R. 1546, the "Retirement Savings Opportunity Act of 1999." Both bills would make the nation's retirement plan system significantly more responsive to the retirement savings needs of Americans. Both bills would encourage retirement savings by providing appropriate tax incentives to employers and individuals; and both would eliminate many of the unnecessary limitations that discourage small employers from establishing retirement plans and individuals from trying to save for retirement. The Institute commends the sponsors of H.R. 1102 and H.R. 1546 and other members of this committee for their interest in retirement savings policy.

Retirement savings are of vital importance to our nation's future. Although members of the "Baby Boom" generation are rapidly approaching their retirement years, studies strongly suggest that as a generation, they have not adequately saved for their retirement.[2] Additionally, Americans today are living longer. Taken together, these trends will place an enormous strain on the Social Security program in the near future.[3] In order to ensure that individuals have sufficient savings to support themselves in their retirement years, much of this savings will need to come from individual savings and employer-sponsored plans.

The Institute and mutual fund industry have long supported efforts to enhance the ability of individual Americans to save for retirement in individual-based programs, such as the Individual Retirement Account or IRA, and employer-sponsored plans, such as the popular 401(k) plan. In particular, we have urged that Congress: (1) establish appropriate and effective retirement savings incentives; (2) enact saving proposals that reflect workforce trends and saving patterns; (3) reduce unnecessary and cumbersome regulatory burdens that deter employers—especially small employers—from offering retirement plans; and (4) keep the rules simple and easy to understand.

It is our view that together H.R. 1102 and H.R. 1546 achieve these objectives.

I. Establish Appropriate and Effective Incentives to Save for Retirement

A. *Raise Low Caps That Unnecessarily Limit Retirement Savings.*

In order to increase retirement savings, Congress must provide working Americans with the incentive to save and the means to achieve adequate retirement security. Current tax law, however, imposes numerous limitations on the amounts that individuals can save in retirement plans. Indeed, under current retirement plan caps, many individuals cannot save as much as they need to. One way to ease these limitations is for Congress to update the rules governing contribution limits to employer-sponsored plans and IRAs. Increasing these limits will facilitate greater retirement savings and help ensure that Americans will have adequate retirement income.

H.R. 1102 contains several provisions that would address this issue, which the Institute strongly supports. Section 101 of the bill would increase 401(k) plan and 403(b) arrangement contribution limits to $15,000 from the current level of $10,000; government-sponsored 457 plan contribution limits would increase to $15,000 from the current level of $8,000. Another important provision of H.R. 1102 would repeal the "25% of compensation" limitation on contributions to defined contribution plans. These limitations can prevent low and moderate-income individuals from saving sufficiently for retirement. (As is noted below, the repeal of these limitations is also necessary in order to enable many individuals to take advantage of the "catch-up" proposal in the bill.) H.R. 1546 contains similar provisions.

H.R. 1546 also contains an additional proposal that the Institute urges Congress to enact. Specifically, Section 101 of H.R. 1546 would increase the annual IRA contribution limit to $5,000 and permit future adjustments to account for inflation.[4] To-

---

tual fund members have assets of about $5.860 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

[2] For instance, one study concluded that the typical Baby Boomer household will need to save at a rate 3 times greater than current savings to meet its financial needs in retirement. Bernheim, Dr. Douglas B., "The Merrill Lynch Baby Boom Retirement Index" (1996).

[3] Social Security payroll tax revenues are expected to be exceeded by program expenditures beginning in 2014. By 2034, the Social Security trust funds will be depleted. 1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

[4] H.R. 1102 proposes such an increase, but limits its availability only to individuals able to make a fully deductible contribution under current income-based eligibility rules. This targeted approach complicates these rules, which, as we explain below, already are too confusing. Confusing eligibility rules deter individual participation in the IRA program.

day's $2,000 contribution limit was set in 1981—almost 20 years ago. If adjusted for inflation, this limit would be at about $5,000 today. IRAs are a critical component of the personal savings tier of the nation's three-tiered approach to retirement savings. But at the current $2,000 contribution limit IRAs no longer provide sufficient savings opportunities for many Americans in light of its loss of real value to inflation over time, longer anticipated life expectancies and continuing increases in medical costs for our elderly population. Only the IRA is available to all working individuals, including those without access to an employer-sponsored plan. Raising the IRA contribution limit will provide all individuals with expanded retirement savings opportunities.

B. *Simplify IRA Eligibility Rules And Bring Back The Universal Deductible IRA.*

H.R. 1546 would simplify IRA eligibility criteria. Current eligibility rules are so complicated that even individuals eligible to make a deductible IRA contribution are deterred from doing so. When Congress imposed the current income-based eligibility criteria in 1986, IRA participation declined dramatically—even among those who remained eligible for the program. At the IRA's peak in 1986, contributions totaled approximately $38 billion and about 29% of all families with a head of household under age 65 had IRA accounts. Moreover, 75% of all IRA contributions were from families with annual incomes less than $50,000.[5] However, when Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and never recovered—to $15 billion in 1987 and $8.4 billion in 1995.[6] *Among families retaining eligibility to fully deduct IRA contributions, IRA participation declined on average by 40% between 1986 and 1987, despite the fact that the change in law did not affect them.*[7] The number of IRA contributors with income of less than $25,000 dropped by 30% in that one year.[8] Fund group surveys show that even more than a decade later, individuals did not understand the eligibility criteria.[9]

Based on these data, the Institute recommends the repeal of the IRA's complex eligibility rules, as proposed in H.R. 1546. These rules deter lower and moderate income individuals from participating in the program. A return to a "universal" IRA would result in increased savings by middle and lower-income Americans.

II. Enact Savings Proposals That Reflect Workforce Trends and Savings Patterns

A. Make Retirement Account Balances Portable.

On average, individuals change jobs once every five years. Current rules restrict the ability of workers to roll over their retirement account from their old employer to their new employer. For example, an employee in a 401(k) plan who changes jobs to work for a state or local government may not currently take his or her 401(k) balance and deposit it into the state or local government's pension plan. Thus, the Institute strongly supports Sections 301 and 302 of H.R. 1102, which would enhance the ability of American workers to take their retirement plan assets to their new employer when they change jobs by facilitating the portability of benefits among 401(k) plans, 403(b) arrangements, 457 state and local government plans and IRAs. This change in the law would make it easier for individuals to consolidate and manage their retirement savings. A related proposal in H.R. 1546 would clarify the ability of individuals to open an IRA "on-line." Such clarification of the law would facili-

[5] Venti, Steven F., "Promoting Savings for Retirement Security," Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

[6] Internal Revenue Service, Statistics of Income.

[7] Venti, supra at note 4.

[8] Internal Revenue Service, Statistics of Income.

[9] For example, American Century Investments asked 534 survey participants, who were self-described "savers," ten general questions regarding IRAs. One-half of them did not understand the current income limitation rules or the interplay of other retirement vehicles with IRA eligibility. Based on survey results, it was concluded that "changes in eligibility, contribution levels and tax deductibility have left a majority of retirement investors confused." "American Century Discovers IRA Confusion," *Investor Business Daily* (March 17, 1997). Similarly, even expansive changes in IRA eligibility rules, when approached in piecemeal fashion, require a threshold public education effort and often generate confusion. *See, e.g.*, Crenshaw, Albert B., "A Taxing Set of New Rules Covers IRA Contributions," *The Washington Post* (March 16, 1997) (describing 1996 legislation enabling non-working spouses to contribute $2,000 to an IRA beginning in tax year 1997).

tate individuals seeking to directly rollover retirement plan assets in a computer-based environment and thus encourage the preservation of retirement savings.[10]

B. *Allow Individuals To "Catch-Up" When Able.*

The laws governing pension plans also must be flexible enough to permit working Americans to make additional retirement contributions when they can afford to do so. Individuals, particularly women, may leave the workforce for extended periods to raise children. In addition, many Americans are able to save for retirement only after they have purchased their home, raised children and paid for their own and their children's college education. Section 201 of H.R. 1102 and Section 401 of H.R. 1546 would address these concerns by permitting additional salary reduction "catch-up" contributions. The catch-up proposal in H.R. 1102 would permit individuals at age 50 to save an additional $5,000 annually on a tax-deferred basis. Similarly, H.R. 1546 would permit the same individuals to increase their contributions by 50% over the otherwise permitted amounts. The idea is to let individuals who may have been unable to save aggressively during their early working years to "catch up" for lost time during their remaining working years. H.R. 1546 takes the additional step of exempting the catch-up contributions from nondiscrimination testing. We believe this is necessary to maximize the provision's effectiveness. Repeal of the "25% of compensation" limit, which is proposed in both bills, could further enhance the ability of Americans to "catch-up" on their retirement savings.

The "catch-up" is an excellent idea and is a sorely needed, practical response to the work and savings patterns of Americans today. We urge Congress to act on this proposal.

III. Expand Retirement Plan Coverage Among Small Employers

A. *Eliminate Unnecessary Regulatory Disincentives To Plan Formation.*

The current regulatory structure applied to retirement plans contains many complicated and overlapping administrative and testing requirements that serve as a disincentive to employers, especially small employers, to sponsor retirement plans for their workers. Easing these burdens will promote greater retirement plan coverage and result in increased retirement savings.

Meaningful pension reform legislation must focus on the need to increase pension plan coverage among small businesses. Although these businesses employ millions of Americans, *less than 20 percent* of them provide a retirement plan for their employees. By comparison, about 84 percent of employers with 100 or more employees provide pension plans for their workforce.[11]

Unnecessarily complex and burdensome regulation continues to deter many small businesses from establishing and maintaining retirement plans. The "top-heavy rule" is one example of such unnecessary rules.[12] A 1996 U.S. Chamber of Commerce survey found that the top-heavy rule is the most significant regulatory impediment to small businesses establishing a retirement plan.[13] The rule imposes significant compliance costs and is particularly costly to small employers, which are more likely to be subject to the rule. It is also unnecessary because other tax code provisions address the same concerns and provide similar protections. While the Institute believes the top-heavy rule should be repealed, Section 104 of H.R. 1102 would make significant changes to the rule, which would diminish its unfair impact on small employers.

---

[10] Increasingly, individuals are able to access plan account balances on-line. According to one 1998 study, approximately 26 percent of mid-size companies currently provide Internet access to plan accounts. This number is expected to increase. Indeed, one mutual fund complex has reported that more 401(k) plan participants access plan information on-line than contact the company's phone representatives to do so.

[11] *EBRI Databook on Employee Benefits (4th edition),* Employee Benefit Research Institute (1997).

[12] The top-heavy rule is set forth at Section 416 of the Internal Revenue Code. The top-heavy rule looks at the total pool of assets in a plan to determine if too high a percentage (more than 60 percent) of those assets represent benefits for "key" employees. If so, the employer is required to (1) increase the benefits paid to non-key employees, and (2) accelerate the plan's vesting schedule. Small businesses are more likely to have individuals with ownership interests working at the company and in supervisory or officer positions, each of which are considered "key" employees, thereby exacerbating the impact of the rule.

[13] *Federal Regulation and Its Effect on Business—A Survey of Business by the U.S. Chamber of Commerce About Federal Labor, Employee Benefits, Environmental and Natural Resource Regulations,* U.S. Chamber of Commerce, June 25, 1996.

B. *Provide Incentives To Encourage Small Employers To Establish Plans.*

In addition to eliminating rules that deter small businesses from establishing retirement plans, such employers also need appropriate tax incentives to encourage plan formation and address their unique economic concerns. There are two tax incentives, which are proposed, that we believe would effectively encourage small employers.

First, Congress should provide a tax benefit that would reduce the start-up costs associated with establishing a pension plan. Both H.R. 1102 and H.R. 1546 propose a tax credit for small employers of up to 50% of the start-up costs of establishing a plan up to $1,000 for the first credit year and $500 for each of the second and third year after the plan is established. This modest tax credit would encourage more small employers to establish retirement plans by diminishing initial costs.

Second, Congress should provide assistance to small employers who would like to contribute to a retirement plan for their employees in addition to offering them a salary deferral plan. Because many small employers have cash flow constraints, they are often reluctant to make a commitment to contribute to a retirement plan for their employees. H.R. 1546 would grant small employers a tax credit for 50 percent of their contributions (up to 3% of employee compensation) to a plan for non-highly compensated employees during the first 5 years of a plan's operation. This proposal is effectively designed to assure it helps those who need assistance the most—smaller employers and lower-paid individual employees—and would be an excellent way to help small employers deliver a meaningful retirement benefits to lower-paid employees.

C. *Expand The Effective SIMPLE Plan Program.*

The Institute also strongly supports expanding current retirement plans targeted at small employers. Specifically, the Institute supports expansion of the SIMPLE plan program, which was instituted in 1997 and offers small employers a truly simple, easy-to-administer retirement plan.

The SIMPLE program has been very successful. The Institute has found a continued pattern of strong small employer interest in SIMPLE plans over the program's two-year history. Indeed, new SIMPLE plan formation has continued unabated in the second year of its availability. Based on Institute estimates, mutual funds held in SIMPLE IRAs experienced tremendous growth in 1998, increasing from $0.3 billion to $2 billion.

Additionally, information gathered in informal Institute surveys of its members demonstrates just how popular this program is. For instance, one firm alone reported almost 10,000 SIMPLE plans and 47,000 SIMPLE accounts as of December 31, 1997. This increased by about 50 percent over the next quarter to about 14,000 plans and 72,000 accounts. By year-end 1998, the firm had an estimated 23,000 SIMPLE plans and 219,000 accounts. Thus, over one year the number of SIMPLE plans had more than doubled and the number of SIMPLE accounts had more than quadrupled. Other firms for which such data are available demonstrate similar growth rates. An Employee Benefit Research Institute study published in October 1998 similarly demonstrates the effectiveness of the SIMPLE, finding that 12% of small employers with a defined contribution plan report having established a SIMPLE plan over a period of less than 2 years. By comparison, only 9% of small employers surveyed sponsored a SEP, a program that has been available since 1979.[14]

Moreover, the SIMPLE plan has been especially popular with the nation's smallest employers. Institute surveys indicate that about 90% of those employers establishing SIMPLE plans had 10 or fewer employees. Employers with 25 or fewer employees constitute nearly the entire market.[15]

The success of the SIMPLE program is extremely significant, because the lack of retirement plan coverage in the small employer population has been stubbornly nonresponsive to previous policy initiatives and industry efforts. As noted above, under 20 percent of employers with less than 100 employees provide a retirement plan for their employees, as compared to about 84 percent of employers with 100 or more employees.

Despite these successes, Congress can strengthen the SIMPLE program in two ways, each of which the Institute strongly supports. First, both H.R. 1102 and H.R. 1546 would raise the SIMPLE plan contribution limits from $6,000 to $10,000. This increase would assure that individuals who work for small employers will have op-

---

[14] Paul Yakoboski and Pamela Ostuw, "Small Employers and the Challenge of Sponsoring a Retirement Plan: Results of the 1998 Small Employer Retirement Survey," EBRI Issue Brief No. 202 (Employee Benefit Research Institute, October 1998).

[15] Institute informal survey results suggest that SIMPLE plan formation is negligible for employers of more than 25 employees.

portunities to accumulate sufficient retirement savings. (As noted above, other provisions of the bills would increase the contribution limits for 401(k), 403(b) and 457 plans.) Second, H.R. 1102 would provide for a salary-reduction-only SIMPLE plan. We believe that this would make the program much more effective for employers of 25–100 employees.

IV. Simplify Unnecessarily Complicated Rules

Simplicity is the key to successful retirement savings programs. This is the lesson of the SIMPLE and IRA programs. H.R. 1102 recognizes the need to keep the rules simple in the case of employer-sponsored plans. As we have noted above, complex and confusing rules diminish retirement plan formation and significantly reduce individual participation in retirement savings programs. We strongly support numerous provisions in H.R. 1102 that would simplify rules. We discuss several of these provisions below.

First, H.R. 1102 would provide a new automatic contribution trust nondiscrimination safe harbor. This safe harbor would simplify plan administration for employers electing to use it, enabling them to avoid costly, complex and burdensome testing procedures.[16] This provision is also an effective way to increase participation rates in 401(k) plans, especially the participation rates of non-highly compensated employees.

Second, the bill also would modify the anticutback rules under section 411(d)(6) of the Internal Revenue Code in order to permit plan sponsors to change the forms of distributions offered in their retirement plans. Specifically, the bill would permit employers to eliminate forms of distribution in a defined contribution plan if a single sum payment is available for the same or greater portion of the account balance as the form of distribution being eliminated. This proposed modification of the anticutback rule would make plan distributions easier to understand, reduce plan administrative costs and continue to adequately protect plan participants. In addition, H.R. 1102 would permit account transfers between defined contribution plans where forms of distributions differ between the plans; this modification of the anticutback rule also would simplify plan administration. It also would enhance benefit portability, which, as noted above, is an important public policy objective.

Finally, H.R. 1102 contains other provisions that would simplify currently burdensome rules and which the Institute supports. These proposals include repeal of the multiple use test and simplification of the separate line of business rules.

V. Conclusion

Improving incentives to save by increasing contribution limits to retirement plans and IRAs will provide more opportunities for Americans to save effectively for retirement. Similarly, rules that accommodate the work and savings patterns of today will enable millions of Americans to save toward a secure future in their retirement years. Additionally, providing appropriately structured tax incentives, such as start-up and contribution tax credits for small employers, would increase plan formation. And finally, simplifying the rules applicable to employer-sponsored plans and IRAs would result in a greater number of employer-sponsored plans, a higher rate of worker coverage and increased individual savings. The Institute strongly supports the provisions described above and commends the sponsors of H.R. 1102 and H.R. 1546 for supporting reforms of the pension system that will increase plan coverage and encourage Americans to save for their retirement. We encourage members of this Committee and Congress to enact this legislation this year.

Statement of National Association of Manufacturers

Mr. Chairman, we are pleased to submit the following statement for the record in support of Section 510 of H.R. 1102, the "ESOP Dividends May Be Reinvested Without Loss of Dividend Deduction" provision. We are submitting this statement on behalf of the National Association of Manufacturers—"18 million people who make things in America"—the nation's largest and oldest multi-industry trade association. The NAM represents 14,000 members (including 10,000 small and mid-sized

[16] To qualify for the safe harbor, employers would need to make automatic elective contributions on behalf of at least 70% of non-highly compensated employees and match non-highly compensated employee contributions at a rate of 50% of contributions up to 5% or make a 2% contribution on behalf of each eligible employee.

companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. Headquartered in Washington, DC., the NAM also has 11 additional offices across the country.

The Comprehensive Retirement Security and Pension Reform Act of 1999 (H.R. 1102), cosponsored by Reps. Rob Portman (R–OH) and Ben Cardin (D–MD), has attracted over 101 bipartisan cosponsors to date. The NAM strongly supports this legislation that would make pensions more secure and cut red tape, thereby encouraging greater pension coverage. Given the impending retirement of the baby boom generation, the passage of pension reform legislation is especially critical.

Among the many provisions of H.R. 1102 is Section 510 ("ESOP Dividends May Be Reinvested Without Loss of Dividend Deduction"), which would promote two critical and intertwined goals: to encourage workers to save for retirement and to promote employee ownership in their companies in which they work. Under current law, employers are able to deduct dividends on employer stock held in the employee stock ownership plan (ESOP), provided the dividends are paid out in cash to participants. The deduction is also permitted in the case of a leveraged ESOP, provided the dividends are used to make payments on a loan that was made for purposes of acquiring company stock for the ESOP.

While current law encourages employee ownership, it fails to fulfill another important goal. It prohibits employees from reinvesting those dividends in the plan. This is especially unfortunate given the low rate of national savings and the need for baby boomers, in particular, to prepare for their retirement. Although it is currently possible for some workers to reinvest some dividends in the ESOP through an IRS special letter ruling, the process is cumbersome, and the dividends count toward the employee's 401(k) limits, diminishing what can be saved in the plan. Codification of ESOP dividend reinvestment would solve this problem.

There are approximately 10,000 ESOPs in the United States with 10 million employee owners. This is almost 10 percent of the American workforce. Both large and small firms participate. Of the NAM's membership, over 7 percent of small firms have ESOPs and in the large firm category the percentage is much greater. ESOPs promote employee ownership and a stake in America's future. Legislative means to promote their growth should be encouraged. Section 510 is an important step in this regard.

Section 510 has attracted wide support. In addition to the growing list of bipartisan cosponsors for H.R. 1102, more than 15 members of the Ways and Means Committee have written to the original cosponsors of H.R. 1102, Reps. Rob Portman and Ben Cardin, praising the concept of employee stock ownership and urging a change in the law to permit an employer dividend deduction so employees can reinvest their dividends and save for retirement and for other important purposes.

On behalf of the NAM's 14,000 members, we urge your support for Section 510 as part of H.R. 1102. Taken together, ESOP dividend reinvestment and the other important provisions of H.R. 1102 would do much to build retirement security for America's workers and to encourage continued economic growth for America's future.

Statement of National Association of Professional Employer Organizations, Alexandria, Virginia

I. Introduction

The National Association of Professional Employer Organizations (NAPEO) appreciates the opportunity to submit this statement for the record of the Committee's hearing on retirement and savings issues. NAPEO is the national trade association of the professional employer organization (PEO) industry. NAPEO represents nearly 600 member firms from start-ups to large, publicly traded companies. NAPEO members are found in all 50 states and employ the vast majority of worksite employees in PEO arrangements.

We applaud the Committee's interest in these issues and willingness to look at the tax code for ways to address our savings problem in this country, particularly our pending retirement savings crisis. It is our view that only through a partnership between the government and the private sector can this crisis be averted.

NAPEO's members would like to participate in that effort and in fact, we think that we are already doing so. That is because our members are in the business of expanding coverage and providing benefits to American workers. The professional employer organization or "PEO" assists mainly workers of small- and medium-size businesses. While the owners of these small and med-sized businesses focus on the "business of their business" PEOs assume the responsibilities and liabilities of the "business of employment." The PEO assumes responsibility for paying wages and employment taxes generally to all the workers of its client companies. It maintains employee records, handles employee complaints, and provides employment information to workers, such as an employee handbook.

Most significantly, the PEO provides to the workers of its customers retirement (usually a 401(k) plan), health, dental, life insurance, dependent care and other benefits, which for many of these workers is the first opportunity that they have had to obtain these benefits through their employment.

The average NAPEO member customer is a small business with just 18 workers and the average wage of these workers is around $20,000. These are truly small businesses with employees attempting to provide a working wage for themselves and their families. Unfortunately, because these workers are employees of small businesses, they are often left without the option of needed employee benefits.

A recent Dun & Bradstreet Corporation survey of businesses with fewer than 25 employees revealed that only 39% offered health care and just 19% offer retirement savings plans. PEOs, on the other hand, can provide benefits to these workers on a more affordable basis because they can aggregate the workers of all of their customers together into a larger group, thereby obtaining economies of scale that enable them to set up a qualified plan and purchase group health and other employee benefit plans. PEOs have the expertise to operate these plans in compliance with a rather complex set of requirements imposed by the tax code and ERISA.

An analyst at Alex. Brown & Sons estimates that 40% of companies in a PEO co-employment relationship upgrade their total employee benefits package as a result of the PEO relationship and further, that 25% of the companies upgrading their benefits are offering health care and other benefits to their workers for the first time.

A NAPEO survey of its members revealed that 98% offer health and dental insurance, 86% offer disability coverage, 80% offer vision care and 82% offer retirement savings plans.

Moreover, in some cases, workers co-employed by a PEO obtain the benefits of COBRA rights and the protection of other employment laws and regulations, only because they are included in the larger workforce of a PEO. By pooling employees of small businesses, PEOs bring workers under the protection of federal laws applicable to large employers such as HIPPA and the Family and Medical Leave Act. In addition, there is generally a higher rate of compliance with COBRA and other laws by a professional employer (PEO) than by its various clients. PEOs employ staff who are knowledgeable about these laws and regulations, and who are responsible for addressing employment concerns of worksite employees.

II. Problems With Present Law: An Outdated Tax Code

PEOs have found a need for these types of skills and benefits in the market place, as small- and medium-sized businesses have slowly but steadily sought out the services of PEOs over the past decade. The industry has expanded to meet this demand. At the state level, NAPEO sought recognition for PEOs and supported regulation, such as licensing, to ensure that the industry could grow.

At the Federal level, however, PEOs have been confronted with a tax code that was written long before the development of this industry. Therefore, the current rules for who can collect taxes and provide benefits do not neatly fit a PEO, its customers and workers. In fact, under some interpretations of the tax law, PEOs could not do the very things that small businesses want and need: collect employment taxes and provide retirement, health and other benefits.

Last year, Congressman Portman (R–OH) and Congressman Cardin (D–MD) attempted to address this problem by introducing H.R. 1891, which gained the support of 27 Members of this Committee. After its introduction, the sponsors and the industry met with other interested parties, including the Administration, who raised some specific concerns with the original bill. As a result, we went back to the drawing board to try to come up with an approach to our problem that was narrower, addressing the expressed concerns yet allowing us to do what we were already doing for small businesses and workers—providing benefits and collecting taxes.

III. Revised Proposal: Certified PEO Status

We are pleased to present to the Committee the fruits of those efforts—a revised proposal that continues to enjoy the support of our original sponsors, Mr. Portman and Mr.

Cardin, and addresses the concerns raised by the Administration with the original proposal. This new proposal, unlike H.R. 1891, applies only to PEOs, not to temporary or other staffing firms. Thus, the proposal would not affect the litigation pending in the 9th Circuit, or any similar litigation. Nor does the proposal make any changes in the common law tests for who is an employee. In fact, the proposal specifically states this through the inclusion of a no-inference rule with respect to employment status.

In brief, what the new proposal does is to provide a safe harbor for PEOs who elect to meet certain requirements, which permits a PEO to assume liability for employment taxes with respect to worksite employees and to offer retirement and other benefits to such workers. In order to take advantage of this safe harbor, a PEO must be certified by the IRS. The certification requirements include a net worth test (if a PEO wants to have exclusive liability for employment taxes), and the submission of an annual audit by a CPA.

In order to prevent a customer from obtaining any better treatment under the tax code's nondiscrimination or other qualification rules under this proposal, a PEO's qualified plan would be tested under these rules on a customer-by-customer basis. A more detailed summary of the proposal is attached as an appendix.

IV. Conclusion: Workers Get the Benefits They Need and Deserve

Most importantly, this clarification of a PEOs' ability to offer retirement and health benefits permits the industry to continue to provide the workers of small and medium businesses with the benefits that they need and deserve. Current PEO customers can breathe a sigh of relief that the PEO plans in which their workers are currently participating will not be disqualified. PEOs can establish new plans under clear tax code rules. The market place's creative response to the difficulties of affording and providing benefits in a small business context can flourish without the uncertainty imposed by outdated tax rules. We believe this represents an ideal model of the public-private partnership that is needed to address the impending retirement savings crisis as well as the immediate health problem presented by our country's uninsured workers, and we urge its support by this Committee.

Overview of Proposed Certified Professional Employer Organization Legislation

I. Guiding Principles

• Difficulties in reaching conclusions regarding the highly factual determination of an "employee" and an "employer" should not limit the ability to provide workers with retirement, health, and other employee benefits.

• Clients of the CPEO should generally not get any significantly better or worse treatment under the nondiscrimination or other qualification rules than they would get outside of the CPEO arrangement.

• Employment tax administration should not be significantly affected by the use of a CPEO.

II. General Structure

If certain conditions are satisfied, an entity certified by the Internal Revenue Service as a Certified Professional Employer Organization (a "CPEO") will be allowed to elect (1) to take responsibility for employment taxes with respect to worksite employees and (2) to provide such workers with employee benefits under a single employer plan sponsored by the CPEO.

III. No Inference with Respect to Employment Status of Workers

The legislation will expressly state that it does not override the common law determination of an individual's employer. The legislation will not affect (and will explicitly state that it does not affect) the determination of who is a common law employer under federal tax laws or who is an employer under other provisions of law (including the characterization of an arrangement as a MEWA under ERISA), nor will status as a CPEO (or failure to be a CPEO) be a factor in determining employment status under current rules.

IV. Certification by IRS

In order to be certified as a CPEO under the legislation, an entity must demonstrate to the IRS by written application that it meets (or will meet) certain requirements. Generally, the requirements for certification will be developed by the IRS using requirements similar to the requirements for the ERO (electronic return originator) program and to practice before the IRS, as described in Circular 230 and will include review of the experience of the PEO and audit conducted by a certified public accountant. In addition, in order to be certified, a CPEO must represent that it (or the client) will maintain a qualified retirement plan for the benefit of 95% of worksite employees.

The CPEO must notify the IRS in writing of any change that affects the continuing accuracy of any representation made in the initial certification request. In addition, after initial certification, the CPEO must continue to file copies of its audited financial statements with the IRS within 180 days after the close of each fiscal year.

Procedures would be established for suspending or revoking CPEO status (similar to those under the ERO program). There would be a right to administrative appeal from an IRS denial, suspension, or revocation of certification.

V. Operation As a CPEO With Respect to Particular Workers

After certification, a CPEO will be allowed (1) to take responsibility for employment taxes and (2) to provide employee benefits with respect to "worksite employees." A worker is a "worksite employee" if the worker and at least 85% of the individuals working at the worksite are subject to written service contracts that expressly provide that the CPEO will:

- Assume responsibility for payment of wages to the worker, without regard to the receipt or adequacy of payment from the client for such services;
- Assume responsibility for employment taxes with respect to the worker, without regard to the receipt of adequacy of payment from the client for such services;
- Assume responsibility for any worker benefits that may be required by the service contract, without regard to the receipt or adequacy of payment from the client for such services;
- Assume shared responsibility with the client for firing the worker and recruiting and hiring any new worker; and
- Maintain employee records.

For this purpose, a worksite would be defined as a physical location at which a worker generally performs service or, if there is no such location, the location from which the worker receives job assignments. Contiguous locations would be treated as a single physical location. Noncontiguous locations would generally be treated as separate worksites, except that each worksite within a reasonably proximate area would be required to satisfy the 85% test for the workers at that worksite.

The legislative history will indicate that the 85% rule is intended to describe the typical, non-abusive PEO arrangement whereby a business contracts with a PEO to take over substantially all its workers at a particular worksite, and that this 85% rule is intended to ensure that the benefits of the bill are not available in any situation in which a business uses a PEO arrangement to artificially divide its workforce.

VI. CPEO Employee Benefit Plans

A. *CPEO May Sponsor Employee Benefit Plans*

The CPEO may provide worksite employees with any type of retirement plan or welfare benefit plan that the client could provide. Worksite employees may not, however, be offered a plan that the client would be prohibited from offering on its own. For example, government workers may not be offered participation in section 401(k) plan. Similarly, a CPEO may not sponsor a plan that it would be prohibited from offering on its own (e.g., a section 403(b) plan). However, an eligible client could maintain such plan as discussed below.

In general, employee benefit provisions (in the Internal Revenue Code and in directly correlative provisions in other Federal law) that reference the size of the employer or number of employees will generally be applied based on the size or number of employees of the CPEO. For example, CPEO workers will be entitled to COBRA coverage. Similarly, a CPEO welfare benefit plan will be treated as a single employer plan for purposes of section 419A(f)(6). Plan reporting requirements are met at the CPEO level. However, a client which could meet the size requirements for eligibility for an MSA or a SIMPLE plan could contribute to such an arrangement maintained by the CPEO.

B. *Nondiscrimination testing*

The nondiscrimination rules of the Code relating to employee benefit plans (including sections 401(a)(4), 401(a)(17), 401(a)(26), 401(k), 401(m), 410(b) and 416 and similar rules applicable to welfare and fringe benefit plans) will generally be applied on a client-by-client basis.

That portion of the CPEO plan covering worksite employees with respect to a client will be tested taking into account the worksite employees at a client location and all other nonexcludable employees of the client, but worksite employees would not be included in applying the nondiscrimination rules to portions of the plan including worksite employees of other clients, to the portion of the plan including nonworksite employees, to other plans maintained by the CPEO or to other plans maintained by members of the CPEO's controlled group. Consequently, the CPEO workforce (other than worksite employees) will be treated as a separate employer for testing purposes (and will be included in applying the nondiscrimination rules to plans maintained by the CPEO or members of its controlled group). Thus, for example, in applying nondiscrimination rules to a plan maintained by the parent of a CPEO for employees of the parent and for nonworksite employees of the CPEO, CPEO worksite employees will not be taken into account.

For purposes of testing a particular client's portion of the plan under the rules above, general rules applicable to that client would apply as if the client maintained that portion of the plan. Thus, if the terms of the benefits available to the client's worksite employees satisfied the requirements of the section 401(k) testing safe harbor, then that client could take advantage of the safe harbor. Similarly, a client that meets the eligibility criteria for SIMPLE 401(k), testing would be allowed to utilize that safe harbor to demonstrate compliance with the applicable nondiscrimination rules for that client.

Application of qualified plan and welfare benefit plan rules other than the nondiscrimination rules listed above will generally be determined as if the client and the CPEO are a single employer (consistent with the principle that the CPEO arrangement will not result in better or worse treatment). Thus, there would be a single annual limit under section 415. Section 415 will provide that any cutbacks required as a result of the single annual limit to be made in the client plan. Deduction limits and funding requirements would apply at the CPEO level. In determining deduction limits and minimum funding requirements for the CPEO plan, compensation means compensation paid to worksite employees by the CPEO. In addition, if the client portion of a plan is part of a top heavy group, any required top heavy minimum contribution or benefit will generally need to be made by the CPEO plan.

The legislation will also contain language giving the IRS the authority to promulgate rules and regulations that streamline, to the extent possible, the application of certain requirements, the exchange of information between the client and the CPEO, and the reporting and record keeping obligations of the CPEO with respect to its employee benefit plans.

C. *Service Crediting*

There will be special "crediting" of service for all benefit purposes. The break in service rules will be applied with respect to worksite employees using rules generally based on the Code section 413 tracking rules.

Worksite employees will not generally be entitled to receive plan distributions of elective deferrals until the worker leaves the CPEO group. In cases where a client relationship terminates with a CPEO that sponsors a plan, the CPEO will be able to "spin off" the former client's portion of the plan to a new or existing plan maintained by the client. Where the terminated client does not establish or wish to maintain the client's portion of the CPEO plan, the CPEO plan may distribute elective deferrals of worksite employees associated with a terminated client only in a direct rollover to an IRA designated by the worker. In the event that no such IRA is so designated before the second anniversary of the termination of the CPEO/client relationship, the assets attributable to a client's worksite employees may be distributed under the general plan terms (and law) that applies to a distribution upon a separation from service.

D. *Plan Qualification*

The legislative history will provide that, similar to IRS practice in multiple employer plans, disqualification of the entire plan will occur if a nondiscrimination failure occurs with respect to worksite employees of a client and either that failure is not corrected under one of the IRS correction programs or that portion of the plan is not spun off and/or terminated. Existing government programs for correcting violations would be available to the plan sponsor for the plan and, in the case of nondiscrimination failures tested at the client level, to the client portion of the plan with the fee to be based on the size of the affected client's portion of the plan. Moreover, the CPEO plan, as a single employer plan, will only be required to obtain a single opinion letter and pay a single user fee.

E. *Testing of Plans Maintained by Client*

The legislation will treat all worksite employees (who are not employees of the client) as "per se" leased employees of the client, thus requiring clients to include to include all worksite employees in plan testing. In accordance with current leased employee rules, the client will get credit for CPEO plan contributions or benefits made on behalf of worksite employees.

Consistent with this treatment of worksite employees, the client would be permitted to cover worksite employees under any employee benefit plan maintained by the client and compensation paid by the CPEO to worksite employees would be treated as paid by the client for purposes of applying applicable qualification tests. Limits such as section 404 will apply to the client's plan only to the extent the benefits and contributions, in aggregation with those under the CPEO's plan, do not exceed the limits.

F. *Transition Issues*

The legislation will direct the IRS to accommodate transfers of assets in existing plans maintained by a CPEO or CPEO clients into a new plan (or amended plan) meeting the requirements of the legislation (e.g., client-by-client nondiscrimination testing) without regard to whether or not such plans might fail the exclusive benefit rule because worksite employees might be considered common-law employees of the client.

VII. Employment Tax Liability

An entity that has been certified as a CPEO must accept liability for employment taxes with respect to wages it pays to worksite employees of clients. Such liability will be exclusive or primary, as provided below. The PEO would generally be required to provide the IRS on an ongoing basis with a list of clients for which employment tax liability has been assumed and a list of the clients for whom it no longer has employment tax liability.

All reporting and other requirements that apply to an employer with respect to employment taxes apply to the CPEO for wage payments made by the CPEO. In addition, the remittance frequency of employment taxes will be determined with reference to collections and the liability of the CPEO.

Wages paid by the client during the calendar year prior to the assumption of employment tax liability would be counted towards the applicable FICA or FUTA tax wage base for the year in determining the employment tax liability of the CPEO (and vice versa). Exceptions to payments as wages or activities as employment, and thus to the required payment of employment taxes, are determined with respect to the client.

A CPEO will have exclusive liability for employment taxes with respect to wage payments made by the CPEO to worksite employees (including owners of the client who are worksite employees) if the CPEO meets the net worth requirement. The net worth requirement is satisfied if the CPEO's net worth (less good will and other intangibles) as certified by an independent certified public accountant is, on the last day of the fiscal quarter preceding the date on which payment is due and on the last day of the fiscal quarter in which the payment is due, at least:

$50,000 if the number of worksite employees is fewer than 500
$100,000 if the number of worksite employees is 500 to 1,499
$150,000 if the number of worksite employees is 1,500 to 2,499
$200,000 if the number of worksite employees is 2,500 to 3,999
$250,000 if the number of worksite employees is more than 3,999.

In the alternative, the net worth requirement could be satisfied through a bond (for employment taxes up to the applicable net worth amount) similar to an appeal bond filed with the Tax Court by a taxpayer or by an insurance bond satisfying similar rules.

Within 60 days after the end of each fiscal quarter, the CPEO will provide the IRS with an attestation from an independent certified public accountant that states that the accountant has found no material reason to question the CPEO's assertions with respect to the adequacy of federal employment tax payments for the fiscal quarter. In the event that such attestation is not provided on a timely basis, the CPEO will prospectively cease to have exclusive liability with respect to employment taxes (regardless of the net worth or bonding requirement). Exclusive liability will not be restored until a subsequent attestation is filed.

For any tax period for which any of these criteria for exclusive liability for employment taxes are not satisfied, or to the extent the client has not made adequate payments to the CPEO for the payment of wages, taxes, and benefits, the CPEO will have primary liability and the client will have secondary liability for employment taxes.

VIII. EFFECTIVE DATE

These provisions will be effective on January 1, 2001 or, if later, 12 months after the date of enactment. The statute will direct the IRS to establish the PEO certification program at least three months prior to the effective date.

Statement of Kenneth B. Allen, Executive Vice President and Chief Executive Officer, National Newspaper Association, Arlington, Virginia

Thank you for allowing me to submit this testimony on behalf of the National Newspaper Association in order to comment briefly on the inherent unfairness of the estate tax. The National Newspaper Association, established in 1885, represents nearly 4,000 daily and weekly newspapers nationwide. America's community papers inform, educate and entertain 170 million readers every week. NNA members are the building blocks upon which America's communities are founded. More importantly, our members are primarily family-owned businesses. As part of the Family Business Estate Tax Coalition, we support the reduction and elimination of the estate tax rates, specifically the passage H.R. 8, the Death Tax Elimination Act, as introduced by Representatives Jennifer Dunn and John Tanner.

NNA believes the confiscatory nature of the estate tax punishes family-owned businesses and entrepreneurs. In fact, NNA fully supported the estate tax relief provided by Congress in the Taxpayer Relief Act of 1997. That legislation raised the exemption from $600,000 to $1 million by 2005. The law also created a new $1.3 million exemption from estate taxes for small business and farms that qualify as "family-owned." We applaud Congress and the President for that key first step. However, our goal remains the elimination of the estate tax.

Many community newspapers are forced to sell when the owner dies since their assets are not liquid. The families need to sell in order to pay the estate tax. This has a devastating impact on the entire community. At minimum, someone from outside the community could purchase the paper. In the worst cases, the paper is sold and closed. When a newspaper that has been covering and reporting local news for several generations is either sold or closes its doors, the sense of community is lost forever. The newspaper owner's family is not the only one paying the tax. The reporter who covers local sports, the restaurant owner who feeds the newspaper staff and the department store that advertises in the paper all suffer under the current system. These are two examples of the impact on community papers:

- Everett Bey, Chairman of Feather Publishing Company, Inc. is facing this very problem. His company prints and publishes six weekly newspapers including the Feather River Bulletin, the Indian Valley Record, the Chester Progressive, the Westwood Pinepress, the Portola Reporter and the Lassen County Times with staff and offices in each location. When Mr. Bey's wife passed away two years ago, her shares of the company were placed in a trust. When Mr. Bey passes, the entire business will be left to his only daughter and her husband. Feather Publishing Company, Inc. grosses over $3 million annually. Based on these revenues, it is entirely possible that the Mr. Bey's daughter will be forced to sell the business—a business he has owned for nearly 30 years. Mr. Bey started this company with seven employees and today he has almost 100. It is fundamentally wrong to punish Mr. Bey's family for their hard work and success.
- Another community newspaper publisher, Helen Buffington of the Jackson Herald, the Commerce News, the Banks County News and the Madison County Journal in Georgia explained how she and her husband are preparing to transfer the paper to their children. Starting with a struggling Georgia daily paper, the Buffingtons built a firm that is now worth more than $2 million. They have been gifting the business to their sons for several years and have spent tens of thousands of dollars on legal expenses and insurance premiums in an effort to save their children from the consequences of the death tax. By reinvesting their profits back into the company, the Buffingtons have created a family legacy for their children and grandchildren. But they fear that when they pass that the IRS will come looking to collect. (See attached letters)

As you know, Representatives Dunn and Tanner have introduced H.R. 8, the Death Tax Elimination Act, which would gradually reduce the estate tax rate by 5 percent a year until the tax is eliminated in 2010. We would prefer to see a more rapid phase out, but we support this bill, as it is a good piece of legislation and has bipartisan support. Sen. Campbell has introduced a companion bill, S. 38, the Estate and Gift Tax Rate Reduction Act, which also reduces the estate tax rates by 5 percent each year until they are eliminated.

A study released in 1998 by the Congressional Joint Economic Committee concluded that the estate tax is a leading killer of family-owned businesses. Additionally, valuable resources that could be used to strengthen and expand businesses, improve working conditions or increase employee's wages are rather spent in an attempt to avoid paying the tax. The best way I have heard the death tax described is as a "virtue" tax. Unlike a "sin" tax, which focuses on vices such as tobacco products and alcohol, the estate tax punishes people for their hard work and saving for the future. Meanwhile, these are qualities many seek to instill in our communities.

Only 30 percent of family owned businesses survive into the second generation and only 17 percent survive to a third. This is something that must change because small businesses are the backbone of our economy and community papers are the heart and soul of our communities. It is vital that Congress repeal this bad policy or our community newspapers, as we know them, will not survive.

Again, Mr. Chairman, thank you for allowing me the opportunity to submit this testimony on behalf of the nation's community papers.

July 10, 1998

Senny Boone
National Newspaper Association
Arlington, VA 22209

Dear Ms. Boone:

My husband and I had a dream—a dream of owning our own community newspaper.

In 1965, we realized our dream. We purchased a struggling weekly in North Georgia for $25,000, including the building and equipment. To raise the 10 percent down payment and have a little operating capital, we cashed in my insurance policy and sold our home and a small tree farm we owned.

Today, thanks to a number of factors, our firm includes that newspaper and three other weeklies, as well as a thriving commercial printing operation. Our two sons are in the business. And both my husband and I, in our early 70s but being blessed with good health, also lend a hand.

The firm is now worth well over $2 million, according to an appraiser. But what happens when my husband and I die? We want our sons to have the business and we've been gifting it to them for several years. We also have spent thousands of dollars to get legal advice and pay insurance premiums in an effort to see that our sons don't have to sell the business in order to pay the estate taxes. But we don't know what will happen.

We have worked hard and taken relatively little out of the firm over the years in an effort to get it established and to have something for our children and grandchildren.

But as we understand it, the government could levy a tax of up to 58 percent on it. We don't feel this is fair. We have paid both corporate and personal taxes over the years on the earnings of this firm. And it seems totally unfair to then require our descendents to pay another hefty tax because we have saved and established a strong business. It would, in fact, be punishing them for our thriftiness and hard work. This, I believe, discourages people from establishing family businesses.

The estate tax should be totally abolished.

Sincerely,

HELEN BUFFINGTON (MRS. HERMAN)
Editor Emeritus

NNA
Attn: Government Relations

Re: Estate tax issue

Feather Publishing Co., Inc. is a wholly family-owned printing and publishing business, located in the Sierra Nevada mountains of Northern California, in Plumas and Lassen Counties, with headquarters in Quincy, CA. We publish six weekly newspapers: Feather River Bulletin at Quincy; Lassen County Times at Susanville; Portola Reporter at Portola; Indian Valley Record at Greenville; Chester Progressive at Chester-Lake Alamanor; and the PinePress at Westwood, all with individual offices and staff at each location.

When my wife died two years ago, her share of the corporate stock was placed in a trust. When I die, that trust and my stock will all go to my only daughter and her husband, the latter now serving as publisher of our publications. Our annual gross is over $3 million. On this basis, it is entirely possible that they will have to sell the business in order to pay the estate taxes.

We have owned this business for almost 30 years, buying the Bulletin and two other small weeklies in 1968, inheriting 3 offices and 7 employees. We now have grown to 6 offices, 97 employees, producing 28 to 36 page standard newspapers, plus 8 or 10 advertising inserts, weekly for each flag. We also publish a two-county telephone directory that incorporates phone numbers for three phone companies serving the area.

Over the years, we have seen the number of independent family-owned weeklies become smaller and smaller in California. Something has to be done to relieve the estate tax burden and allow these family-owned enterprises to continue their independent voices.

Sincerely,

EVERETT E. BEY
Chairman of the Board
Feather Publishing Co., Inc.

ENHANCING HEALTH SECURITY FOR RESPONSIBLE AMERICANS BY A PRIVATE CITIZEN IN ST. LOUIS, MISSOURI

Overview:

The passage of the Health Insurance Portability and Accountability Act is a commendable step in improving access to health insurance and reducing job lock. While improving access to insurance, it does nothing to ensure affordable rates, if an individual must switch to individual insurance, after having developed a health condition under an individual plan. Further reform is needed to ensure that responsible citizens who carry health insurance will be able to retain affordable coverage over the long term if they should become ill.

This proposal is divided into the following sections:

Problems with the Current System of Health Insurance
The Core Reform Proposal
Cost Issues Related to the Core Proposal
Other Comments about the Core Proposal
Additional Reforms Needed
Cost Issues Related to the Additional Reforms

Problems with the Current System of Health Insurance:

PORTABILITY PROBLEMS

—The Health Insurance Portability and Accountability Act (HIPAA) does nothing to ensure affordable rates, if an individual must switch to individual insurance, after having developed a health condition. Individuals may be exposed to extremely high premiums.

OTHER PROBLEMS CONCERNING INDIVIDUAL INSURANCE

—If an individual becomes ill under an individual policy, their rates can be raised or their policy canceled.

—Insurance companies should not be allowed to move individual policy holders from one internal risk group to another so that they can increase individual premiums on some groups of their policy holders due to claims. I have heard from some insurance agents that this practice may occur under some policies without the knowledge of policy holders.

—When one insurance company takes over another insurance company, the individual policy holders need to be protected from behind the scenes risk class manipulations, and other detrimental changes to their policy.

—Insurance companies have sometimes deliberately failed to send a renewal notice to sick policy holders, hoping they would forget to renew their policy.

—There should be a guarantee that parents can obtain insurance for a child born with health problems or birth defects. Or at least, considering the principle that one ordinarily buys insurance prior to the risk, parents should be about to buy the insurance for the child during pregnancy without health considerations.

PROBLEMS CONCERNING GROUP INSURANCE

—HIPAA provides protections for employer group policies and not other types of groups, such as alumni associations, professional and trade organizations, etc.

—HIPAA does not prevent an insurer from raising the premium on a group due to claims from its members.

—When an employer self-insures health of its employees, the employer should be subject to any regulations that would effect insurance companies offering a similar policy, including any applicable consumer protections and liability, if the plan is of HMO style. The ERISA provisions that release employers and their HMO's from liability can harm the employee.

PROBLEMS CONCERNING LEAVING AN EMPLOYER GROUP

—The current guaranteed ability for employees to convert their existing group policy to an individual policy on leaving the company is often too expensive, and sometimes reduces the coverages, if the original policy had riders for some of its coverages.

—A group policy may not always continue its riders when used under COBRA. Riders such as prescription drug coverage should continue.

—COBRA places a responsibility on the employer to continue insurance, but the insurance company is not required to carry COBRA customers, sometimes leaving an employer to his own devices to determine how to provide the ex-employee with insurance. If the employer cannot meet the responsibility, the ex-employee patient may be unable to use HIPAA to get an individual policy because he did not do COBRA first. This places both the employer and patient in an unfair bind.

Insurance companies have delayed the application process of HIPAA applicants to cause them to run out their 63 day eligibility period, in order to avoid covering them.

OTHER PROBLEMS

—Coverage disputes with HMO's need to involve an independent third party in the appeals hearing.

—The problems regarding health insurance stem partly from the federal income tax code, which encouraged the practice of associating health insurance with employment. The tax code is inconsistent in that employer health insurance is tax free, while individuals who buy their own insurance pay taxes on income used for this purpose, except if they are self employed, then there is partial tax deductibility.

—Many insurance companies and agents refuse to send a sample insurance policy. This makes shopping for all types of insurance more difficult.

The Core Reform Proposal:

The following provisions would solve what I believe are some of the worst problems of the health insurance system:

—To make health insurance more portable (e.g. to better allow transitions to situations of self employment, jobs that don't offer health insurance, or leaving the workforce), a person who developed a condition while under a health insurance policy (group or individual) would be able to move to a new individual policy and pay the same rate and be underwritten in the same class or group of policies as a healthy person of the same age, sex, and smoking status, in addition to avoiding the delay for coverage of pre-existing condition.

—A person would retain this protection through multiple policy changes over a lifetime, as the insurance industry offerings evolve. This protection is important if a person has individual insurance and loses it or becomes dissatisfied because the insurance company ceases service in the area, goes bankrupt, discontinues or changes the product an unsatisfactory manner, is merged or taken over by another insurance company, or the individual cannot afford the premium and needs a lower cost plan whether offered by the original insurer or a competitor.

—These protections would apply whenever an individual does not have a break in coverage longer than 63 days since their prior period of insurance coverage. To prevent this time limit from being wasted by stonewalling insurance companies, the 63 days should be counted backward from the date of application for new insurance, and insurance companies must process applications in a timely manner.

—These insurance protections should apply to allow insured young adults to transfer from a parent's health insurance plan to their own insurance, regardless of health and for Senior Citizens to transfer between Medicare Supplement policies and HMO's and vice versa.

—For those who have had a gap exceeding 63 days, insurance companies would be free to use a separate risk group and higher prices, based on health history, in order to protect the system from people who wait until they are sick to purchase insurance.

—The use of standard risk class for these insurance transfers may imply some minimal protection, even if the law to allow them is later repealed, as any individual policy obtained by these guidelines would be an ordinary individual policy, rather than a separate product or risk class, as now created by HIPAA, which could be priced or discontinued separately.

—Insurance companies would not be allowed to move individual policy holders from one risk group to another so that they can increase individual premiums on some persons. Individual premiums should be based solely on age, sex, smoking status, geographic location (a broad-brush division of the state into several areas), and health history (only if individual has had a gap in coverage of 63 days or longer immediately prior to the application date). Individual experience rating should be prohibited, to prevent rate increases resulting from a decline of health during coverage.

—The guaranteed acceptance into a group policy for a new employer would be extended to all groups that a person is a member of for which health insurance is sold (Alumni associations, professional and trade organizations, etc.). For example, if an Alumni association offers group health insurance to graduates of a particular school or university, it would have to take all graduates of that school and not impose delays or higher premiums for pre-existing conditions (subject to the 63 day gap rule).

—Insurance companies would not be allowed to raise the premium on a group policy due to change in health of existing members.

Cost Issues Related to the Core Proposal:

—The approach of providing total portability only when an individual has prior coverage is superior to a simple total ban on health history questions and pre-existing condition considerations, as it requires a person to have had insurance to receive the protections, thus protecting the system against abuse by people waiting to get insurance until they are sick.

—Imposing this protection only in cases where the person had prior coverage should minimize any resulting increase in the cost of individual health insurance, as the total cost borne by the industry in claims should not be strongly impacted if a chronically ill person moves from one policy to another, as that person would not move now if he could not get satisfactory coverage. (It may be necessary to require that the policies be similar, to prevent a dramatic, abusive upgrade in coverage at standard prices after a person becomes ill. It would also be necessary to allow transfer to a slightly better policy sometimes, to prevent a long term erosion toward inferior coverage for people who become chronically ill for decades and go through several insurers.)

—A reinsurance pool could be used by insurance companies to protect themselves from the risk of a disproportionate number of transfers of sick persons to their policies, but this pool should be invisible to the consumer.

—Due to the provision against raising group premiums, there may be some small increases in the cost of group insurance for the more healthy groups that would take place instead of sharp increases in the cost of group insurance for groups that have one or more unhealthy members. This is a good thing, as it make insurance do what it was intended to do—spread the risk.

—The Core Proposal will require no public funds other than those used to monitor insurance companies and enforce the rules.

Other Comments about the Core Proposal:

—These protections would help responsible self employed and small business owners/employees who have maintained health insurance, as they could obtain individual insurance at an affordable price.

—The COBRA problems would disappear, as COBRA would fall into disuse due to the new better options.

Additional Reforms Needed:

The following provisions would make a more complete reform, but are outside what I consider to the be core proposal:

—For the poor, Medicaid should be considered a qualifying insurance for purposes of allowing purchase an individual policy when a period of poverty ends.

—There should be a guarantee that parents can obtain insurance for a child born with health problems or birth defects. Or at least, considering the principle that one ordinarily buys insurance prior to the risk, parents should be about to buy the insurance for the child during pregnancy without health considerations.

—One should be able to purchase health insurance in a standard risk class upon reaching adulthood, regardless of whether the parents maintained insurance during childhood, e.g. to not hold the young adult responsible for mistakes of his or her parents.

—Many insurance companies and agents refuse to send a sample insurance policy. The text of all insurance policies of all types should be a part of the public record to aid shoppers for insurance. The text of policies can be shown on the World Wide Web (WWW) at minimal cost to the public and/or insurance companies may be required to make the sample policies available at their cost.

—The inconsistent tax treatment of health insurance premiums should be corrected to reduce this unfairness in the tax code. Regulations regarding the deductibility of health insurance premiums should not vary depending on whether premiums are paid by employer, employee, self-employed individual, or non worker. But it would be dangerous to implement the tax change without the other reforms, as some employers would drop insurance, and many sick people would then have inadequate protection.

—Lifetime policy dollar limits should be prohibited, or at least required to be indexed for inflation using a health care index, or perhaps insurance companies should provide a choice of several indexed dollar limits, much as a policy buyer chooses a deductible. Perhaps a minimum dollar limit should be considered.

—When an employer self-insures health of its employees, the employer should be subject to any regulations that would effect insurance companies offering a similar policy, including applicable HMO consumer protections, if the plan is of HMO style.

—When one insurance company takes over another insurance company, policyholders of the old company should have the option of keeping the original terms of their policy.

—Insurance companies should be required to send bills and renewal notices to all policy holders in a timely manner. They should provide the option to the policy holder to have their bills sent by certified mail return receipt requested for an extra billing fee equal to the additional postage. If a policy holder chooses this option, then the insurance company shall be forbidden to cancel the policy for nonpayment of premium for at least 30 days after the day the bill is sent, or 30 days after the renewal date, whichever is later, and then only if they have the card back that the bill was received. This provides the customer the option to make it the insurance company's legal obligation to remind them of their premiums via a bill and to ensure that the bill must be received. If certified mail billing is not chosen, cancellation should not occur before 30 days after the renewal date.

Cost Issues Related to the Additional Reforms:

—The provisions for children and transition to adulthood may require public funds or the cost may be spread out in higher premiums for everyone or higher premiums for child and young adult policies.

—If sample policies are to be shown on a government operated web site, there would be some costs for web development services to create and maintain the site.

—The tax provision may have a cost, or may raise revenue, depending on whether all premiums are made deductible, partially deductible, or taxable.

Statement of Hon. Bill Thomas, a Representative in Congress from the State of California

I hope the Ways and Means Committee will include additional pension and Individual Retirement Account options in the coming tax relief bill because we still face a retirement savings crisis in the very near future. While Congress is concentrating on Social Security, we cannot afford to ignore the need for substantial private savings if Americans are to maintain their lifestyles after retiring.

Measured by almost any standard, the situation is dire. Pensions and personal savings are forming the other legs of retirement security, so it would seem reasonable to expect Americans to put as much aside as possible. That simply is not happening. During the 1990s, our national savings rate was a dismal 3.6%. Last year, with the economy doing well, we might have expected more savings. Instead, the savings rate dropped to 1/2 of one percent. The savings devices we have available simply are not doing the job.

I am cosponsoring the Portman-Cardin pension reform bill and have introduced pension and Individual Retirement Account expansion legislation of my own, the Retirement Savings Act of 1999 (H.R. 1546), because it is clear that we need to act immediately. Merrill Lynch has consistently found in its market research that Americans are saving only a third of the resources they need to set aside to prepare for their retirement. Those approaching retirement are also beginning to see the problem: 60% of those over 50 years old admit they will not have what they need. Unfortunately, the distribution of knowledge is limited. Many people are just flat ignoring the danger and even among those 51 to 61, a third have a grand total of $10,000 in savings. We need to give people more tools with which to save as soon as possible.

Initial evidence on the results of our 1997 expansion of Individual Retirement Accounts shows Americans will respond favorably to new incentives for saving. Merrill Lynch reports that its customers increased IRA contributions 80% last year and that new information about the “Roth IRA” even got customers interested in the traditional IRA. Similarly, we can expect people to respond favorably to H.R. 1546’s proposed expansion of IRA contribution limits to $5,000 and similar increases in limits for 401(k) and government plans. Its creation of new “back loaded” tax free savings options for participants in more traditional savings accounts, and its provision of opportunities for older workers to make increased contributions as they approach retirement.

Now is the time for us to act on these expansions. Including H.R. 1546 in the coming tax bill would be a productive way for us to cut taxes and help working Americans prepare for the retirement income needs they will inevitably face. A summary of key elements of the bill follows.

H.R. 1546

RETIREMENT SAVINGS OPPORTUNITY ACT OF 1999

Increase IRA dollar limit from $2,000 to $5,000 per year. Limit will be increased in $100 increments to offset inflation.

Increase Other dollar-based benefit limits: 401(k) and 403(b) plan contributions are increased from $10,000 to $15,000, 457(b) plan contributions from $8,000 to $12,000 and the SIMPLE plan limit to $10,000.

Increase IRA Income Caps:

- Eliminates income limits on deductible IRA contributions.
- Eliminates income limits on Roth IRA contributions.
- Income cap for conversion of traditional IRAs to Roth IRAs will be raised to $1 million.

Catch Up Contributions: Those over 50 will be able to contribute an additional amount in excess of annual limits equal to additional 50% of the annual limit.

Elimination of 25% of Compensation Limitation: Maximum contribution to a defined contribution plan for an individual will be $30,000 per year as a result.

Roth 401(k) and Roth 403(b) plans: Gives participants in these plans an opportunity to contribute to these plans on an after-tax basis with earnings being tax free on distribution.

IRA Contributions to an Employer Plan: Allows Employers to establish plans to which employees can make direct contributions through payroll deductions.

Full funding limit increase: Law preventing contributions to a pension plan in excess of 150% of current liability amount of the plan is repealed.

Electronic Signatures for IRA accounts: facilitates electronic investment by allowing electronic signatures to be used in funding and controlling Individual Retirement Accounts.

PROVIDING TAX RELIEF TO STRENGTHEN THE FAMILY AND SUSTAIN A STRONG ECONOMY

WEDNESDAY, JUNE 23, 1999

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

The Committee met, pursuant to notice, at 10:00 a.m., in room 1100 Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
June 9, 1999
No. FC–11

Archer Announces Second Day in Hearing Series on Reducing the Tax Burden: II. Providing Tax Relief to Strengthen the Family and Sustain a Strong Economy

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold the second in a hearing series on reducing the tax burden on individuals and businesses to review proposals for providing tax relief to strengthen the family and sustain a strong economy. On June 2, 1999, Chairman Archer announced that the Committee on Ways and Means would conduct a hearing series to examine various proposals to provide tax relief (FC–10). On the first hearing day, scheduled for June 16, 1999, the Committee will consider tax proposals to enhance retirement and health security. The second day of the hearing will take place on, Wednesday, June 23, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony will be from both invited and public witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

Taxes as a percentage of Gross Domestic Product (GDP) continue to rise, increasing the tax burden on American families and businesses. In January 1998, the Congressional Budget Office (CBO) reported that taxes as a percentage of GDP were 19.9 percent. One year later, CBO reported that taxes as a percentage of GDP had risen to 20.7 percent. CBO also reports that the Federal budget surplus has materialized sooner than anticipated because of the sharp increase in revenues relative to GDP. Individual income taxes are responsible for most of the recent increase.

Despite these increases in the tax burden and growing budget surpluses, the Joint Committee on Taxation (JCT) reported in February that President Clinton's FY 2000 budget represents an $89.7 billion tax increase over the next 10 years. According to the JCT, the budget contains 47 tax proposals that lower taxes by $82.1 billion, but it also contains 75 proposals that raise taxes by $171.8 billion, for a total tax increase of $89.7 billion.

In announcing the hearing, Chairman Archer stated: "Taxes are too high, and American families and businesses deserve relief. When taxes are the highest they've been since World War II and keep going up, we should be looking for ways to cut taxes, not raise them even higher. I am committed to providing meaningful tax relief this year. If we don't cut taxes now, the politicians in Washington will spend every last dime—they always have, and they always will."

FOCUS OF THE HEARING:

The focus of the second hearing day will be on proposals to strengthen the family and sustain a strong economy. Attention will first be given to proposals such as marriage penalty relief, education incentives, and individual alternative minimum tax relief. Attention will then be focused on proposals including: expiring tax provisions, investment incentives, corporate alternative minimum tax relief, and other domestic business tax incentives.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Pete Davila at (202) 225–1721 no later than the close of business, Tuesday, June 15, 1999. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee on staff at (202) 225–1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard.

Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

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

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, of their prepared statement for review by Members prior to the hearing. Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than, Monday, June 21, 1999.

Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, July 7, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material

not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

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

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

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

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

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. Good morning to everyone on this beautiful June day.

The Committee will continue its hearings today into how best to reduce the peacetime record-high tax bite on the American people. Americans are paying too much in taxes and, as history has shown, any taxpayer money left in Washington most surely will be spent. Today's hearing will focus on ways to help hardworking families and individuals and companies for which they work.

The marriage tax penalty continues to penalize 21 million American couples with a higher tax burden for the simple reason that they are married. At a time when the experts tell us that children in one-parent families often fare worse than those with two parents, we should be encouraging marriage, not penalizing it.

Likewise, we should be looking for ways to strengthen and improve education. No question, many Americans receive a world-class education. But for many other Americans, the state of education is not as good as it could be. I am very interested in proposals like my Education Savings Account bill which would give a helping hand to our children, their parents, and their schools. That bill received bipartisan support in the House and Senate, but did not receive favor from President Clinton. I hope President Clinton will reconsider his opposition to this common sense approach because elected officials and wealthy Americans should not be the only ones who can afford to send their children to good schools.

As I said in February, my 1999 tax bill will include a $2.5 billion school construction initiative that makes permanent changes to tax-exempt bond rules to spur school construction now and in the future. This plan will make it much easier for State and local governments to comply with complicated bonding rules and will help build more public schools all across the country, from the Spring

Branch Independent School District in Texas to larger school districts in Los Angeles, New York, and everywhere in between.

Finally, we will explore ways to encourage savings and investment, which helps families build wealth and keeps our economy strong. The Congressional Research Service projects that 83.6 million Americans will own stock in 1999. That is an all-time high. It is 170 percent more than in 1970. Today owning stocks is no longer just for Wall Street and high-rollers. Women are creating investment clubs at an amazing pace all across the Nation.

Clearly, we are at a crossroads. The old approach of income redistribution has failed to end poverty or close the widening income gap. We shouldn't be fixing old problems with old ideas. Rather, we should work to expand opportunity for all Americans so they, too, can enjoy our strong economy and now is our chance, this year.

I now recognize Mr. Rangel for any statement that he might like to make. Without objection, all Members will be entitled to insert any written statements in the record.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman, for this opportunity to listen to some views that people may have as to how we can improve our Tax Code and encourage economic growth, as well as views about strengthening the family. I will be brief since I intend to testify as a witness myself. I do hope that these open hearings will continue and that we in the Minority will have the opportunity to work with those of you in the Majority so that we can develop a bipartisan tax bill which not only we can support, but that the President can sign into law.

Thank you.

Chairman ARCHER. I thank the gentleman. Our lead-off witness today is a man whose name has been well-known in history to the people of this country. I might say one that I have greatly respected all of my life. For the purpose of introduction, I am going to recognize the gentleman from Ohio, Mr. Portman.

Mr. PORTMAN. I thank the Chairman very much for allowing me to briefly introduce a long-time friend and, actually, one of my most distinguished constituents, Bob Taft. Bob is our new and very popular Governor of the state of Ohio, but he is not new to these issues, Mr. Chairman. He has been, as Secretary of State, up here in Washington giving us guidance, working with the National Association of the Secretaries of State. Before that, he was a State representative. Before that he was a country commissioner. So he brings a wealth of government experience and knowledge to the task before us today which is looking at the Federal Unemployment Tax. And I applaud him for the work he is now doing, picking up for Governor Voinovich and others, as head of the Coalition for Employment Security Financing Reform. And we are delighted to have him before the Ways and Means Committee today.

Chairman ARCHER. Governor, welcome. We are honored to have you here and we will be pleased to receive your testimony.

STATEMENT OF HON. ROBERT "BOB" A. TAFT, GOVERNOR, STATE OF OHIO; ON BEHALF OF COALITION FOR EMPLOYMENT SECURITY FINANCING REFORM

Governor TAFT. Thank you very much, Mr. Chairman. I want to thank you and Congressman Rangel and also my hometown Congressman Portman for the courtesy you have shown in allowing me to testify first this morning. I really appreciate that.

Mr. Chairman, Members of the Committee, my name is Bob Taft, Governor of the state of Ohio. Thank you for the opportunity to appear in support of the repeal of the temporary Federal Unemployment Tax surcharge and to urge you to reform the employment security financing system to provide full funding for the unemployment insurance and employment services programs.

Congress enacted the FUTA, Federal Unemployment Tax Act, surcharge in 1976 to provide funds to reimburse depleted trust fund accounts that have long since been restored. The Balanced Budget Act of 1997 extended this surcharge much longer than necessary to the fiscal year 2007. There is no longer any justification for the extension of this temporary tax surcharge at the level of .2 percent.

Not only are employers being overtaxed, but appropriations from this dedicated source of administrative funds have been cut. In 1997, 49 of the 53 States and jurisdictions receiving administrative funding for unemployment insurance and employment service functions received less from Washington than the FUTA taxes they collected from employers in their States. Since 1990, less than $0.58 of every employer FUTA tax $1.00 has been returned in administrative funding to the prepared states.

A comparison of the taxes paid by employers to administrative funds provided to the prepared States paints a compelling picture. From 1993 to 1997, FUTA tax collections increased from $4.23 billion to $6.45 billion while administrative funding to the prepared states was cut from $3.81 billion to $3.36 billion. I have included with the testimony a graph of this trend to demonstrate the growing inequity of this system. Although the latest data are available only through 1997, the trend line has continued in 1998 and 1999, rendering the return of employer taxes to the prepared States an increasingly smaller percentage with each year.

In our State of Ohio, we receive less than $0.37 on the $1.00 that we send to Washington. Inadequate funding in recent years has caused us to close 22 local employment offices, significantly reduce staff, and use State general revenues to make up for cuts in Federal funds that are being maintained in trust, ostensibly to provide the very services that have been cut through the appropriations process. The differential between Federal administrative funds provided and actual costs continues to increase for our State. In 1993, the State deficit in Federal funding compared to cost was $13.3 million. By 1997, that deficit had grown to $18.1 million.

We must do a better job of supporting State efforts to ensure the ability of American families to adjust to the demands of the work force in the coming century by providing adequate funding for employment services for those who become unemployed. It is time for a change. We need a system that properly funds States for administration and minimizes the tax burden on the employers who pay for it. We need to ensure employers that the employment taxes they pay will be used for the employment services promised when the tax was first imposed.

A coalition of 28 State and over 90 State and national employer organizations representing millions of employers have formed a coalition for reform of employment security financing. The coalition worked with Representative Clay Shaw to develop H.R. 3684 in the last session. Ohio Senator Mike DeWine has introduced a similar bill, S. 462 earlier this year designed to reform the system.

The proposal has been carefully crafted to address the Federal/State partnership, appropriate funding levels, and employer taxes. The proposal includes provisions to repeal the 0.2 percent FUTA surcharge; to transfer responsibility for collection of the FUTA tax to States; to provide adequate dedicated funds for administration of the unemployment insurance program and public employment services; and to increase the flexibility of the use of funds as part of the work force development system designed by each State.

It is time to repeal this unnecessary surtax. I urge you to favorably consider legislation such as that introduced by Senator DeWine.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

Statement of Hon. Robert "Bob" A. Taft, Governor, State of Ohio; on behalf of Coalition for Employment Security Financing Reform

Mr. Chairman, members of the committee, my name is Bob Taft, Governor of Ohio. Thank you for the opportunity to appear before you today in support of the repeal of the "temporary" Federal Unemployment Tax (FUTA) surcharge and urge you to reform the employment security financing system to provide full funding for the unemployment insurance and employment service programs.

Congress enacted the FUTA surcharge in 1976 to provide funds to reimburse depleted trust fund accounts that have long since been restored. The Tax Relief Act of 1997 extended this surcharge much longer than necessary through the year 2007. There is no justification for the 30 year extension of this "temporary" tax surcharge.

Not only are employers being overtaxed, but appropriations from this dedicated source of administrative funds have been cut. In 1997, 49 of the 53 states and jurisdictions receiving administrative funding for unemployment insurance and employment service functions received less than the FUTA taxes collected from employers in the states. Since 1990, less than 58 cents of every employer FUTA tax dollar has been returned in administrative funding for states.

A comparison of the taxes paid by employers to administrative funds provided to the states paints a compelling picture. From 1993 to 1997, FUTA tax collections increased from $4.23 billion to $6.45 billion while administrative funding was cut from $3.81 billion to $3.36 billion. I have provided a graph of this trend to demonstrate the inequity of the system. Although the latest data is only available through 1997, the trend line has continued in 1998 and 1999, rendering the return of employer taxes to the states an increasingly smaller percentage with each year.

In Ohio, we receive less than 37 cents on the dollar. Inadequate funding in recent years has caused us to close 22 local offices, significantly reduce staff, and use State general revenue to make up for cuts in federal funds that are being maintained in trust ostensibly to provide the very services that have been cut through the appropriations process.

The differential between federal administrative funds provided and actual costs continues to increase. In 1993 the state deficit in federal funding compared to cost was $13.3 million. By 1997 the deficit had grown to $18.1 million.

We must do a better job of supporting state efforts to ensure the ability of American families to adjust to the demands of the workforce in the coming century by providing adequate funding for employment services for those who become unemployed.

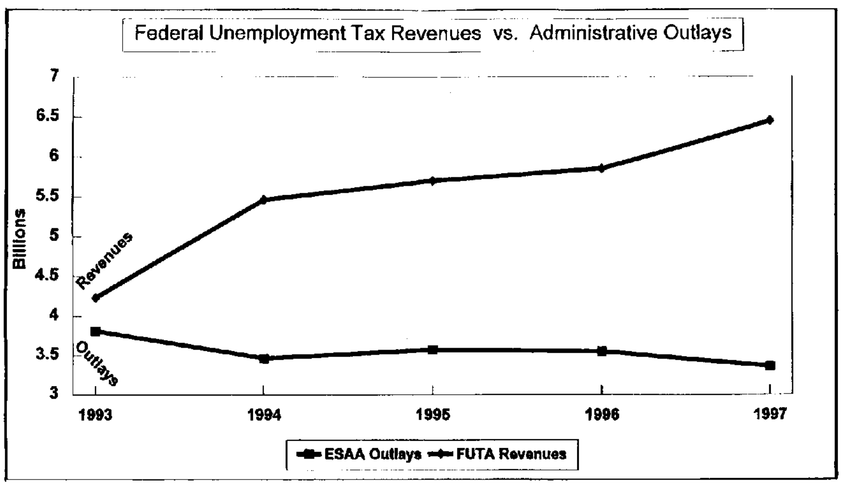
It is time for a change! We need a system that properly funds states for administration and minimizes the tax burden on the employers who pay for it.

A coalition of 28 states and over 90 state and national employer organizations representing millions of employers have formed a coalition for reform of employment security financing. The coalition worked with Representative Clay Shaw to develop HR 3684 last session. Senator Mike DeWine introduced a similar bill, S 462, earlier this year designed to reform the system.

The proposal has been carefully crafted to address the federal/state partnership, appropriate funding levels, and employer taxes. The proposal includes provisions to:

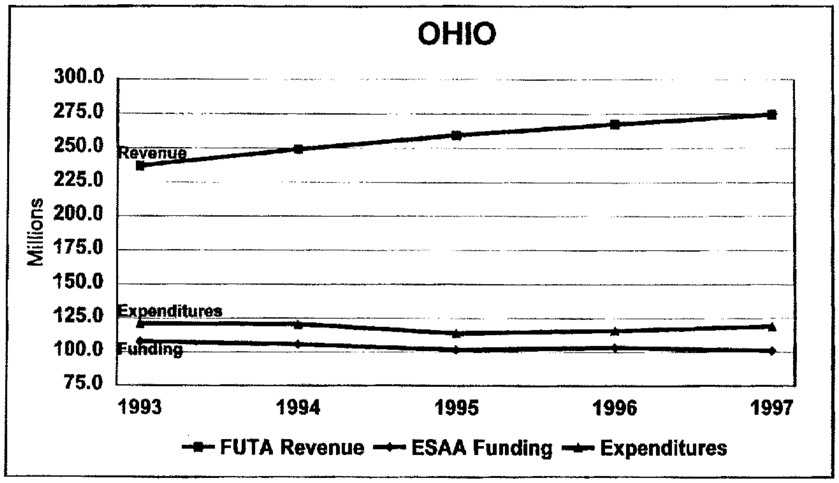
- Repeal the .2 FUTA surcharge;
- Transfer responsibility for collection of the FUTA tax to the states;
- Provide adequate dedicated funds for administration of the unemployment insurance program and public employment services; and
- Increase the flexibility of the use of funds as part of the workforce development system designed by each state.

It is time to repeal this unnecessary tax. I urge you to favorably consider legislation such as that introduced by Senator DeWine.



YEAR	ESAA Outlays (billions)	FUTA Revenues (billions)
1993	$3.81	$4.23
1994	$3.46	$5.46
1995	$3.57	$5.70
1996	$3.55	$5.85
1997	$3.36	$6.45

Source: USDOL, UI Outlook August 1997



OHIO	1993 (In millions)	1994	1995	1996	1997
FUTA Revenue	237.1	249.0	259.4	267.5	274.3
ESAA Funding	107.8	105.7	101.6	103.3	100.9
Percentage	45.5%	42.4%	39.2%	38.6%	36.8%
Expenditures	121.1	120.7	113.8	115.9	119.0

Chairman ARCHER. Governor, thank you for taking your time to appear before us on an issue that I believe is extremely important. Has the Governors Conference taken a position on this issue?

Governor TAFT. The National Governors Conference has not, but it is a project that I will be urging them to take on in our summer conference in St. Louis this year. As I indicated, we have 28 States signed up. Other States are supportive, and I believe that we have a good chance of getting NGA support for the project.

Chairman ARCHER. Do you know of any Governor who does not share your views?

Governor TAFT. I do not. There may be some, but I have not had a chance to speak to every Governor on this particular issue.

Chairman ARCHER. OK. I only have one last question. As you are aware, the President has said that the States should use their unemployment trust funds in order to pay for family leave. Do you have a position on that?

Governor TAFT. We are aware that the President has made this proposal. We are examining the costs and benefits of this proposal currently in Ohio. We are also waiting for additional clarification from the Department of Labor that would assist us to understand the consequences of the proposal, so we have that proposal under examination at the present time.

Chairman ARCHER. So, currently, you do not have a position established on that proposal.

Governor TAFT. That is correct.

Chairman ARCHER. Thank you, very much, Governor.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. And thank you, Governor. I think our President's position is that the funds could be used for family leave, not that they should. As a matter of fact, I think, Governor, that you yourself would like to use the funds for work force development systems.

Governor TAFT. Work force development, yes, sir.

Mr. RANGEL. And, clearly, family leave could be incorporated. Could be, but I think that would be your call. You would not object if you wanted to use it that way, would you?

Governor TAFT. Well, we are reviewing that whole issue in Ohio.

Mr. RANGEL. Exactly.

Governor TAFT. And, you know, we will be in a better position after we hear more from the Department of Labor about what is contemplated to take a position on that issue.

Mr. RANGEL. Well, I think President Clinton has made it clear that this is a State issue for Governors to decide and certainly not the White House.

Governor TAFT. Yes, we would feel a lot better about some of these new proposals if we could get more of our Federal employer taxes back in Ohio.

Mr. RANGEL. Well, tell me, you indicated that you receive back only less than $0.37 on the $1.00 paid in. That is as it relates to the FUTA tax?

Governor TAFT. Yes.

Mr. RANGEL. Do you know what your return is on the Federal dollar coming back to Ohio, as opposed to the Federal taxes that are paid?

Governor TAFT. Are you referring to total Federal dollars for all purposes?

Mr. RANGEL. Yes. Yes.

Governor TAFT. We are under 100 percent, but I don't have the exact percentage with me this morning.

Mr. RANGEL. What other examples of work force development systems would you think about using the funds for?

Governor TAFT. Well, we have a huge challenge, Congressman, in implementing the Welfare Reform Act. We have made progress, but we need to do more to help those folks who remain on the rolls to address their issues through training, through education, through services, through matching them with jobs in order to meet the goals that have been established by the Congress in the Federal Welfare Reform Act.

In addition to that, we now have many of these people who are working. So, really, they have transferred over from the welfare system to the unemployment or employment system. We are very concerned as to what happens to them if they should lose their employment, that they need services promptly, expeditiously, effectively, to help them to reenter the work force and obtain employment once again. So we want to improve and streamline and use these funds to improve our work force development and training programs, both for welfare reform and also to match employees throughout the state to jobs in a very tight economy.

Mr. RANGEL. Well, I certainly support the goals that you want to achieve and thank you so much for taking the time to share your views with this Committee.

Governor TAFT. Thank you very much, Congressman.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Governor Taft, tell us again why this 0.2-percent surtax was levied in the first place.

Governor TAFT. It was levied back in 1976 because at that time the trust funds were depleted. There was much unemployment and economic hardship at that time. There was extension of unemployment compensation benefits. But my understanding is that those funds were replenished in 1987, which is, of course, 12 years ago. And my understanding also is that, currently, the balances in the unemployment and employment services trust funds now are in the neighborhood of $20 billion and the current Federal obligations could be met merely by the interest on the trust funds that have accumulated over the years.

Mr. MCCRERY. So this was a dedicated tax, dedicated to a specific purpose, levied on employers around this country and that specific purpose was met in 1987.

Governor TAFT. That is correct. It cost employers $14.00 per employee.

Mr. MCCRERY. And so, since then, this tax has been extended, not for the original purpose, but really just to provide general revenues to the Federal Government.

Governor TAFT. That is exactly right. It is on-budget money that is used for the Federal deficit.

Mr. MCCRERY. In Louisiana, we get about 40 percent of the administrative funds back from the Federal Government. You stated that less than 58 percent, generally, around the United States, is returned to the States. So Ohio and Louisiana are not doing as well as the national average. We need to work on that.

But it is really, the Federal portion of the unemployment tax is principally used, is it not, or dedicated, to administrative expenses of the States in administering this program.

Governor TAFT. That is exactly right. The tax I am referring to, the FUTA tax, is for administrative purposes.

Mr. MCCRERY. So its principal purpose is not to pay benefits, but to pay administrative expenses.

Governor TAFT. That is correct. These changes have nothing to do with and do not alter the payroll tax that States collect for benefits and forward to the U.S. Treasury, which is in turn paid out for benefits. This is the administrative side of the equation.

Mr. MCCRERY. And you are telling us that even though that tax is supposedly dedicated to reimbursing the States for administrative expenses, States are only getting back 58 percent of what they pay in.

Governor TAFT. That is exactly right.

Mr. MCCRERY. How does welfare reform fit with this picture? Does it make it more difficult on the States in terms of the administrative expenses of their unemployment program?

Governor TAFT. Well, we are trying to modernize our work force development system in Ohio through the use of computers and telecommunications and other means to help to place those recipients who are still on our rolls into jobs. And we have an opportunity to do so in a tight job market, but the lack of Federal funding coming back for work force development and employment service training is making it more difficult for us to achieve those goals and realize the targets that have been set for us under Federal welfare reform legislation.

Mr. MCCRERY. Governor Taft, I agree with you that this is a tax that should have been repealed a long time ago. I think it is unfair for the American people and, in this case, particularly, employers to be told they are going to be taxed for a specific purpose and then that specific purpose is satisfied and yet the tax continues to be levied. That is just not the way we ought to operate, in my view, as representatives of the people in this country.

Governor TAFT. I am very pleased to hear that.

Mr. MCCRERY. So I appreciate very much your testimony.

Governor TAFT. Thank you.

Mr. MCCRERY. Thank you.

Chairman ARCHER. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman. Governor, great to have you here.

Governor TAFT. Thank you.

Mr. HOUGHTON. Let me try to understand this in terms of a taxpayer. There was a tax levied in 1976. It served its purpose. The purpose is no longer there. Therefore, you want to repeal that tax. But, at the same time, if I understand it, if I am a citizen of this country, I will still be paying the same tax, but it will be levied by the State. Is that right?

Governor TAFT. No, no. Regarding the 0.2-percent surcharge, we propose and Senator DeWine's legislation proposes, should be completely eliminated. So the employers would no longer have that burden. That would relieve the employers of the country of a tax burden of about $1.6 billion per year.

Mr. HOUGHTON. Yes, but does the State pick up that corresponding part of the tax if it needs it later on?

Governor TAFT. No. No, that would not be picked up by the State. The 0.2-percent surcharge is just a small part of the total FUTA tax. The total FUTA tax net is about 0.6 percent. That 0.6 percent tax for administering unemployment compensation would remain in place unaffected by this.

Mr. HOUGHTON. I see. Thank you very much.

Chairman ARCHER. Does any other Member wish to be recognized? Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Governor Taft, aren't State trust fund accounts currently running balances that are lower as a proportion of covered wages than in earlier periods?

Governor TAFT. I am not—could you repeat that question again? I am not sure that I understand it.

Mr. COYNE. Well, the percentage of the balances in the trust fund account are lower than the total wages that people earn that are covered by unemployment insurance. It is a lower percentage.

Governor TAFT. Well, in terms of unemployment compensation benefits, those are basically in balance. The benefits paid out and the taxes collected for benefits are basically in balance and the States have the ability to adjust those under Federal law to make sure that they do balance. If there is a need for additional dollars, then the unemployment compensation tax would be increased in any particular State. So those funds stay in balance.

What we are referring to here today is the administrative side of the equation. And all of these trust funds, by the way, are held in the U.S. Treasury and the States draw down from them. But in the administrative accounts for unemployment administration, there is a total balance here in Washington of in excess of approximately $20 billion.

Mr. COYNE. But if—or more likely when—we have the next recession, if you were not to have this surcharge, would that not put an administrative burden on the States that they wouldn't be able to handle if, as I say, or when, the recession comes?

Governor TAFT. Well, the States will be able to pay their share. For example, for extended unemployment compensation benefits that would be paid in a time of recession, the States pay 50 percent. We are prepared to pay that share. The Federal Government's share is also 50 percent. And there is a special fund dedicated in the Federal Government to pay that amount. It is called the Extended Unemployment Compensation Account.

Currently, in 1999, the balance in that account is $16.9 billion. The last recession in the early nineties cost a total, in terms of additional costs to the Federal Government, of about $4 billion. So you have a balance, currently, more than four times what the last recession cost in terms of providing extended unemployment compensation benefits to workers who had lost their jobs.

Mr. COYNE. Well, as I look at it——

Governor TAFT. Healthy balance.

Mr. COYNE [continuing]. Yes. As I look at it, the trust fund is a trust fund that is needed for a rainy day. We are all experiencing a very vibrant and positive economy in this country today, but I think that the purpose of this fund has always been for the rainy day that is sure to come. It is not a matter of whether it is going to come, it is when it is going to come.

Thank you.

Governor TAFT. Yes, that is correct. But just to reiterate, the almost $17 billion balance in that particular fund would be more than ample for virtually any kind of a rainy day that would be contemplated, based on previous recessions.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. And, Governor, again, thanks for taking the time to be in Washington today to help us out with this issue. In terms of the rainy day issue, I think it is probably important to note that the U.S. Department of Labor has set some standards and, based on the Department of Labor's own standards, I think those trust funds at the Federal level exceed the projections of payout through fiscal year 2004.

Governor TAFT. In fact, Congressman Portman, I understand, under current Labor Department projections, the interest alone on the Federal trust funds is adequate to pay for the anticipated Federal expenses through fiscal year 2004.

Mr. PORTMAN. Well, I appreciate your raising this issue with the Membership. I think a lot of Members of Congress probably aren't as focused on this as you are, heading up this coalition and now some of the other Governors. I think it would be helpful if we could hear from you as to the impact on employers in the state of Ohio and all the other States represented by this panel today. What is the impact of continuation of the surcharge tax?

Governor TAFT. Well, in the state of Ohio alone, in terms of the 0.2 percent surcharge, employers are paying $70 million per year. And across the country, that would translate into $1.6 billion, just the surcharge portion alone. So we would be talking about significant savings to employers.

In addition to that, currently the States collect the tax for benefits and the Federal Government, IRS, collects the tax for administration. So employers have to deal with two different entities on basically the same program. This is very complicated and imposes significant additional administrative costs on employers across the country. I have seen one estimate as much as $1 billion of additional administrative expenses. And what we propose in Senator DeWine's legislation is that the States would collect both those taxes, which would streamline the collection of taxes and save some additional administrative expenses to employers, in addition, of course, to the reduction they would see from the elimination of the surcharge.

Mr. PORTMAN. Well, again, I encourage you to keep pursuing that overall reform. I think it is worth noting that the DeWine legislation and the Shaw legislation from last year goes beyond repealing the surcharge, which, again, was put in place in 1976 for a problem that was resolved by 1987. And it seems to me that is inappropriate, given the Department of Labor's own projections to continue to hoard here in Washington when it should be going back.

But these reforms go beyond that, as you indicate, to streamline the system. And I know there is a lot of interest on this panel in doing that. Even outside this panel, Mr. Traficant has approached me a number of times. Mr. Collins has worked on this issue. Mr. McCrery is working on this issue. Mr. Shaw and others and colleagues from the other side of the aisle. So I hope it is something that we can work on this year, in conjunction with the Senate, and begin not just to look at the surcharge, which is a very important issue—I know that is the focus of your comments today—but also your other ideas on how to streamline the system and make it better for employers.

After all, this is much like the Social Security payroll tax. The employer side comes out of the employees pocket. And we are talking about an impact on employers, but, ultimately, it comes out of the worker's paycheck.

Governor TAFT. That is right.

Mr. PORTMAN. Again, thank you very much for being willing to spend the time with us today.

Governor TAFT. Thank you, Congressman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. Governor, it is a pleasure to have you here.

Governor TAFT. Thank you.

Mr. CARDIN. Let me just make one point. I think many of us are sympathetic to the concerns that you raise about repealing the 0.2 percent surcharge, but, as has been pointed out, under our budget rules, that would have to be offset. That that is revenues that come in under the Unified Budget as an on-budget revenue source, as you have pointed out. Some of us aren't very happy about our budget rules, but we have to comply with our budget rules.

So I am just curious. Have you come forward today with some suggestions on how we might be able to offset that?

Governor TAFT. First of all, I want to congratulate the Congress on the tremendous progress you have made toward achieving a balanced budget. I think it is truly remarkable. In fact, your success creates the opportunity for us to now come in and say, "Now that you are balancing your budget, how about this surtax that you imposed over 20 years ago that we are still paying? And you are not sending us back enough to administer our unemployment compensation programs." And I recognize there would be a cost of $1.6 billion which the Congress would have to find from some source. And I would like to think it most appropriate for me to leave it to the wisdom of you and your Members and the Congress to determine how that might occur.

But we would really earnestly ask you to consider looking at this particular issue. Because I think we can make the system both better and more fair.

Mr. CARDIN. Well, having served on this Committee for now close to 10 years, I can assure you we don't have exclusive wisdom on that. So we will take whatever help we can get on trying to come up with offsetting revenues.

Let me mention the second point. I also served in the Maryland legislature for 20 years during a very difficult period in the eighties when we went into special session because of unemployment insurance and had a crisis in our State in order to try to meet the burdens that were on our workers who were out of work. You point out that there is at least some balance, a significant balance, in the fund to deal with these problems. But let me just caution all of us that when we change these funding sources, to remember that when we go into recession, it is difficult to raise the revenues necessary to deal with extended benefits. And extended benefits can be more costly than the $4 billion that you mentioned.

And if we are going to make a permanent change in repealing the surcharge, then I think we also must have a safe plan to deal with workers who are going to be out of work needing extended benefits, perhaps for an extended period of time. That was the whole concept of the shared relationship between the Federal Government and the States. And this surcharge does go into that fund. It is not just administrative. The moneys go into the extended benefit program as part of the 0.8 percent and goes into a loan fund that is available to States if they need to do that.

So I guess my point is I agree with your testimony. Clearly the original purpose for which the surcharge was put into effect, we have accomplished those goals. But we should be mindful that when you are in recession, it is the most difficult time to try to find the revenues necessary, particularly at the state level, to deal with these issues. And I would invite your comments.

Governor TAFT. Yes, I would concur with your comment there, and we certainly would not propose that you reduce the balances—the very, really extraordinary balances that exist now in the different funds that provide that cushion against a recession. That is very, very important. All we are suggesting is that it may not be necessary, because of the size of these surpluses, to continue to add additional money to those surpluses at the expense of the States.

Mr. CARDIN. Well, one of the things that you could do is have some form of an automatic trigger so that it doesn't require additional congressional action if the fund balances drop below a certain amount. There are certain things that we could do in order to ensure that the extended benefit program is adequately financed.

Governor TAFT. Yes.

Mr. CARDIN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Governor, for being here with us this morning.

Governor TAFT. Thank you.

Mr. COLLINS. The former Governor of Georgia, Governor Zel Miller, was very supportive of not only repealing the surtax, but also devolving the tax back to the States, as well as our former labor commissioner who came up several times on this particular issue. Where we have always run into opposition here or problems is from organized labor. And you can understand their concerns. Which are that they are afraid that if this tax, the surtax, is repealed and the tax is devolved back to the States, that it could have some negative impact on benefits. Do you see any negative impact?

Governor TAFT. Absolutely not. This is an entirely separate funding stream. In fact, it might be possible that, as a result of this reform, more of the administrative moneys would find their way into the benefits fund, which would create the opportunity to possibly even increase benefits if necessary at a time of recession.

Mr. COLLINS. Well, I think that is a point that should be well made by you and other Governors and labor commissioners across the country who support not only repeal, but devolving the tax back to the States. As you say, it can help support your State labor agency itself and the programs there. It also gives you a lot of flexibility. Mr. Cardin mentioned a special session in Maryland. We went into legislature in Georgia back in the late eighties and early nineties. Commissioner Joe Tanner wore out a pair of shoes walking the halls of the general assembly encouraging an increase in the tax in Georgia to build a fund. And he was successful and I voted for that. It was one of the very few times that I have ever voted for any type of tax increase at all.

But we did that under the pretense, too, that if we built this fund, at some point we would be able to give relief to employees. And I see where here we can give relief to employers and employers then can also have the funds to better the benefits of their employees in other ways.

Governor TAFT. Exactly.

Mr. COLLINS. Rather than through a tax that has to be funneled back through the government which, oftentimes, as you say, is just totally eaten by administrative costs. So we appreciate your support.

Governor TAFT. Thank you very much.

Mr. COLLINS. Appreciate you being here. And, hopefully, we will be successful. As far as the offset, as I have told a lot of groups that I have spoken to in the last few days, this is a game of dealer's choice. The dealer happens to be the Chairman from Texas. I hope this is part of his choice.

Thank you. [Laughter.]

Governor TAFT. Thanks very much, Congressman.

Chairman ARCHER. Governor, I see—let me first recognize the gentleman from Michigan, Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome, Governor.

Governor TAFT. Thank you.

Mr. LEVIN. We have met under—in other ways and I have enjoyed our relationship.

Governor TAFT. Thank you.

Mr. LEVIN. And I am glad you are here because—for a variety of reasons—you help open up the discussion of unemployment compensation maybe beyond your expectation. But it is useful to do that.

Mr. Cardin and Mr. Coyne raised questions about extended benefits and I hope you would take a look again, if you would, at the experience of Ohio and other industrial States. And not in the recession of the early nineties, but the recession in the early and mid-eighties. Because you referred to enough moneys to handle the unemployment in the a recession type of nineties, but, you know, in the mid-eighties, we were struggling incessantly here with the issue of extended benefits. And I don't have, offhand, the amount, but it was far beyond the amount needed in the recession of the nineties.

We have an extended benefit program that is inadequate and was grossly so in the eighties. And your State suffered terribly as a result. And it was two or three times that we had to struggle to revise the extended benefit formula. So I would hope, as Governor of a large and important and dynamic State, you would take another look at the extended benefit program and tell us whether you think it is adequate. Because the focus should not only be on the 0.2 percent—and I think there are problems with the administrative end of it—but also with the entire system that the 0.8 percent finances.

Because you may be unhappy if there is another recession with action taken here. I have a chart from the Labor Department and I don't know all the definitions, but it diagrams, it spells out how much the States have in their funds to last for their own programs in the case of a severe recession. And Ohio is toward the bottom, quite below the state average in terms of how long the funding would last.

State Level Program Indicators - CY 1998

(preliminary)

Replacement Rates

Rhode Island	56
Hawaii	55
New Jersey	54
North Carolina	53
Pennsylvania	53
Texas	53
Iowa	53
Arkansas	52
Maine	52
Florida	52
Kansas	52
Oklahoma	50
Washington	50
Idaho	49
Minnesota	49
Wisconsin	49
Utah	49
Indiana	49
Delaware	49
Colorado	49
Vermont	48
Michigan	48
North Dakota	48
Maryland	48
South Carolina	48
Nevada	47
Oregon	47
South Dakota	47
Tennessee	47
Massachusetts	47
New Mexico	47
Virginia	47
Mississippi	46
Wyoming	46
Kentucky	46
US Average	**46**
Dist. of Columbia	46
Alabama	46
Nebraska	46
Georgia	45
Arizona	45
Connecticut	45
Puerto Rico	44
New York	44
Missouri	43
Ohio	43
Montana	42
West Virginia	41
Louisiana	41
Illinois	41
New Hampshire	40
California	38
Alaska	32
Virgin Islands	n/a

Average High Cost Multiples

Virgin Islands	2.78
New Mexico	2.66
Vermont	2.44
Georgia	2.19
New Hampshire	2.17
Delaware	2.02
Mississippi	1.85
Utah	1.81
Arizona	1.74
Oklahoma	1.72
Florida	1.68
Wyoming	1.67
Indiana	1.53
Virginia	1.50
Puerto Rico	1.45
South Carolina	1.37
Oregon	1.33
Montana	1.31
Louisiana	1.30
Iowa	1.27
Hawaii	1.24
Nebraska	1.24
New Jersey	1.18
Kansas	1.18
North Carolina	1.17
Wisconsin	1.13
Idaho	1.11
Colorado	1.08
Nevada	1.08
Alaska	1.07
Massachusetts	1.07
Connecticut	1.06
Washington	1.02
Tennessee	0.99
US Average	**0.94**
Maryland	0.94
South Dakota	0.92
Maine	0.90
Dist. of Columbia	0.89
Kentucky	0.79
Rhode Island	0.79
Alabama	0.77
California	0.74
Pennsylvania	0.66
Michigan	0.66
Missouri	0.65
Ohio	0.63
Arkansas	0.63
Minnesota	0.61
Illinois	0.50
West Virginia	0.45
North Dakota	0.34
Texas	0.33
New York	0.29

Recipiency Rates

Alaska	67
Massachusetts	57
Rhode Island	56
Connecticut	55
Vermont	54
Washington	53
Pennsylvania	53
Wisconsin	52
New Jersey	48
Michigan	48
Minnesota	47
Nevada	46
Oregon	43
Delaware	41
Maine	40
Idaho	40
Arkansas	40
California	39
Illinois	39
North Carolina	39
Iowa	38
Tennessee	37
US Average	**36**
Hawaii	35
New York	35
Missouri	35
Alabama	34
Indiana	33
Puerto Rico	33
South Carolina	32
North Dakota	32
Montana	31
Dist. of Columbia	31
Kentucky	31
West Virginia	31
Ohio	31
Maryland	29
Mississippi	27
Nebraska	27
Wyoming	26
Kansas	25
Florida	25
Virginia	25
Utah	24
Texas	23
New Mexico	22
South Dakota	21
New Hampshire	21
Colorado	21
Georgia	21
Arizona	20
Louisiana	19
Oklahoma	17
Virgin Islands	n/a

States who have reduced UI taxes at some point between 1992 and 1997 are shaded.

** RECIPIENCY RATES UPDATED TO REFLECT ANNUAL BLS BENCHMARK REVISIONS

Date: 3/11/99

Also—and it is not directly related—but the recipiency rates have been going down in this country. And today the U.S. average unemployment covering the unemployed is 36 percent—only 36 percent—of the unemployed are covered by the present system. My own State of Michigan, that is 48 percent. Pennsylvania is 53 percent. I am using other industrial States. And Illinois, if I can pick it out here, is 39 percent. And Ohio is 31 percent. So the way your unemployment system in your State is structured, less than a third of the unemployed receive unemployment compensation.

So I urge that we take this proposal and look at the extended benefit program, as well as other facets of our unemployment compensation system. And coming from a State that has experienced ups and downs maybe beyond the norm or the average, I would be interested in your sending us your thoughts about the extended benefit program. You know, one of the problems is it doesn't click it. As I remember it, Ohio wasn't even covered by the present law during the severe recession of the eighties. We had to redo the formula.

Governor TAFT. We did provide extended benefits, I know, but——

Mr. LEVIN [continuing]. But the original—the formula as it is presently devised I don't think covers it. So give us the wisdom of your further inquiry, if you would. And let us look at the administrative part of this, but also other facets of the system that are supposed to be financed beyond administrative.

Governor TAFT. We will do that.

Mr. LEVIN. All right. Thank you.

Governor TAFT. Thank you.

Chairman ARCHER. Does any other Member wish to inquire?

[No response.]

If not, Governor, thank you so much for taking the time to make your presentation to us.

Governor TAFT. Thank you very much, Mr. Chairman. I really appreciate the opportunity to testify.

Chairman ARCHER. You are welcome.

Governor TAFT. Congressman Rangel, thank you very much.

Chairman ARCHER. Our next panel is a number of our colleagues, led by Mr. Rangel. You will come and take seats at the witness table. If a few more of our Members go down and join you, then we will not have anybody up here to ask the questions. Mr. Rangel, welcome to the Ways and Means Committee. We would be pleased to receive your testimony.

STATEMENT OF HON. CHARLES B. RANGEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. RANGEL. Thank you. The last time that you, Mr. Chairman, testified as a witness, you made it clear that it may be your last time. I hope this is not the last time that I have a chance to testify.

Let me thank you and my other colleagues for being here this morning as we listen to ideas that Members and others have as to how we can improve the Tax Code and quality of life for most Americans. As I said earlier in my opening statement, I hope we have the same opportunity to share ideas when we are drafting the tax bill as we have had today to listen to ideas.

Mr. Chairman, as you and I work together to see how much support we can get in a bipartisan way to repair our Social Security system, I believe that, if we are able to accomplish this, it would give a lot of confidence to the House of Representatives and, hopefully the Senate, that we can tackle serious problems in a serious way. If there are some people who believe that Democrats can benefit by the failures of the Majority, I don't agree with them. I don't think that the electorate is sophisticated enough just to pick out Republicans as having failed. We might all get caught in their outrage and achieve that reputation as well.

And I do believe that with the serious problems that we face as a nation, there are serious, very serious, differences in how Republicans and how Democrats approach those problems. Under our great system, we give the voters an opportunity to see which direction is most compatible with their beliefs.

Certainly, when we deal with the questions of health care, the patients bill of rights, gun safety, or housing, there is enough controversy. But to me, one of the most important issues on which we are divided is education. When we move into this next century, our young people have to be prepared better than ever before to meet the challenges of international trade and competition. We have an obligation not to say that education is a local or State issue, but instead to make certain that American workers are the best trained workers in the entire world.

It has been reported that some people in the Majority would want a State to be able to remove itself from the direction of Federal legislation in providing assistance to kids that come from poorer communities, that is to allow that State to opt out of that system and to use the money for whatever purpose it wishes without any Federal direction. There are others who believe that the best way to handle the problem of education is to allow the parent to deposit money into a bank account on which the parent would receive tax-free benefits and that the money could be used in any way to assist the child, perhaps for private education. Of course, if you spend the principal, perhaps because you are poor and need to eat you have no interest; you have no benefit. But this is the thinking of some people.

Others believe that we should use a voucher system. They say let the parents decide where they want their children to attend school. After all, wealthy kids go to private schools. This thinking does not take into account the fact that it is public schools that 90 percent of our kids attend. It is the public school system that is the institution that has allowed so many people like myself even to dream of getting out of poverty.

And that is the reason, Mr. Chairman, why I am asking for support for H.R. 1660. This bill would allow local and State communities to issue bonds. And the bonds would be virtually cost-free for the communities because the Federal Government would provide a tax credit equivalent to the interest payments communities would otherwise be required to pay. The General Accounting Office has indicated that it would take $112 billion to repair and to renovate existing public schools. And another $60 billion during the next decade for upkeep and to build the new schools that will be necessary to educate our children.

For those who are anxious to support the private school system, by all means do that and encourage that. But for those communities that have only the public school system, I am not here to defend the entire system. However, I hope that we can identify the communities where that public school system is not working and demand that the school system go into partnership with the private sector, with the local and State governments, to come up with the curricula that are needed to make the children productive and to make certain that we never are able to say that education is not a Federal responsibility, even though we only contribute 7 percent toward the financing of public education throughout the country.

And we have to keep in mind that in the areas where the public schools are failing, whether it is in the rural areas or whether it is in the inner-city areas, all of us lose because these students are not able to produce, not able to be as productive, not able to make a contribution toward improving our economy because of their lack of training. When a kid knows that there are no opportunities, then the temptations of drugs and violence and making unwanted babies are there. Take a look at the prison population that has increased dramatically from 250,000 in 1970 to 1.3 million today, the highest level of any Nation in the entire world. And in the great city of New York, we are prepared to spend $84,000 for every kid that gets arrested as opposed to the $8,000 that we are forced to fight for to provide a decent public school education.

H.R. 1660 is supported by the teachers, supported by the superintendents, supported by the mayors and, supported by businesses and unions alike. I ask you, no matter how you intend to put together the bill that you may place before this Committee, to please consider this legislation. It is needed because we are losing teachers. We are losing students. And, indeed, we are losing schools, unless we have the resources to build and to rebuild and to modernize the existing schools that we have today.

Thank you, Mr. Chairman, and I thank you, my colleagues.

[The prepared statement follows:]

Statement of Hon. Charles B. Rangel, a Representative in Congress from the State of New York

Colleagues. I am pleased to testify before you today about the state of the public school system in the United States. It is becoming increasingly apparent that the most important challenge facing this country today is the need to improve our educational system. Investment in public education is the key to developing young minds and giving all of America's children a chance to excel.

At the present time, however, some of our young people attend schools where facilities are crumbling, classrooms are overcrowded, students are without computer and internet access, and many teachers are uncertified and under qualified. It is a shame that the United States maintains a public education system that subjects some of its students to a poor quality of education—in effect, dooming them to a future that is bypassed by the prosperity and promise of the new global economy.

Many children today are attending school in trailers or in dilapidated school buildings. We cannot expect learning to occur in those environments. The General Accounting Office reports that approximately one-third of America's public schools is in need of extensive repair or replacement. The report estimates that it will cost $112 billion to repair, renovate, and modernize our existing schools and another $60 billion over the next decade to build new schools. It is estimated that in New York City alone more than one-half of the city's 1,100 school buildings are over half a century old. Thirty-eight percent of these schools are estimated to be in need of extensive renovation.

In an effort to help schools meet their capital needs, I have introduced legislation, H.R. 1660, a bill designed to provide approximately $24 billion in interest-free funds to State and local governments for school construction and modernization projects. I believe this bill is a meaningful first step in addressing the problem of crowded, dilapidated and outdated school facilities.

H.R. 1660, The School Construction and Modernization Act of 1999, extends and enhances the education zone proposal that was enacted on a limited basis in the 1997 Taxpayer Relief Act. This program is designed to create working partnerships between public and private entities to improve education and training opportunities for students in high poverty rural and urban area.

Some have argued that the Federal government should have no role in assisting the public school system at the K through 12 level. I disagree strongly. The Federal government historically has provided financial resources to the public school system. It has done so in part by providing tax-exempt bond financing that enables State and local governments to fund capital needs through low-interest loans. This bill is, in many respects, very similar to tax-exempt bond financing. The bill provides special tax benefits to holders of certain State and local education bonds without requiring any additional layers of bureaucracy at the Federal or State level. The procedures used to determine whether bonds are eligible for those special benefits are substantially the same as the procedures applicable currently in determining whether a State or local bond is eligible for tax-exempt bond financing.

I also want to be very clear that H.R. 1660 supports our public school system. I believe that improving our public school system should be our highest priority. Approximately 90 percent of the students attending kindergarten through grade 12 attend public schools. If we can find the resources to provide additional tax incentives, it is imperative that these incentives focus on improving a public school system that serves such a large segment of our student population. For this reason, I have and will continue to oppose legislation, such as the so-called "Coverdell" legislation, that diverts scarce resources away from our public school system.

The Republicans are promoting a change in the tax-exempt bond arbitrage rules that they claim is a meaningful response to the problem of dilapidated and crowded school buildings. Under current law, a school district issuing construction bonds can invest the bond proceeds temporarily in higher-yielding investments and retain the arbitrage profits if the bond proceeds are used for school construction within two years. The Republican arbitrage proposal would extend the period during which those arbitrage profits could be earned for four years. The Republican proposal does not benefit those districts with immediate needs to renovate and construct schools. It benefits only districts that can delay completion of school construction for more than 2 years. It is inadequate at best. At worst, it may increase costs for those districts most in need because more bonds could be issued earlier.

My bill includes a provision that would extend the Davis-Bacon requirements to construction funded under the new program. This provision is consistent with the policy that Federally subsidized construction projects should pay prevailing wage rates. The bill also includes provisions designed to ensure that local workers and contractors are able to participate in the construction projects.

It is becoming increasingly clear to many across the country that some parts of our current education system are producing students who come out of high school with a knowledge base that is incomplete or obsolete. Some schools produce graduates ill-equipped to compete in an increasingly fast-paced, knowledge-based, technological world. It is deplorable that some of our young people are doomed to failure because they attend resource-poor schools where facilities are crumbling, classrooms are overcrowded, students are without computer and internet access, and many teachers are uncertified and under qualified.

Tragically, the young people who are most likely to be subjected to an inferior education in this system are those who attend school in urban and rural areas with high rates of poverty and those who are of African American and Hispanic descent. In a country that prides itself on its leadership in world affairs, the negative effects of race and income continue to have a pervasive impact on the quality of education and the life's chances of affected students. These educational disparities are a national disgrace and must be addressed.

Failing students in poor communities are almost sure to face high rates of illiteracy, incarceration, joblessness, and drug abuse. Since 1970, the prison population has increased from 260,000 to 1.8 million people in 1997 (nearly a 600% increase). Studies indicate that 70% of inmates lack basic literacy skills, 49% have not completed high school, more than 70% used illegal drugs one month prior to their arrest, and 40% in state prisons lived below the poverty level prior to incarceration. It is important to realize that these incarcerated individuals are not born criminals. Many are the products of failed support systems, including schools that have neglected to provide them with the proper tools to compete and excel in today's society. It is unacceptable that some of our children are locked up with no hope for the future in the richest, most powerful country in the world. This is a waste of talent and productivity.

Supporting a punitive incarceration policy rather than front-end investments like education and training is also a waste of money. Why do we spend $84,000 per year to keep someone incarcerated but only $9,000 per year to educate him or her? Wouldn't it make more sense to provide people with the tools they need to compete before they end up in jail or on the street? The U.S. must reassess its misplaced priorities and make a greater investment in its public education system so that all of America's children can receive a quality education that enables them to compete in the global economy of the 21st Century.

Now that the war in Kosovo has ended, it is time to declare a war much closer to home—one of great significance to national security and to the economic and social stability of our nation. America's new "war" at home should be a national initiative to reform failing public schools. Contrary to what some claim, the answer is not to throw out the entire public education system when only a few parts are dysfunctional. The U.S. must focus on turning disadvantaged schools inside out so that they can be transformed into model schools where students can learn in a positive and affirming environment. This effort requires a serious commitment from the federal government with substantial cooperation from local and state government, teachers unions, parents, and businesses. Serious school reform would entail providing better teacher training, more effective curricula, improved access to new technologies, refurbished or new facilities, smaller class sizes and innovative partnerships between schools, businesses and communities.

As a community, we should establish strong expectations for student performance based on academic literacy, social competency, civic responsibility, occupational opportunity, and technical proficiency. Additionally, these expectations should be aligned with the needs of the U.S. economy so that we can continue to produce strong economic growth. Investment in public education is the key to developing young minds and giving all of America's children a chance to excel.

The President recently embarked on a new initiative to focus federal resources in those areas of the country that have been underdeveloped in terms of business opportunities. It is important to recognize that this "new markets" initiative cannot thrive without also nurturing the underdeveloped human talent in these distressed areas. We must have new minds for new markets if we are serious about truly improving the conditions of poor communities throughout America.

There is no reason why a country possessing the genius and talent to develop the internet, create innovative computers and software, and generate enough produce to feed the world, cannot successfully reform its own public education system. We have the know-how and expertise, now we need the willpower and commitment.

Due to a strong economy and budget surpluses, the U.S. now has a unique opportunity and strong incentive to invest in its human capital. Public education has helped make the U.S. the world leader that it is today. It must be our nation's priority to radically reform poor performing public schools if we are to guarantee our children's future in the global economy.

Chairman ARCHER. Thank you, Mr. Rangel.

Our next witness is Congressman Jerry Weller from Illinois.

Mr. Weller, you may proceed.

STATEMENT OF HON. JERRY WELLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. WELLER. Thank you, Mr. Chairman. And I want to thank you and this Committee for the opportunity to testify today on an issue that I believe is really an issue of fairness. And that is the issue of eliminating the marriage tax penalty which is imposed on married working couples in 66 different ways by our current Tax Code.

Earlier this year, Representative McIntosh, Representative Danner, and I introduced bipartisan legislation, H.R. 6, to eliminate the marriage tax penalty for the majority of Americans who suffer it by doubling the standard deduction as the chart here to my right shows and broadening each tax bracket for joint filers to twice that of singles. And I am please to tell you that we now have gained a majority of House as bipartisan cosponsorship of 230 cosponsors of our legislation to eliminate the marriage tax penalty.

In the last 30 years, our tax laws have punished married couples when both spouses work. For no other reason than the decision to be joined in holy matrimony, more than 21 million couples a year are penalized an average, according to the Congressional Budget Office, of $1,400 per year. They pay more in taxes than they would if they were single and not only is the marriage penalty unfair, it is wrong that our Tax Code punishes society's most basic institution. I would also note that the marriage tax penalty exacts a disproportionate toll particularly on working women and low-income couples with children.

Let me give you a couple of examples of how the marriage tax penalty unfairly affects middle class, working couples in the district that I represent. In the first example, two schoolteachers live in the district that I represent. They are from Joliet, Illinois. Shad Hallohan makes $38,000 a year in salary. His wife Michelle makes $23,500 a year in salary, both as teachers. Since they chose to live their lives in holy matrimony and, of course, file jointly, their combined income of $61,500 pushes them into a higher tax bracket of 28 percent, producing a marriage tax penalty of $957 in higher taxes. Michelle and Shad would have liked to have been here today, but the couple is about to have their first baby and Michelle's doctor cautioned against travel. But Michelle did ask me to relay a message to the Committee today. For their new and growing family, $957 marriage tax penalty means 3,000 diapers for their new baby.

I also have a chart here to my right which illustrates how the marriage tax penalty works and our solution to solve it. To my right on this chart, of course, I have a machinist who works at Caterpillar in Joliet and a schoolteacher who works in the Joliet public schools. They have identical incomes. As single individuals, after you consider the standard deduction and exemption, they each, if they file as single and stay single, pay in the 15-percent tax bracket. But if they choose to marry, they, on average, with their combined income pushing them into a higher tax bracket, combined income of $60,500, pay the average marriage tax penalty of almost $1,400. The marriage tax penalty—excuse me, the Marriage Tax Elimination Act would eliminate this marriage tax penalty for this machinist who works at Caterpillar and this local schoolteacher.

Marriage Penalty Example

	Machinist	School Teacher	Couple	H.R. 6
Adjusted Gross Income	$31,500	$31,500	$63,000	$63,000
Less Personal Exemption and Standard Deduction	$6,950	$6,950	$12,500	$13,900 (Singles x2)
Taxable Income	$24,550 (x .15)	$24,550 (x .15)	$50,500 (Partial x .28)	$49,100 (x .15)
Tax Liability	$3,682.50	$3,682.50	$8,635	$7,365
		Marriage Penalty	$1,270	Relief $1,270

On average, America's working couples pay $1,400 more a year in taxes than individuals with the same incomes. And that is real money back home in Illinois. $1,400 is 1 year's tuition at a local community college in Illinois as well as 3 months' day care at a local day care center. If you think about, over 10 years, the average married working couples suffers a marriage tax penalty of $1,400 in higher taxes just because they are married and that is real money. For many people, that is a new car.

I believe that in the era of Federal budget surpluses which do not include Social Security revenues, American families deserve to have their tax burden lowered. We should focus on Tax Code simplification, beginning with eliminating the unfairness of the marriage tax penalty.

I would also note that Tax Code simplification is the focus of legislation that I partnered up with Jennifer Dunn on and we have introduced on March 11 of this year called the Lifetime Tax Relief Act. This legislation simplifies the Tax Code by eliminating the marriage tax penalty, phasing out the death tax, providing alternative minimum tax relief for middle-class families and making the R&D tax credit and other extenders permanent.

This legislation eliminates the marriage tax penalty by doubling the standard deduction and widening the 15-percent tax bracket for married couples. I would also point out that our legislation widens the 15-percent tax bracket by 10 percent, guaranteeing that a family making under $55,000 will not be pushed into the 28-percent tax bracket.

I believe the issue of eliminating the marriage tax penalty can best be framed by asking these questions: Do Americans feel it is fair that our Tax Code imposes a higher tax on marriage? Do Americans feel it is fair that the average married working couple pays almost $1,400 more in taxes than a couple with almost identical income living together outside of marriage? I think all Americans agree. The marriage tax penalty is unfair and today is the day to eliminate it.

Eliminating the marriage tax penalty addresses an important issue of fairness. I hope we can work together, Mr. Chairman and Members of this Committee, in a bipartisan way, as we have demonstrated with the Marriage Tax Elimination Act, to make elimination of the marriage tax penalty punishing 21 million married working couples just for being married the number one priority for family tax relief this year.

Thank you, Mr. Chairman.

[The prepared statement and attachment follows:]

Statement of Hon. Jerry Weller, a Representative in Congress from the State of Illinois

I want to thank you for holding this hearing on providing tax relief to families. I appreciate the opportunity to testify on an issue that is really an issue of fairness, eliminating the marriage tax penalty imposed on married working couples in 66 different ways by our tax code.

On February 10, 1999, Representatives McIntosh, Danner and I introduced H.R. 6 to eliminate the marriage tax penalty for the majority of Americans families who suffer it by doubling the standard deduction and broadening each tax bracket for joint filers to twice that of singles. H.R. 6 now enjoys broad bipartisan support with 230 cosponsors.

Since 1969, our tax laws have punished married couples when both spouses work. For no other reason than the decision to be joined in holy matrimony, more than 21 million couples a year are penalized an average $1,400 per year. They pay more in taxes than they would if they were single. Not only is the marriage penalty unfair, it's immoral that our tax code punishes society's most basic institution. The marriage tax penalty exacts a disproportionate toll on working women and lower income couples with children.

Let me give you two examples of how the marriage tax penalty unfairly affects middle class married working couples in my district.

In my first example, two school teachers live in my district in Joliet, Illinois. Shad makes $38,000 a year in salary. His wife Michelle makes $23,500 a year in salary. If they would both file their taxes as singles, as individuals, they would pay 15 percent.

But if they chose to live their lives in holy matrimony, and now file jointly, their combined income of $61,500 pushes them into a higher tax bracket of 28 percent, producing a tax penalty of $957 in higher taxes. Michelle and Shad would have liked to have been here today but, the couple is about to have their first baby and Michelle's doctor cautioned against any travel. Michelle asked me to relay a message to the Committee today, for their growing family, $957 means 3000 diapers for their new baby.

Another couple from my district, living in Wilmington, Illinois, pays an even higher marriage penalty each year. Calley is a bank teller and earns $21,800. John is an insurance salesman that earned $51,700. Their marriage tax penalty was $1,053 last year.

On average, America's married working couples pay $1,400 more a year in taxes than individuals with the same incomes. That's serious money. $1,400 is a year's tuition at Joliet Junior College and 3 months of daycare at a Joliet child care center. Over ten years, average couples pay $14,000 more in taxes than singles! This can represent the cost of a new car or a year of college tuition at almost any university in America.

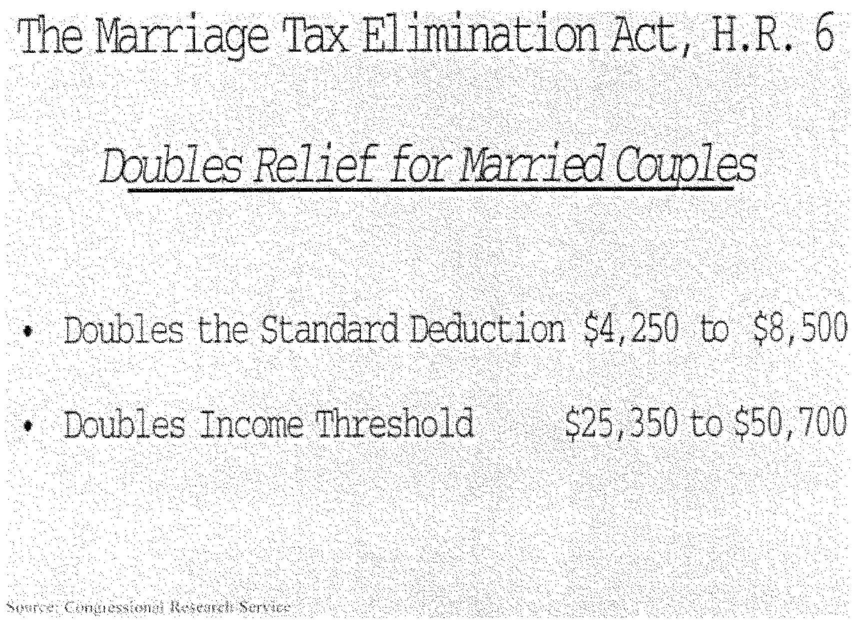
I believe that in an era of federal budget surpluses which do not include Social Security revenues, American families deserve to have their tax burden lowered. We should focus on tax code simplification beginning with eliminating the unfairness of the marriage tax penalty.

Tax code simplification is the focus of a bill that Jennifer Dunn and I introduced on March 11, 1999 called the Lifetime Tax Relief Act. This bill, H.R. 1084, simplifies the tax code by eliminating the marriage tax penalty, phasing out the death tax, adjusting the AMT for families, and making the "extenders" permanent.

H.R. 1084 eliminates the marriage tax penalty by doubling the standard deduction and 15% tax bracket for married couples, as is accomplished in H.R. 6. Additionally, the Lifetime Tax Relief Act widens the 15% tax bracket by 10%. This guarantees that a family making under $55,000 will not be pushed into the 28% tax bracket.

I think the issue of the marriage penalty can best be framed by asking these questions: Do Americans feel its fair that our tax code imposes a higher tax penalty on marriage? Do Americans feel its fair that the average married working couple pays almost $1,400 more in taxes than a couple with almost identical income living together outside of marriage—is it right that our tax code provides an incentive to get divorced?

Eliminating the marriage tax penalty addresses a important issue of fairness—I hope we can work together to eliminate it. Mr. Chairman, I would again like to thank you for giving me the opportunity to address the Committee on this important issue affecting 21 million American families. I would be happy to answer any questions.



Chairman ARCHER. Thank you, Mr. Weller. You stand out as a leader in attempting to give relief on this particular area of the Tax Code.

Mr. WELLER. Thank you.

Chairman ARCHER. We are pleased also to have with us today Congresswoman Pat Danner. We are delighted to have you here. Welcome and we will be pleased to receive your testimony.

STATEMENT OF HON. PAT DANNER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Ms. DANNER. Thank you, Mr. Chairman. An aspiring Speaker some years ago asked then-President Franklin Roosevelt for his suggestions in public speaking and the President said: Be brief, be sincere, and be seated. So I will try to follow that admonition.

I thank you all for the opportunity to testify before you today. I know that my colleague Jerry Weller has discussed in detail the benefits of eliminating the marriage tax penalty. And today I would like to inform you of Missouri's experience and, indeed, leadership on this issue. And I think that the Congressman seated to my left who is a Member of your Committee would concur with my remarks, since we are both Missourians, probably.

When the minister utters the phrase "for better or worse," although the couple doesn't realize it at the time, he is uttering a phrase that will have a reflection on their income tax returns when they file married tax returns. For some taxpayers, it is for the better. For some taxpayers, it is for the worse. In my home State of Missouri, fortunately, it is for the better.

Missouri permits married couples to file jointly or separately on the same tax form using whichever of the options imposes the least amount of taxes on their income. Despite this loss of revenue that Missouri experiences because of our friendly married couple filing tax laws, Missouri is in the process of refunding money this year to all who pay income tax. As a matter of fact, married couples in Missouri will receive an estimated refund this year of $108 and, as Congressman Hulshof notes, we have already started receiving those checks.

Mr. Chairman, Missouri, the Show Me State, has shown the Federal Government there should be and is fairness and equity in the way our State income tax system addresses the issue of taxes levied on married couples. Years ago, Missouri's general assembly gave couples relief from a marriage tax penalty. Today our State is still able to provide them with a tax refund. The Congress can and should do no less.

I hope you will agree I have been brief. I have been sincere. And I am already seated.

[The prepared statement follows:]

Statement of Hon. Pat Danner, a Representative in Congress from the State of Missouri

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify before you today. I know my colleague, Mr. Weller, has discussed with you in detail the national benefits of eliminating the marriage tax penalty. Today, I would like to inform you of Missouri's experience, and indeed leadership, on this issue.

Mr. Chairman, Missouri—the Show Me State—can show the Federal Government that there should be, and is, fairness and equity in the way our state income tax system addresses the issue of taxes levied upon married couples.

Married taxpayers filing in Missouri have two options. They may file jointly or separately—using whichever of the options imposes the least amount of taxes upon their income.

Now is the perfect time for the federal government to emulate Missouri. The booming economy in Missouri has made more revenue available—so much so that tax refund checks are flooding back to our citizens.

Missouri's Governor has stated, "Our robust economy makes it possible to offer new, meaningful tax relief this year. And we can afford to give Missourians this reasonable tax relief without jeopardizing our investments in education, public safety and other crucial state services."

Years ago, Missouri's General Assembly gave couples relief from a marriage tax penalty, and today our state is still able to provide them with a tax refund. The Congress can, and should, do no less!

Chairman ARCHER. Ms. Danner, you are a superb witness.

Thank you very much. [Laughter.]

Ms. DANNER. Mr. Chairman, sometimes I sit on that side of the witness table and I recognize what we as Members would laud in those who testify before us.

Chairman ARCHER. Well, the Chair greatly appreciates your brevity.

Mr. Hulshof, we are delighted to have you before the Committee on the other side. And we will be pleased to receive your testimony.

STATEMENT OF HON. KENNY HULSHOF, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. HULSHOF. Thank you, Mr. Chairman. What I would like to do, Mr. Chairman, is really deviate from my prepared remarks as I expect them to be submitted for the record and really want to follow up on what the gentleman from New York has said.

First of all, thank you for having this hearing. But I want to talk a little bit about education, specifically about H.R. 7. Mr. Chairman, the American people, and I think this Congress, are clearly placing a priority on the education of our kids and I think the policies, of course, and the Education Committee will get part of the job done. But I think this Committee really does have a lot to offer regarding helping parents be more involved in their education.

Chairman ARCHER. Would you suspend for a moment?

Mr. HULSHOF. Be happy to, Mr. Chairman.

Chairman ARCHER. The Chair would suggest that perhaps Congressman McIntosh and Congressman Baird go, vote, and then come back. We want to continue this through the vote.

Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. I think everybody on this Committee would agree that the best tool that we could employ would be to bring parents involved into the education process. We cannot, of course, legislate mandatory attendance at the parent-teachers meetings. We cannot require parents through legislative fiat spending time with their kids and maybe helping them with their homework. We can, however, bring in the power of the purse and provide some flexibility for parents to put aside some additional moneys for education and that is what I want to focus on in the few minutes that I have got today.

I think that we can build on what this Committee did and what Congress did and, ultimately, what the President signed into law back in 1997 when we first enacted the education savings accounts. The idea that we have, Mr. Chairman, in H.R. 7—and it is regrettable that Senator Coverdell was not able to be here today. He has been the champion of this legislation in the other body—but what we would like to do with the education savings accounts is not pick winners or losers. We want to commit as many resources as possible to the education system period.

And, listening to Mr. Weller and thinking about the marriage tax penalty, if there were some way that we could eliminate the marriage penalty and, especially as young couples begin to start a family, they are not thinking about retirement. Yes, Roth IRAs are a great idea, but when you think about $1,400 more each year that they pay in income taxes, what a great solution if they were able to dedicate that $1,400—instead of paying it to the Federal Government—if they were to put it into a savings for student account. Just think, as Mr. Rangel pointed out, that there would not be sufficient moneys there for these education expenses. Boy, if you were putting this $1,400 instead of paying in a marriage tax penalty to the government, if you were putting it into a savings for student account from the time that the child was their first year of age. By the time they were ready for first grade, they would have nearly $8,400 in that account plus probably about $10,000, including the additional savings from the earnings from interest.

What we do in this bill, in H.R. 7, is really expand the education savings account by taking the $500 contribution limit off, raising that up to $2,000. As you know, Mr. Chairman, the education savings account was specifically focused on college education. Let us remove that restraint and allow these aftertax dollars that buildup on these education accounts be used for kindergarten all the way through the 12th grade.

If a parent chooses to home-school their kids, they can use it. If you choose to send your kid to public school, they can use it. If you choose to have a private education, parents are making that choice. I would point out for Members of the Committee, anticipating your question, the Joint Tax Committee says that 70 percent of the savings to the taxpayers would be, first of all, families making $75,000 or less and sending their kids to public education.

So this is a win-win situation. If you have special needs students, if your child is having a tough time with math, you can hire a tutor. If your child is having a tough time reading, you can use this money for Hooked on Phonics. But the decisions are not made here in Washington; they are made right around the kitchen table with parents working with teachers for the betterment of their kids. I think it is a win-win situation. I would urge this Committee to consider H.R. 7.

Thank you for the time to visit about it today.

[The prepared statement follows:]

Statement of Hon. Kenny Hulshof, a Representative in Congress from the State of Missouri

Mr. Chairman, let me start by thanking you for holding this hearing as part of the three part series on reducing the federal tax burden. In particular, I appreciate the opportunity to testify today on behalf of my legislation, H.R. 7, the Education Savings and School Excellence Act.

The American people clearly place a priority on our children's education. As Members of Congress, we should be responsive to this worthwhile objective and enact policy that encourages accountability, quality and makes it easier for parents to get involved in the process of ensuring that their children receive an education that will prepare them for the challenges they will face in the future.

The 106th Congress is off to a good start. Acting in a bipartisan manner, we passed and the President signed the Ed-Flex bill, which will give educators at the local level the ability to use federal resources were they are needed most. In the future, I would expect the U.S. House to begin its consideration of a bill to reauthorize the Elementary and Secondary Education Act (ESEA). I hope the bipartisan spirit that prevailed during the debate on the Ed-Flex bill carries over to the consideration of ESEA.

As a member of this committee, I firmly believe that we can make some commonsense changes to the tax code to help in the effort of improving education for our children. Some of these proposals are included in H.R. 7, the Education Savings and

School Excellence Act. I would like take the opportunity to thank Representative Lipinski, a Democrat from Illinois, for joining me in this bipartisan effort.

The Taxpayer Relief Act (TRA) of 1997, which this committee crafted, established Education IRA's. These savings vehicles were designed to help parents save for a child's college education. It was wise for us to enact this provision—but we can do better.

H.R. 7 builds on the Education IRA's included in TRA 97. I call these expanded Education IRA's *Savings for Students Accounts (SFSA's).* Savings for Students Accounts would expand the current law contribution limit on Education IRA's from $500 annually to $2,000 annually. The money set-aside in a Savings for Students Account could be used to help pay for both college and K–12 education expenses. H.R. 7 also modifies the rules governing existing Education IRA's to give parents the ability to provide essential education materials and services to special needs children.

I think that everyone would agree that regardless of the policies we pass in Washington, the best tool to improve a child's education is engaged, caring parents. We cannot legislate involved parents. Congress cannot force a parent to attend a PTA meeting or to meet regularly with their child's teachers.

But we can make it easier for parents to make a contribution to their child's education. For example, under my bill, if a student is having difficulty in Math class, a parent could use funds set aside in a Savings for Student Account to pay for a tutor, buy computer software for the home PC or enroll the child in after-school classes. This will help parents and teachers work together as powerful allies in the effort to improve our children's education.

Let me also briefly mention some of the other provisions in the Education Savings and School Excellence Act. Prepaid tuition plans have become an increasingly popular way for parents to save for a child's college education. H.R. 7 will make distributions from both public and private prepaid tuition plans to pay for higher education expenses tax free. Representatives English, Granger, and Scarborough all deserve credit for their hard-work on this important issue.

The Education Savings and School Excellence Act also helps foster continuing education by encouraging employers to cover an employee's undergraduate studies. This is accomplished by excluding employer-provided education assistance from an employee's income for tax purposes. H.R. 7 will also help provide relief from complicated bond arbitrage regulations to encourage the construction and rehabilitation of public schools. Lastly, my bill excludes amounts received from National Health Service Corps Scholarship Program from income for tax purposes.

Last month, the Senate Committee on Finance approved S. 1134, the Affordable Education Act of 1999, which is similar to H.R. 7. The bipartisan efforts of Senator Coverdell, Republican of Georgia and Senator Torricelli, Democrat of New Jersey, have helped enhance the visibility of this issue in the U.S. Senate. It is my hope that this bipartisan spirit of cooperation will prevail in the U.S. House and that we will be able to give parents the meaningful tools in H.R. 7 to help educate our children.

Helping families save for their children's education while improving public education is a win-win proposal. I look forward to working with my colleagues on this committee to improve the quality of education our children receive.

Chairman ARCHER. Thank you, Mr. Hulshof. Mr. Graham, would you like to commence? We only have 4 minutes left.

Mr. GRAHAM. I can do this in 2 minutes.

Chairman ARCHER. All right. That would be great. You may proceed. We are happy to have you.

STATEMENT OF HON. LINDSEY O. GRAHAM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

Mr. GRAHAM. Thank you. Thank you, Mr. Chairman. I would hate to have your job. Every tax plan that has been talked about and I am probably, I think, a cosponsor of everyone and eventually we have got to pick and choose, just as we have to do on spending.

I am here in support of H.R. 1840, the Small Savers Act, which has already been testified to regarding about the Committee by Mr.

Jefferson, who is a Member of your Committee. I have got Mr. Clyburn as a cosponsor, Roy Blunt, Alcee Hastings, Saxby Chambliss, Matt Salmon, Bob Wexler. This is bipartisan. It is something the Congress needs, I think, desperately in this area.

What it does, Mr. Chairman, it addresses the lack of savings in this country. One-third of Americans have no savings. Another third has less than $3,000. This plan has been endorsed by the New York Stock Exchange. Senators Coverdell and Torricelli started this concept in the Senate. It has bipartisan support there. This bill would pass if we could ever get it to the floor and vote on it.

What it does is it changes the tax bracket for millions of Americans by taking the 15-percent bracket and expanding it $10,000 over 5 years, $5,000 for singles. By 2004, a family of 4 making $72,000 will be in the 15-percent bracket, which is a break for a lot of Americans. The first $5,000 of capital gains, long-term capital gains, is tax free. That helps a lot of Americans in their retirement as they get ready to retire. The first $500 in dividend and interest income is tax free. That helps a lot of Americans who are on fixed incomes with small investments to keep more money in their pocket.

It doubles—not doubles, excuse me, it adds the ability to deduct from your IRAs $3,000 rather than $2,000. That would be $6,000 per couple and it will be indexed for inflation by 2009. It allows Americans to save in the middle-class manner. It has bipartisan support. It costs $345.7 billion by 2009, which is half of the non-Social Security surplus. Mr. Chairman, if Americans had this opportunity, they would have a lot money when they retire. They would have a lot more control over their lives. We could do some things with Social Security because the pressure would be off. This is a plan that allows America to save better than it has been able to do in the past. I appreciate your review of it.

[The prepared statement follows:]

Statement of Hon. Lindsey O. Graham, a Representative in Congress from the State of South Carolina

Dear Mr. Chairman and Members of the Committee,

Thank you for allowing me to testify in support of H.R. 1840, the Small Savers Act I introduced along with Reps. William Jefferson (D–LA) and Robert Wexler (D–FL).

One-third of Americans have no savings and another one-third have less than $3,000. With such a low rate of savings, many people are not equipped to deal with financial trouble or plan for retirement. This is a problem which must be addressed.

Our legislation, co-sponsored in the Senate by Paul Coverdell (R–GA) and Robert Torricelli (D–NJ), is the only bipartisan, across-the-board tax relief plan introduced in the 106th Congress.

The provisions of the bill include:

Returning more middle-income taxpayers to the lowest tax bracket—The lowest federal tax bracket, 15 percent, will be expanded by $10,000 over 5 years, $5,000 for singles. By 2004, a family of four making up to approximately $72,000 will still be able to file in the lowest tax bracket.

Reduce taxes on long-term investments—The first $5,000 in long-term capital gains is tax-free.

Encourage savings and investment—The first $500 in dividend and interest income is tax-free, $250 for singles.

Strengthen retirement planning—The contribution limits on traditional (deductible) IRA's will be raised from $2,000 to $3,000 and be indexed for inflation after 2009.

By making some income tax-free, the bill also has the added bonus of reducing the complexity of the federal tax code and allowing more individuals to file their taxes using IRS Form 1040EZ, the simplest IRS tax form.

Estimates provided by the Joint Committee on Taxation show the costs of the bill, $345.7 billion through 2009, to be one-half the expected non-Social Security surplus. With the government running a surplus, it's only right that we should provide the taxpayers with relief.

Every Member of Congress, whether they're Republican or Democrat, has their own ideas about what a tax bill should look like. I think if any of the sponsors were given complete control, they would draw up something different. But in this business, sometimes you've got to give a little here and there to get something done.

That's why I think this bill and the fact we've been able to come together is unique. We're addressing the high taxation problem in a bipartisan manner. I hope this committee and the Congress will look favorably on our work.

Chairman ARCHER. Thank you very much. I think you and I both probably need to go vote. There are 2 minutes left. We appreciate your testimony. Well, the Committee will stand in recess until we have another Member come back to preside.

[Recess.]

Ms. DUNN [presiding]. Please take your seats. The Committee will resume its hearing.

We would like to hear now from Jim Turner, the Member from Texas.

STATEMENT OF HON. JIM TURNER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. TURNER. Thank you, Ms. Dunn. It is a pleasure to appear before the Committee, and I appreciate very much the opportunity to testify on an issue that is very important to me and my district, and I know to you and yours, and the legislation that I testify about today is of course very similar to a piece of legislation that you also have introduced, and so I appreciate this opportunity.

H.R. 1916 is the Reforestation Tax Relief Act of 1999. It deals with an issue that is very important to many of us. In fact, there are over 100 members of the Forestry 2000 Task Force that are heavily dependent upon the forest products industry in their particular districts. I know in my case that forestry is the number one industry in my congressional district.

Back as early as 1980, the Congress recognized that there needed to be some incentive for landowners to reforest their lands. It is not only good for the economy but it is good for the environment, and the Congress passed a tax credit to allow those who plant pine trees or timber on their lands to receive a tax credit and to be able to amortize their expenses over a period of time. Current law provides an amortization period of 7 years and a maximum investment tax credit of 10 percent of a $10,000 maximum expenditure for amortization purposes.

My bill does a very simple thing: it simply doubles those numbers. It allows the writeoff of $25,000 in expenses for reforestation and increases, of course, correspondingly, the investment tax credit to 10 percent of that amount, and it shortens the amortization period from 7 years to 3, thus trying to increase the incentive for private landowners to reforest their lands.

The charts I have at the right will pretty well tell the story. If you look at the East Texas area that I represent, what you see—depicted on the first chart—is the ownership of forest lands in East

Texas. That first chart shows you that the public lands of the national forest are about 7 percent; it shows you that the forest products industry, the large timber companies, own about 32 percent of the land; and small landowners, which I call the nonindustrial, private landowners, own about 61 percent. On the next chart, you see what is happening in terms of reforestation of those forest lands. It shows you that the forest products industry, the large timber companies, are doing a pretty good job. They harvest about 73,000 acres of land on average in a year, and they are replanting about the same amount, about 99 percent. On the other hand, the small, private landowners, the mom-and-pop folks who own a little land and hopefully would be encouraged by this legislation to plant pine trees, are not doing that currently. Apparently, the current incentive in the law is not sufficient. They are harvesting 91,000 acres in an average year and only replanting about 40 percent of that. My bill is directly aimed to try to encourage those small landowners to replant their trees.

Now, why is this important? Let us see the next chart. What you see is that for a number of years in an area like East Texas—and I suspect you will find this pretty much true all across the South and the Southeast—that through about 1964 and 1987, in East Texas, we were actually growing more timber than we were harvesting. That trend reversed in about 1987, and you see the projections in the outyears. We will harvest more timber than we plant. That is a very dangerous trend for the economy of regions like mine because it is essential that the forest products industry has access to an adequate supply of timber at a reasonable price if we are going to be competitive in the international market in producing lumber and paper and other forest products. If we allow the supply to diminish, those mills that depend upon that supply will have to pay higher prices. The law of supply and demand will govern, and these mills will have to pay higher prices for that raw product, and our forest products will not be competitive either in our country or internationally. Therefore, the survival economically of areas like mine depends upon how good a job we do in replanting our forest so that we can have the kind of supply that is necessary.

The next chart shows you the environmental benefits of reforestation; they are obvious—the absorption of carbon dioxide and the preservation of wetlands. Reforestation is essential so that we don't cut trees where we shouldn't be cutting them.

On the final chart you will see the economic impact of reforestation. The Texas Forest Service that provided the data that you see here today has as its goal the reforestation of 1 million acres within 10 years in Texas. That would generate—if we were successful—new jobs for East Texas. You see the numbers there—15,000 jobs and an added $3 billion to the economy.

So, I would urge the Committee to seriously consider this legislation. I think it is important for the economic and environmental impacts it will have on many of our districts in the long term.

[The prepared statement and attachments follow:]

Statement of Hon. Jim Turner, a Representative in Congress from the State of Texas

Thank you very much, Mr. Chairman, Mr. Rangel (NY), members of the Committee. Thank you for asking me to come here before you this morning.

It is truly a pleasure to be able to testify, with my fellow colleagues, before the House Ways and Means Committee regarding such an important issue as providing needed and well-deserved tax relief to Americans. As members of Congress, American families and businesses are relying on us to deliver meaningful tax relief. It is my belief that as a result of this hearing, Congress will be better suited to take the necessary steps to provide substantial tax relief to millions of Americans.

As part of this effort, I recently reintroduced H.R. 1916, the Reforestation Tax Relief Act of 1999, which will provide expanded and immediate tax incentives to encourage timberland owners to reforest their lands. Representing over 150,000 private forest landowners in my congressional district, I realize the importance of maintaining a strong and viable forestry industry in the United States and am convinced this legislation is a step in the right direction for our economy and for our environment.

The economy of the Second District of Texas and many of the districts represented by the 107 Congressional members of the Forestry 2000 Task Force are heavily dependent on the long-term viability of the forestry industry. We must act today to provide needed tax incentives to landowners to encourage the replanting of our forests. If we do not act now to promote reforestation practices, through improved and immediate tax incentives, we will be unable to maintain a competitive forest and wood products industry with reasonable timber prices in the future. In addition, the ecological impact on the quality of our environment will be severe for many generations to come.

The decision to reforest, particularly after harvesting, can be a difficult one. Evidence shows that America's larger, industrial land owners and foresters are doing an acceptable job of reforesting; however, our smaller, non-industrial forest owners need added incentives to help in the reforestation process. Since 1985, the amount of timber harvested in Texas has exceeded the annual growth rate of reforestation efforts and future harvests are projected to substantially outpace annual growth of replanting activities on commercial timberland. As a matter of fact, in Texas, non-industrial foresters harvest an estimated 91,000 acres per year but only replant 36,000 acres per year. For the sake of our nation's forests, for the sake of our environment, for the sake of our economy, and for the sake of all Americans, this alarming trend must be halted.

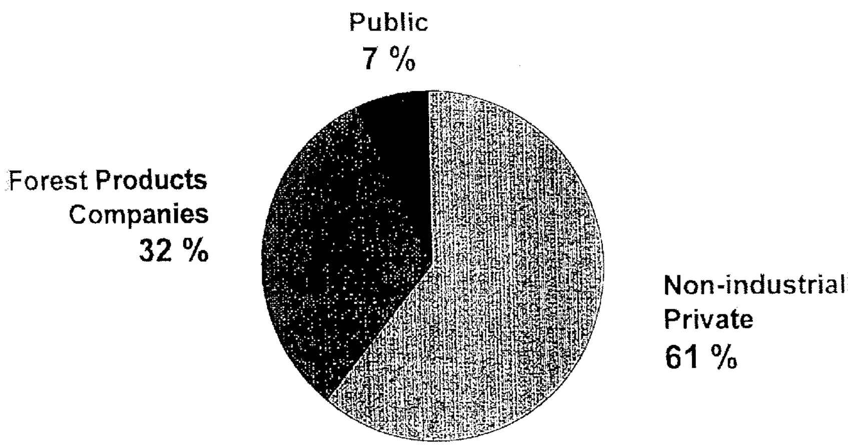
A shortage of timber in the future will mean that forests will continue to disappear, our nation's beautiful environment will ultimately suffer, and we will see higher prices for raw material, which will in turn make it difficult to survive in an increasingly competitive market. The expenses are high and the eventual benefits of reforestation are long term because of the simple fact trees must grow for many years until mature enough for harvesting. I believe this legislation is necessary to overcome the economic reality faced by those involved in this industry. Reforestation is good for the environment, good for economy and good for the industry.

H.R. 1916 addresses the concerns I mentioned before by making simple changes to existing law through increasing the amount of reforestation expenses that can be amortized from $10,000 to $25,000 per year, reducing the required amortization period from 84 to 36 months, and increasing the annual tax credit from $1,000 to $2,500 for reforestation expenses. With these changes, forest landowners will be encouraged to operate in an ecologically sound manner that leads to the expansion of investment in this vital natural resource. Several House Members have cosponsored this legislation in a show of bipartisan support, which translates into potential good news for the future stability of our forestry-based economy.

Environmentalists agree that reforesting can have numerous benefits for the environment. By replanting our nation's forests we will also further protect our wetlands, streamside and wildlife management zones and critical habitats. Additionally, the planting and replanting of trees will help reduce levels of unhealthy carbon dioxide and produce increased levels of oxygen into the atmosphere. Furthermore, reforestation will help to address the growing concerns associated with noise and air pollution. Lastly, by promoting reforestation tax incentives, landowners will continue to transform marginal and highly erodible agricultural land, which is used for livestock and commodity production, into ecologically beneficial forestland. While I realize the expenses are high and the eventual benefits of reforestation may seem years down the road since trees must grow for many years until mature enough for harvesting, I believe we can all agree that reforestation is not only good for the economy, but is good and needed for the environment.

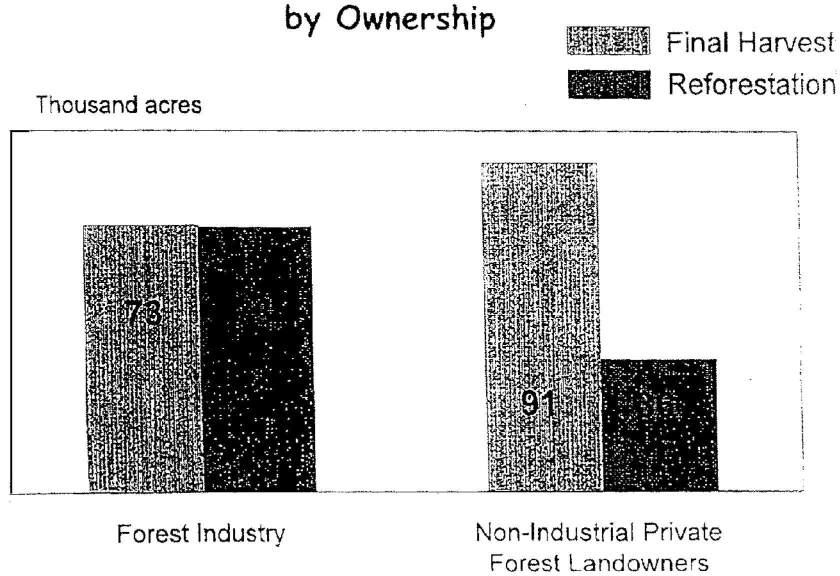
Other states across America can learn from what we are doing in my home state. The goal of the forestry community in Texas is to reforest 1 million acres over the next ten years which will generate more than 15,000 new jobs in the forest-based economy and an additional $3 billion to the economy annually. By all working together, we can make sure the economy and the environment of the 21st Century will be strong and thriving for future generations.

Timberland Ownership in East Texas



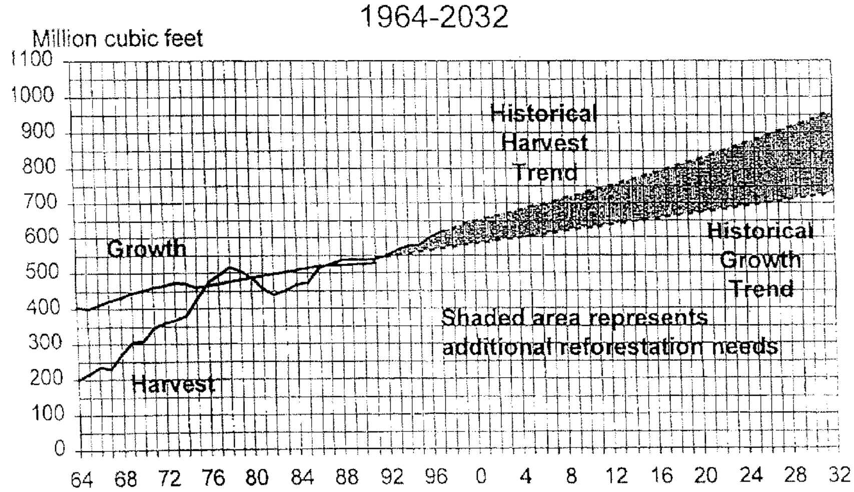
11.8 million acres of commercial timberland, but only 7.1 million acres (60%) is producing at sustainable levels

Reforestation vs. Final Harvest
by Ownership



Annual Averages for Period 1992-1997

Pine Growth and Harvest in East Texas
1964-2032



Environmental Benefits Attributable to The Reforestation Tax Relief Act of 1999

Less Pressure on Forestlands with High Environmental Values

Increase Conversion of Marginal Agricultural Land to Forest

Reduce Atmospheric Concentrations of Carbon Dioxide

Federal Justification
The Reforestation Tax Relief Act of 1999

150% Increase in Acres Reforested

Benefit/Cost Ratio of Federal Investment is 2.21:1

Economic Impact of Expanded NIPF Reforestation on East Texas Economy
1992-2020

Goal: Reforest 1,000,000+ acres within 10 years

15,636 jobs

$3 billion to economy

Essential Elements to Developing Sustainable Private Forest Resources

Incentives for Private Capital Formation to Fund NIPF Reforestation

- H.R 1916: The Reforestation Tax Relief Act of 1999
- Incentives: Texas Reforestation and Conservation Act of 1999
  -- Reduction of property taxes during first 10 years

Expanded Reforestation Delivery System

- Double capacity of tree seedling nursery
- Technical assistance to empower landowners to implement successful reforestation projects
  --Federal Cooperative Forestry Act--FY 2000 funding increase in Forest Stewardship

Ms. DUNN. Thank you very much, Mr. Turner. You are, in fact, correct. It also affects my district and I know many others around this Nation.

We will hear next from the gentleman from Indiana, Mr. McIntosh.

STATEMENT OF HON. DAVID M. MCINTOSH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. MCINTOSH. Thank you very much, Ms. Dunn, and thank you for allowing me to have an opportunity to come before the Committee once again to testify about the Marriage Penalty Elimination Act that Jerry Weller and Pat Danner and I have cosponsored this year. The Committee has already heard from both of them on this, and they explained in great detail the legislation, which I know this Committee is familiar with. So, I would ask permission to summarize my remarks and include the full specs into your record.

Chairman ARCHER [presiding]. Without objection.

Mr. MCINTOSH. Thank you, Mr. Chairman.

This bill is widely supported—19 of the 23 Republican Members of the Committee are in support of it; 230 of our colleagues are cosponsors, including a number of our colleagues on the Democratic side of the aisle. It is a bill that everybody agrees should become law. The task for the Committee is to decide how best to do that in the context of a reconciliation bill.

Last year, I brought two of my constituents here—Sharon Mallory and Darryl Pierce—and I wanted to remind the Committee about that, because in a way their plight demonstrates the urgency of passing this legislation. They explained to the Committee that they work for about $10 an hour at a factory in Connersville, Indiana. They decided they wanted to get married, went to H&R Block, and were told that Sharon would have to give up her $900 tax refund, and they would be penalized about $2,100 if they got married. This happens to millions of people across the country. They ended up postponing their marriage. It broke my heart when I saw their letter. Well, Sharon called our office last week to ask, "How is Congress doing on this?" And we were able to tell her that the Committee is taking up the tax bill once again, but, frankly, we hadn't been able to get anything done last year. Although the Committee did part of it in its bill and the House passed that, we couldn't get the Senate to act. And I told her I am optimistic that this year we will see some work done, and she said, "Good." I asked her if she had gotten married yet, and they still haven't gotten married; still are waiting for some action. They can't afford to, she said, without some action being taken to eliminate this marriage penalty tax.

And, so I come before you today, and in my remarks I talk about the harm to children for families that break up, the harm to working women who pay a disproportionate share of this tax if they decide to go back into the work force after their children have been raised, and the harm to minorities who, in a disproportionate number, are the families in which both the father and the mother work in order to make enough money to raise their family.

But let me just close by saying to the Committee, I commend you moving forward this year on a tax bill. I know that you are constrained by the reconciliation instructions in the Budget Act and that you will hear from a lot of people with very good proposals for changing our Tax Code and that it will be a struggle to fit all of those into the limited amount of tax cuts that can be brought forward under those reconciliation proposals. Having seen the Committee work in the past, I know you will do the best of squeezing as many good provisions into those limitations as possible, but let me urge you to go beyond what you were able to last year with the deductions since there is more money and, at least, taking a look in a 10-year perspective, try very hard to eliminate the bracket effects so that the constituents that Jerry mentioned in his testimony truly will have their problems solved, and they won't be caught in those bracket shifts where suddenly they are thrown from a 15-

percent marginal tax rate into a 28-percent marginal tax rate just because they are both working and they are married.

With that, let me say thank you to the Committee for giving us an opportunity to come and testify, and thank you for taking up this tax bill once again. It is going to be a difficult task, but I think it is critical for us in this Congress to move forward with that.

Thank you.

[The prepared statement follows:]

Statement of Hon. David M. McIntosh, a Representative in Congress from the State of Indiana

Mr. Chairman and members of the Committee, I welcome the opportunity to come before you once again to urge this committee to eliminate the Marriage Penalty, the insidious quirk in the tax code that actually penalizes people for getting married. Since 19 of the 23 Republican members of this committee are cosponsors of the Weller-McIntosh Marriage Tax Elimination Act, I know many of you share my desire to get rid of this tax once and for all.

Last year, if you remember, I brought two constituents of mine, Sharon Mallory and Darryl Pierce, who are victims of the marriage penalty to share their story before this committee. Sharon and Darryl could not afford to get married because of the incredible tax bite that would result from tying the knot. They still aren't married and contacted my office just this last Monday to find out if Congress had taken action yet. It was embarrassing to tell them that Congress has done nothing. It is time to act. I honestly can't find anyone who supports a designed government policy which undermines the traditional institution of the family and discriminates against women and minorities.

The marriage penalty entered our tax code thirty years ago and has contributed to the decline of the family. Our nation has seen a decrease in marriage and increase in divorce. Divorce is reaching epidemic levels. Twice as many single parent households exist in America today as when the marriage penalty came into effect.[1] The terrible financial strain caused by the marriage penalty contributes to the decline of the family. Simply put, the marriage penalty is doing great harm to our society by frustrating family cohesion.

The devastating consequences of divorce on parents and children are well documented. When parents divorce, they are likely to die earlier, their general health is worse, and sadly, many divorced adults, particularly young mothers, are thrown into poverty.[2] The effects on children are no less destructive. The National Fatherhood Initiative has shown that where divorce occurs, the children are more prone to violence, illegal drugs, suicide, and

dropping out of school. Over Ninety percent, Ninety percent!, of children on welfare are from homes with only one parent.[3]

And by the way, don't interpret these facts as an attack on single mothers. I was raised by a single mom. I know the sacrifices she made for us. Single moms are heroes born out of necessity.

Let us simply get rid of the government penalties that help break up families. Beyond its effects on our core institution of marriage, its effects on working women and minorities are particularly devastating.

The marriage penalty could equally be known as "The Tax on Working Women." When the marriage penalty was proposed, America was a far different place. Most women were not yet in the workforce. Today, 75 percent of married couples have two incomes.[4] The marriage penalty always hits the second-earner hardest. Therefore, this tax clearly discriminates against women who may enter and leave the workforce according to their needs at home. They sometimes face a marginal tax rate of an astounding 50%![5] Taxing mothers unfairly for simply wanting to provide for their families is wrong. The Weller-McIntosh legislation provides much greater freedom for women to work without having to worry about the taxman.

African-Americans are especially hard hit by the marriage tax. As you may know, the marriage penalty occurs when both spouses work and make roughly the same

---

[1] The Statistical Abstract of the United States, Department of Commerce, Table No. 146, "Marriages and Divorces," p. 104: 1996.

[2] Dr. Wade Horn, The National Fatherhood Initiative, "Father Facts 2," p.10: 1997.

[3] Ibid.

[4] The Congressional Budget Office, "For Better of for Worse: Marriage and the Federal Income Tax," (June 1997), Table 10, p.39.

[5] The Greater Washington Societies of Certified Public Accountants, Sept. 1997

income. Black women historically have entered the workforce in larger numbers than white women. According to a University of Cincinnati Law School Study by Dorothy Brown, 73% of married back women are breadwinners and black women contribute approximately 40% of their household's income.[6] Our legislation brings fairness back into the tax code so that African-American women and families can keep more of their hard earned money to provide for their children.

Who is against our bill? Only someone who believes that big government is a higher priority than families. I am sick and tired of hearing that the federal government can't afford the passage of this bill. Did anyone in Washington ask married couples if they could afford the $1,400 marriage penalty imposed on them? The federal government can tighten its belt to help families. I contend that we have no choice but to pass this measure because of its hurtful effects on families.

Mr. Chairman, I want to conclude on the subject of families. At a time when we are witnessing the almost unthinkable horror of kids killing kids, I think we can all agree that the need for strong families is greater than ever. Realistically, Congress cannot do a great deal to build stronger families. That process starts in our homes, churches, and communities. However, one thing the Congress *can* do is eliminate the marriage penalty.

We have a choice. We can continue down the path of undermining the family and having more children brought up without knowing the difference between right and wrong. Or we can choose a different path: a path based on the firm conviction that the family must be the foundation of our society. We can choose a path where families are lifted up—not punished by government. We can provide a place where young people like Sharon and Darryl can find happiness and finally be married.

I realize that official Washington scoffs at the idea of strengthening families, but the American people have a special wisdom in these matters. They understand how important this effort is in light of recent events. The American people will support eliminating this unfair tax. It is crucial that we succeed because the future of the family and the future of America are inseparable.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. McIntosh, and thank you for your leadership on this issue. We appreciate your testimony.

Our next witness is Mr. Turner. Have you testified yet?

Mr. TURNER. Yes, Mr. Chairman, while you were out.

Chairman ARCHER. All right. Our next witness is Congressman Baird. Welcome, and we are pleased to receive your testimony.

STATEMENT OF HON. BRIAN BAIRD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. BAIRD. Thank you very much, Mr. Chairman. It is a pleasure and a privilege to be here to address an extremely important issue of fairness and equity in the Tax Code. Before I talk about the particular issue, which is sales tax deduction, I would like to acknowledge my support of inheritance tax reform in the bill, offered by my colleague Congresswoman Dunn and my friend, Mr. Tanner, as well. I think it is another bill whose time has come, and we need to move forward on that.

Mr. Chairman, for good intent, I am sure, the 1986 tax reform bill eliminated the sales tax deduction which was necessary, perhaps, at the time to help us balance the budget, but it created an inequity between States, including States such as yours, mine of Washington, Wyoming, Tennessee, and Florida; those States that have no income tax but pay only sales tax. Every year, when it is time to fill out our Federal tax refund—or, hopefully, refund—our Federal tax return, residents of States that have income tax are

[6] Dorothy Brown, "The Marriage Bonus/Penalty in Black and White," University of Cincinnati Law Review (Spring 1997), p.5.

able to deduct the amount they pay to their State in income tax, but those of us with only sales tax have to enter a zero on that line. It is my belief, and, certainly, the belief of many residents of my State and the other affected States that this is unfair.

What we have proposed to remedy this is H.R. 1433. We have about 30 cosponsors, and, essentially, it is a very simple proposal. It would allow residents of States to deduct either their income tax or their sales tax. We have made it an either/or choice to reduce the scoring impact, but our goal is to restore at least a modicum of fairness to people from different States. Simply put, we don't believe it is the Federal Government's role to dictate to States whether they should have an income tax or a sales tax to support their State government, but that is effectively what the current Federal Code does. So, by giving a choice, we restore some tax fairness, and we keep the scoring impact to a minimum.

Like all my colleagues here, I am committed to a balanced budget, and there has been, indeed, many good proposals put forward for how we might adjust the Tax Code, but, for myself, I think the top priority should be restoring fairness across States.

One other issue I want to briefly address and that is some tax relief for victims of disasters. Particularly in my district, there are folks who have lost all of their belongings to a slow-moving landslide. It has eliminated 130 homes, and they were unable, completely unable, to buy insurance for this kind of disaster. As a result, should they be fortunate enough to have their mortgage forgiven, under current code, that could be counted as a gift, and they would pay full taxes on a house that has been completely destroyed. We will be introducing some legislation to provide tax relief to a very small but important subset of folks who have lost their possessions and home in a disaster, and I hope the Committee will look favorably on that.

I would like, if I may, to yield a couple of minutes to my colleague, Mr. Clement, from Tennessee, to further address the issue of sales tax deduction.

[The prepared statement follows:]

Statement of Hon. Brian Baird, a Representative in Congress from the State of Washington

Thank you, Mr. Chairman.

Mr. Chairman and members of the Committee, I'm honored to be here today for this extremely important hearing, and I truly appreciate the opportunity to share some specific tax concerns that have put a strain on constituents in my home state of Washington.

I'm here primarily to discuss tax fairness in the context of the federal sales tax deduction; but with the Chairman's consent, I would like to take just a moment to mention my strong support for legislation that my colleague from the state of Washington, Congresswoman Dunn, and the distinguished gentleman from Tennessee, Mr. Tanner, have introduced to repeal the estate tax. I also want to take a moment to discuss measures that I have proposed to provide relief to certain disaster victims.

Let me initially discuss the difficulties with the estate tax. In addition to some fundamental problems with the tax that seriously harm family-owned small businesses and smaller family farms, I think there are a few rarely-mentioned reasons for its repeal. One, many of the family-owned small businesses with more capital assets than covered by the exclusion employ many people at good family wages, especially within smaller communities, and often reinvest generously in those communities. Yet, far too often, the estate tax forces families to sell such businesses to larger corporate interests with less involvement in the community and less interest in maintaining a strong, well-paid local workforce.

Second, in my district, and I know that Congresswoman Dunn understands this well, we have a lot of family foresters who have been very good stewards of the land over many years. However, the estate tax may force the families of many of these land-owners to sell off all or part of that forest land before it reaches full maturity. So it is my belief that there are good labor and environmental reasons to provide additional estate tax relief.

Now, if I may return to the principle theme of my testimony, I will explain the rationale for restoring the sales tax deduction. In principle, Mr. Chairman, I believe that the federal government must strive to avoid tax policies that favor residents of some states over others. Unfortunately, I believe that one egregious failure to adhere to this principle is found in the manner in which the federal government allows taxpayers to deduct state and local taxes.

I'm sure, Mr. Chairman and members of the Committee, that you are well aware of the problem. Simply put, residents of states without state income taxes now pay a greater percentage of taxes to the federal government than residents of states with state income taxes. Solely on account of the system of taxation their state uses to collect revenues, they pay more federal tax. That differential treatment of taxpayers is a profound inequity that the 106th Congress should rectify.

The repeal of the sales tax deduction in 1986, although well intended, resulted in a significant disparity between states. By disallowing state sales tax deductions, but retaining state income tax deductions in the federal code, we now have a system in which one individual with an income and financial profile that is identical to another person may pay higher taxes to the same federal government simply because they live in different states. As a result, residents of states such as Texas, Florida, Washington, Tennessee, South Dakota, Nevada, Alaska, Wyoming, and New Hampshire, pay more in federal taxes than residents of equal income in other states. In effect, residents of states without income taxes are underwriting a disproportionate share of the federal budget.

It's not that Washingtonians pay less in taxes. On the contrary, we're in the top quarter of states in amount of our personal income that goes to taxes. The question becomes, should residents of my state pay hundreds more dollars per year to the federal treasury for nothing more in return, than those individuals living across the river in another state. I believe that they should not.

To remedy this situation, I have proposed legislation, along with about 30 cosponsors, including several members of this committee, that will restore the sales tax deduction for taxpayers in states that do not have an income tax. My measure would allow taxpayers to deduct *either* their state income tax *or* state sales taxes paid in a given year. By giving a choice of deducting either sales or income tax, the budgetary scoring is kept to a minimum, but equity and fairness are restored across states.

To keep the sales tax deduction simple for taxpayers, under this legislation the Internal Revenue Service would be directed to develop standard tables for taxpayers to use in determining their average sales tax deduction. Such tables, similar to those used by taxpayers prior to 1986, would include average calculations, based upon income and household size, for a taxpayer in a given state. The bill *does not* restore the itemized deduction of individual purchases; it only allows taxpayers to deduct an averaged amount based on income level and family size.

I, like all of my colleagues in this body, am committed to maintaining a balanced budget, and I am also committed to the principle of equal taxation as dictated by the Constitution. But, as we wrestle with the options for spending projected budget surpluses in the foreseeable future, I ask my colleagues to put themselves in the position of more than 50 million taxpayers who live in sates with no income tax and no means of deducting sales taxes; and I ask that we prioritize the restoration of fairness for taxpayers nationwide.

So, as you review the many tax relief proposals before you today and if, in fact, the committee develops legislation to provide relief in this Congress, I strongly encourage you to consider this common-sense proposal, for the simple reason that it is the right thing to do.

Mr. Chairman, I have one final issue that I would like to bring to the committee's attention a situation in my district that warrants significant tax relief.

Since before I was sworn in as a member of this body, I have been working with a group of constituents from the City of Kelso, in my Southwest Washington district, to provide assistance to their disaster-torn community.

This city has literally has been torn apart by slow-moving landslides that resulted from heavy rainfalls. During the last 14 months, more than 130 homes have been destroyed by those landslides, and the remainder of the homes in the area may suffer the same fate in the next 5 to 10 years.

What differentiates this disaster from many others is the fact that insurance was not readily available for this type of disaster—in fact, most homeowners policies specifically exclude mudslides as a covered peril—and now many of these folks have lost nearly everything they own.

Therefore, Mr. Chairman, I have devised some targeted tax measures that would assist individuals in this type of situation, in state or federally-declared disaster areas resulting from disasters for which insurance is not readily available. First, my measure would clarify the law to ensure that any discharge of debt provided to these homeowners would not be taxable as income. Second, it would establish a tax credit to help those taxpayers whose homes are destroyed, but who are required to continue paying mortgage payments on their destroyed home. Additionally, it would adjust the computation of the casualty loss deduction by allowing taxpayers to deduct the fair market value of a home, instead of only the basis in the home as permitted under current law. Finally, Mr. Chairman, in those cases where the homeowner is fortunate enough to sell a home located in such a devastated area, which may or may not have been irreparably damaged but may be severely devalued, this legislation allows taxpayers to deduct the full value of that loss.

Mr. Chairman, I would be happy to include a copy of this legislation, which I am introducing this week, with my testimony. I realize that the situation in my state may be unusual, but as such, the impact of this measure on the federal government should be limited. However, it's impact in helping to rebuild the lives of our disaster victims would be enormous.

At this point, Mr. Chairman, I would be happy to answer questions from members of the committee about any of this testimony.

Again, I want to thank you, and members of the committee for graciously granting me this opportunity, and I yield back the balance of my time.

Chairman ARCHER. Mr. Clement.

STATEMENT OF HON. BOB CLEMENT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. CLEMENT. Thank you, Mr. Chairman. It is a pleasure to be here before this distinguished Committee and be associated with Mr. Baird, who I think so much of, and his legislation that offers so much to all of us. I also want to agree with him about the legislation proposed by Ms. Dunn and Mr. Tanner, which I strongly support on eliminating the inheritance tax.

In 1997, the citizens of Tennessee paid an average of $927 in State and local sales taxes but could not deduct $1 of it from their Federal income tax returns. So, basically, Tennesseans are being forced to pay taxes on their taxes, just like Texas and the other States that do not have an income tax. My colleagues, this is just not right. In fact, Tennessee Lieutenant Governor John Wilder is exploring options for filing a class-action lawsuit against the Federal Government asserting that the citizens of Tennessee are being discriminated against simply because they live in a State that has chosen not to enact a State income tax.

Mr. Chairman, I submit to you that the Federal Government should treat all taxpayers equally regardless of the system of taxation their State employs. The Tax Deduction Fairness Act simply would allow taxpayers to deduct either their State income tax or State and local sales taxes from their Federal income tax returns. We have an opportunity to restore fairness and equity to the Tax Code in this Congress without making the Tax Code more complex and without abandoning our fiscal discipline.

In addition, this legislation would return to the States the decision of how to fund their operations by removing the incentive toward a State income tax from the Federal Tax Code. Regardless of your views on income taxes, sales taxes, or some alternate tax structures, I am sure you would agree that States should have the right to decide for themselves how they want to collect their revenues without interference from the Federal Government.

In closing, I would like to thank Congressman Baird for introducing this important legislation, and I hope that the Committee will consider including it if there should be a tax relief package in this Congress.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Hon. Bob Clement, a Representative in Congress from the State of Tennessee

Thank you, Mr. Chairman. I appreciate the opportunity to appear before the Committee today to testify about an issue of fundamental fairness for the citizens of Tennessee as well as the other seven states that do not have a state income tax. In 1986, the state and local sales tax deduction was eliminated from the federal tax code in an effort to expand the tax base. While well-intentioned, the elimination of the sales tax deduction created a fundamental inequity between states that have adopted an income tax and those that have not. That's because, under the current tax code, sales tax paid on the purchase of goods or services cannot be deducted from an individual's tax return, while state income tax can be deducted.

In 1997, the citizens of Tennessee paid an average of $927 in state and local sales taxes but could not deduct one dollar of it from their federal income tax returns. So basically, Tennesseans are being forced to pay taxes on their taxes. My colleagues, this is just not right. In fact, Tennessee Lieutenant Governor John Wilder is exploring options for filing a class action lawsuit against the federal government asserting that the citizens of Tennessee are being discriminated against simply because they live in a state that has chosen not to enact a state income tax. Mr. Chairman, I submit to you that the federal government should treat all taxpayers equally, regardless of the system of taxation their state employs.

The Tax Deduction Fairness Act simply would allow taxpayers to deduct either their state income tax or state and local sales taxes from their federal income tax returns. We have an opportunity to restore fairness and equity to the tax code in this Congress without making the tax code more complex and without abandoning our fiscal discipline.

In addition, this legislation would return to the states the decision of how to fund their operations by removing the incentive toward a state income tax from the federal tax code. Regardless of your views on income taxes, sales taxes or some alternate tax structures, I'm sure you would agree that states should have the right to decide for themselves how they want to collect their revenues without interference from the federal government.

In closing, I would like to thank Congressman Baird for introducing this important legislation and I hope that the Committee will consider including it if there should be a tax relief package in this Congress. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Clement.

Our last witness today is Congressman Crowley from New York. Mr. Crowley, we are glad to have you before the Committee. You may proceed.

STATEMENT OF HON. JOSEPH CROWLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. CROWLEY. Thank you, Chairman Archer and Ranking Member Rangel, for giving me the opportunity to talk about the overcrowding and structural problems faced by our schools and the need for the House of Representatives to provide tax-based relief for those problems. My colleague from New York, Mr. Rangel, has introduced legislation, H.R. 1660, which I believe will provide substantial relief to communities across this country at the least cost to the Federal Government.

Mr. Chairman, I represent the Seventh Congressional District in New York, which encompasses parts of Queens and the Bronx. The schools in my district face similar problems to schools all across this country. The New York City School District is the largest in the Nation, serving over a million students, and I represent the Community School District 24, the most overcrowded school district in the city, which operates at 114 percent over capacity. In total, I represent 3 of the 10 most overcrowded schools in the City of New York. Over the next 10 years, this number will increase, and five of the six school districts I represent will be operating over capacity. School District 24, by the year 2007, is predicted to be operating at 168 percent over capacity.

These charts I have brought here show the situation faced by five school districts located within my congressional district—you all have copies of these charts. This first chart illustrates the enrollment versus the capacity of high schools in Queens—this is enrollment, this is capacity. The second chart illustrates the enrollment versus the capacity of high schools in the Bronx. Again, the enrollment on the left, capacity on the right. The third chart I have shows the enrollment versus the capacity of elementary schools and intermediate schools in Queens County. This fourth chart I have shows that even after an aggressive building and modernization plan by the City and State of New York, the City of New York will not have enough seats for its students. In fact, by the year 2007, Queens County is predicted to comprise 66.3 percent of the shortage in New York City. And, last, this chart shows how every single school district in Queens will be operating over capacity within the next 10 years, not by just a few students, but between 5,000 and 10,000 students per district will not have seats in Queens County.

New York City and Queens, in particular, is facing a rapidly growing school-age population. In Queens, the school enrollments are increasing by a minimum of 30,000 students every 5 years. The school system simply cannot handle this rapid growth. In fact, the schools cannot handle the current level of student enrollment. The average New York City school was built 50 years ago—1 in 5 is over 75 years of age—and these older schools do not meet the needs of the 21st century. Some, such as P.S. 87 in Middle Village, Queens, still uses coal to heat its school. Others have converted closets, bathrooms, and even hallways have been converted into classrooms.

In this first picture I have here—it is in District 30 of my district—where you see 50 students and 2 teachers teaching a regular kindergarten classroom in one room; 50 students in one room. The second picture I have here is a picture of a class being taught in the hallway in my district. And the third picture I have here is a picture of a class being taught in a closet.

In May, I hosted an education roundtable in my district. I invited every school principal and superintendent to that roundtable in my district. We had a great discussion, and the overwhelming feeling was that we need new schools constructed and the existing schools to be modernized. I recently sent out a survey asking school principals regarding their schools. The survey asked questions about the makeup of the student body, the school's infrastructure as well as safety concerns and parental involvement. The majority of these principals were concerned about the infrastructure. One school, P.S. 11 in Woodside, Queens, has had to convert their locker rooms, shower rooms, and supply closets into classrooms. This is in addition to the temporary classrooms constructed to accommodate the increased student population. I would also add that P.S. 229, where I went to grammar school, not only has temporary classrooms but has built an additional wing, and the schoolyard, where I grew up and played, no longer exists. The Renaissance High School in Jackson Heights operates on two shifts—from 7:50 a.m. until 5 p.m. at night. What happens to the important extracurricular activities? How about school sports participation? How about volunteer work by students or even after-school jobs? A vital part of our students' overall academic experience is being denied to them, and our students and our communities are the true losers.

Mr. Chairman, I think you will agree that the schools in New York City and in many other cities and towns across this Nation are in a state of crisis. Local communities and States simply do not have the resources to adequately modernize and construct enough new schools to meet the growing enrollment demands.

A commonsense, tax-saving proposal is Representative's Charles Rangel's H.R. 1660, the Public School Modernization Act of 1999. H.R. 1660 contains two tax provisions that will help schools to modernize their buildings and relieve overcrowding conditions. Using tax credits, Mr. Rangel's bill will provide approximately $24 billion in interest-free funds for school modernization projects and new building construction. Essentially, the bill is tax-exempt bond financing for school districts. It does not add to the Tax Code or provide for direct appropriations to States; rather, it would allow State and local governments to issue qualified school construction bonds to fund construction or rehabilitation of public schools. Interest on these qualified bonds would in effect be paid by the Federal Government through an annual tax credit to the bondholders on the amount of interest accrued. An additional benefit of this proposal is that communities whose schools offer bonds will not have to face increased taxes, thereby decreasing the tax burden for our less fortunate communities. Above all, the bonds provide our communities with a flexible and cost-effective approach to school modernization and construction.

I understand there are alternatives out there to Mr. Rangel's bill. However, H.R. 1660 is unique in that it allocates half of its bond authority base on the existing Federal Title I grants formula and the other half to the hundred school districts in the country with the largest number of low-income students. The alternative uses a 50/50 allocation that combines Title I and the overall number of K–12 students. Mr. Rangel's bill will ensure that the neediest communities get the assistance that they desperately need.

And, Mr. Chairman and Members of the Committee, I thank you for your time and ask you to call on me if you need any additional information.

Thank you.

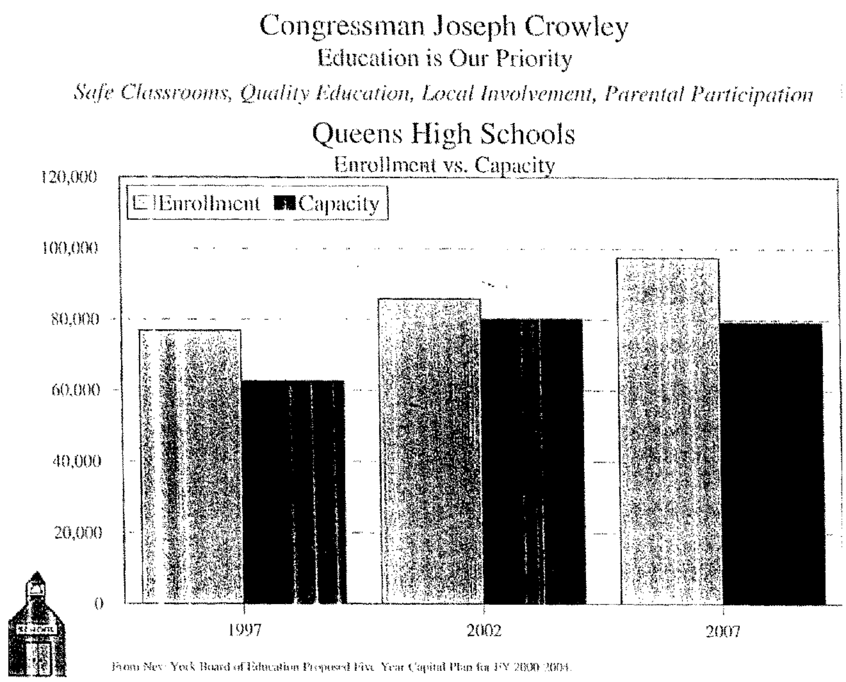
[The prepared statement and attachments follow:]

Statement of Hon. Joseph Crowley, a Representative in Congress from the State of New York

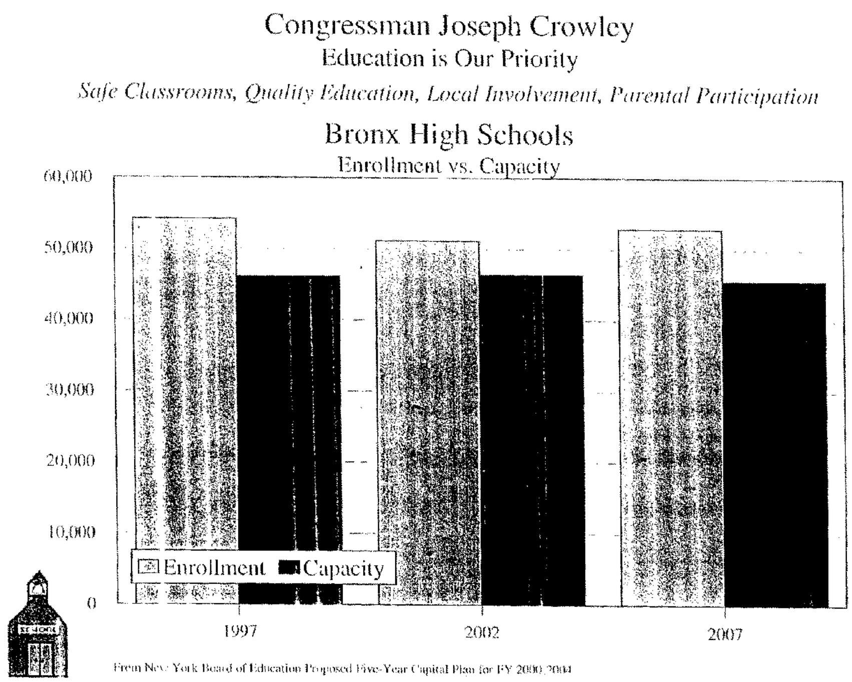
I want to thank Chairman Archer and Ranking Member Rangel for giving me to time to talk about to overcrowding and structural problems faced by our schools and the need for the House of Representatives to provide tax based relief. My colleague from New York, Mr. Rangel, has introduced legislation which I believe will provide substantial relief to communities across the country at the least cost to the federal government.

Mr. Chairman, I represent the 7th Congressional District of New York, which encompasses parts of Queens and the Bronx. The schools in my district face similar problems to schools across the country. The New York City School District is the largest in the nation, serving over a million students. I represent Community School District 24, the most over-crowded school district in the city, which operates at 114% capacity. In total, I represent three of the ten most overcrowded schools in the city of New York. Over the next 10 years, this number will increase and five of the six school districts I represent will be operating over capacity. CSD 24 will be operating at 168% over capacity! These charts I have here show the situation faced by the five school districts located within my Congressional District. (See attached charts).

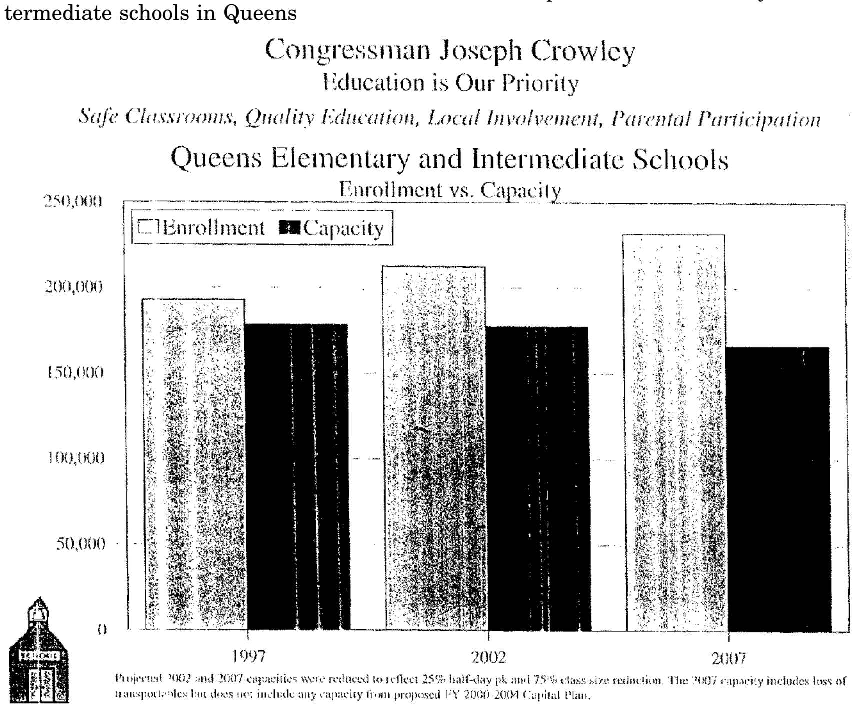
1. This Chart illustrate the enrollments versus the capacities of high schools in Queens



2. This Chart illustrates the enrollments versus the capacities of high schools in the Bronx



3. This Chart shows the enrollments versus the capacities of elementary and intermediate schools in Queens



4. This chart shows that even after an aggressive building and modernization plan by New York City's Board of Education, the City of New York will not have enough seats for its students!

Congressman Joseph Crowley

Education is Our Priority

Safe Classrooms, Quality Education, Local Involvement, Parental Participation

It's a Fact That... Queens is Where the Need Is

Borough	Seats Needed	Seats Planned	Seats Short	% of Total Seats Short
Manhattan	6,650	4,250	2,400	7.2%
Bronx	14,150	10,150	4,000	12.0%
Brooklyn	13,650	9,650	4,000	12.0%
Queens	**53,950**	**31,950**	**22,000**	**66.3%**
Staten Island	1,200	400	800	2.4%
Total	89,600	56,400	33,200	

Figures from Terri Thompson, NY City Board of Education.

5. Lastly, this chart shows how EVERY SINGLE school district in Queens will be operating over capacity within the next ten years. Not by just a few students, but between five and ten thousand students will not have seats!

Overutilization After 10 Years. . .

District	1997	2007
24	119%	168%
25	98%	116%
26	96%	138%
27	110%	152%
28	105%	117%
29	113%	135%
30	109%	141%
78	123%	123%

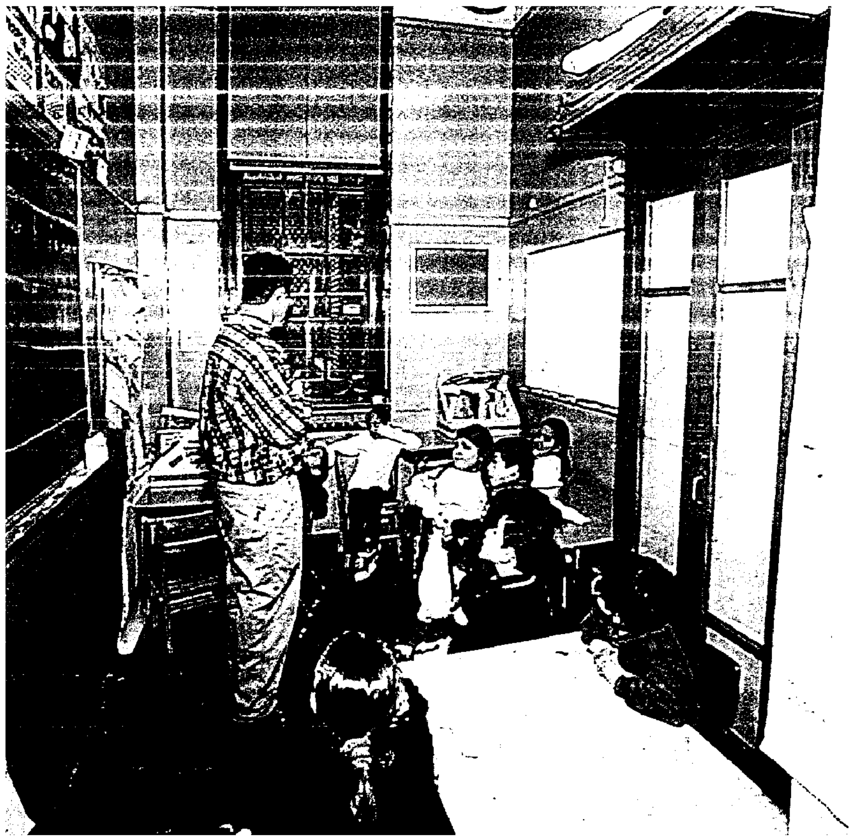
Note: Local districts assume 25% PreK, 100% Class Size reduction, loss of TCU capacity -- goals for the entire city

New York City, and Queens in particular, is facing a rapidly growing school-age population. In Queens, the school enrollments are increasing by a minimum of 30,000 students every five years. The school system simply cannot handle this rapid growth. In fact, the schools cannot handle the current level of student enrollment. The average New York City school was built 50 years ago; one in five over 75 years ago; and these older school do not meet the needs of the 21st century. Some, such as P.S. 87 in Middle Village, Queens, still use coal to heat the schools; others have converted closets, bathrooms, and even hallways into classrooms. See attached photographs.

A regular sized Kindergarden classroom with fifty students and two teachers

A class being taught in a hallway.

A class being taught in a converted closet



In May, I hosted an education roundtable in my district. I invited every school principal and Superintendent. We had a great discussion and the overwhelming feeling was that we need new schools constructed and the existing structures modernized. I recently sent out a survey asking school principal regarding their schools. The survey asked questions about the make-up of the student body, the school's infrastructure, as well as safety concerns and parental involvement. The majority of these Principals were concerned about their infrastructure. One school—P.S. 11 in Woodside, Queens, has had to convert their locker rooms, shower rooms, and supply closets into classrooms. This is in addition to the temporary classrooms constructed to accommodate the increased student population. The Renaissance High School in Jackson Heights operates on two shifts, from 7:50 a.m. until 5:00 p.m. What happens to important extra-curricular activities? How about sports participation? Volunteer work by students? Even after school jobs? A vital part of a students overall academic experience is being denied to them and our students and our communities are the losers.

Mr. Chairman, I think you will agree that the state of schools in New York City, and in many other cities and towns across the nation, is a crisis situation. Local communities and states simply do not have the resources to adequately modernize and construct enough new schools to meet the growing enrollment demands. A commonsense, tax-saving proposal is Representative Charlie Rangel's H.R. 1660, the Public School Modernization Act of 1999.

H.R. 1660 contains two tax provisions that will help schools to modernize their buildings and relieve over-crowded conditions. Using tax-credits, Mr. Rangel's bill would provide approximately $24 billion in interest-free funds for school modernization projects and new building construction. Essentially, the bill is tax-exempt bond financing for the school districts. It does not add to the tax code or provide for a direct appropriation to states. Rather, it would allow State and Local governments to issue qualified school construction bonds to fund construction or rehabilitation of public schools. Interest on these qualified bonds would in effect be paid by the Federal government through an annual tax credit to the bondholders on the amount of interest accrued. An additional benefit of this proposal is that communities whose schools offer bonds will not have to face increased taxes, thereby decreasing the tax burden or our less fortunate communities. Above all, bonds provide our communities with a flexible and cost-effective approach to school modernization and construction.

I understand there are alternatives out there to Mr. Rangel's bill. However, H.R. 1660 is unique in that is allocates half of its bond authority based on the existing federal Title I grants formula and the other half to the hundred school districts with the largest number of low income students. The alternatives use a fifty-fifty allocation that combines Title I and the overall number of K–12 students. Mr. Rangel's bill will ensure that the neediest communities get the assistance that they desperately need.

Mr. Chairman and members of the committee, I thank you for your time and ask you to call on me if you need any additional information.

Chairman ARCHER. Thank you, Mr. Crowley.

Does any Member of the Committee wish to inquire?

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman, and I want to thank my colleague from Washington State, Mr. Baird, for his efforts to reinstate the sales tax deduction. Mr. Chairman, this is a tax that negatively effects you in your State and those of us in Washington State and apparently Tennessee and other States, and I really feel that only being able to deduct a State income tax from Federal taxes is a huge invasion of States' rights, and I think it is something that we ought to pay attention to, and, in fact, wondered, when Mr. Foley was our Speaker, if he might lead us in this direction, and I am delighted that Mr. Baird has done just that.

I also want to thank Mr. Turner particularly for coming here today to testify on behalf of his bill, H.R. 1916, which would allow forest product companies to expense more of their reforestation expenses. We need to do all we can to help industries in this business. Lots of these industries have been lagging lately because of Federal requirements and taxes and regulations, and I think it is really important that he is pushing into this area.

I have also included a similar provision in the bill that I have introduced, which is H.R. 1083, the Reforestation Tax Act, and this provides a comprehensive approach to increasing the global competitiveness of today's forest product companies. H.R. 1083 has the support already, Mr. Chairman—65 Members of Congress, I am sure, many of whom would want to be on your bill, and 14 of those are Members of the Ways and Means Committee, and virtually every forest products company, both large and small, as well as forestry associations and labor unions. And so I want to give a lot of credit to Mr. Turner for recognizing the importance of this issue and helping to advance this worthy cause.

I would say simply one more thing: Mr. Weller and I have included in a larger bill the Lifetime Tax Relief Act, the work that he and Mr. McIntosh have done on the marriage penalty, and we believe this is critically important to be part of a larger tax bill. There are many forms that relief could take, but Mr. Weller and

Mr. McIntosh have been the leaders on this issue, and, as I go home to my district and speak before groups around this country, that is always the primary tax relief issue that comes up in the form of questions. So, not to leave out my work that I have done on death tax relief, and I appreciate your crediting Mr. Tanner and me with that, because we have worked very hard on this, and we think fairness dictates that this sort of relief be given to folks who are paying tax in the United States.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Mr. Chairman, I want to thank all of the panelists. I also appreciate the statement given by the gentleman from Tennessee. Having fought for the deductibility of State income taxes, I can see the equity issue as it relates to sales taxes. Mr. Crowley, while you eloquently described the crisis that exists in New York City schools, we want the Committee to know that the Conference of Mayors has indicated that this same crisis exists throughout the United States, in urban as well as rural areas, and especially in the poorer communities, which would be targeted for assistance by our legislation.

The emphasis of the Majority seems to be on the individual savings accounts where the parents would be able to deposit $2,000, and if that $2,000 was dedicated in any way toward the education of the child, the interest on that amount would be tax free. Could you see how this could possibly alleviate the crisis about which you testify?

Mr. CROWLEY. I can't see how that, in and of itself, could help build schools or modernize the schools, at least in my district; I can't speak for suburban——

Mr. RANGEL. One of the other exciting educational ideas that they have put forth is substituting Federal funding for vouchers. Do you see how that would alleviate the overcrowdedness that exists in the schools about which you were testifying?

Mr. CROWLEY. I don't see how vouchers, in and of themselves, could alleviate the problems we are facing in my district or in the city of New York, and in terms of—vouchers will do nothing to modernize the public school system in our city.

Mr. RANGEL. The most creative proposal that they have recently come up with is to remove all the Federal criteria that target the funds to help meet educational goals and allow the Governors to decide how they would want to use the 7 percent of their spending that comes from Federal dollars. Knowing that you were a member of the State legislature and knowing the spending formulas that relate to New York City and the rest of the State, would you believe allowing the Governors to decide how to use Federal dollars would help you with the problems that you testify today?

Mr. CROWLEY. I particularly fear in New York State that that would not be the case. Having come from there and knowing that we get shortchanged on an annual basis in New York City, to leave it in the hands of the legislature and the Governor would not be a wise thing to do, and I think that is why your plan, Mr. Rangel, would drive the money where it is mostly needed, especially as it pertains to Title I programs in the City of New York and in my district in particular. I know I fare much better with your bill than I would with any of the other bills that are proposed.

Mr. RANGEL. Thank you, and I thank the panel. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. McInnis.

Mr. MCINNIS. Thank you, Mr. Chairman.

First of all, just to kind of piggyback on the state of the death tax situation, another way I think an approach that we could do is a bill I have introduced, which is to take the gift exemption every year from $10,000 to $20,000. We have never seen an adjustment since, I think, in the seventies on that factor, so until we are able to eliminate the death tax of which I wholly support, and, in fact, I am a cosponsor of the bill, I think we should look at the gift tax.

My second thing was for Congressman Baird. I agree with your comments; I am little confused, though. I am not aware of a disaster or a situation where a home burns or something like that that the mortgage company forgives the mortgage. I am not sure they have the authority to forgive the mortgage. Where I have seen a mortgage written off is where somebody doesn't make their payments; they just walk off and abandoned the property. The mortgage company writes the loan off, and the IRS considers that, then, as a taxable event. So, I am trying to distinguish between the two. One, I think the disaster—I would agree with you, if, in fact, that ever occurs—that if it is forgiven, then I think we should look at that as an exemption, and, ironically, in my district, we had somebody who was kidnapped—a bank president. And, believe it or not, the bank gave the bank president's family the money to pay the kidnappers, and then the IRS charged that as a gift. They later backed off of that after publicity, but they initially tried it. So, that happens, but the written off aspect of it, that, I think, is a taxable event. So, would you distinguish for me? Does it occur?

Mr. BAIRD. Let me give you the situation we face. There is a very slow moving landslide; it has taken out about 130 homes. The FEMA funds and SPA and HUD are not really well equipped to deal with a disaster of this sort, and we are trying to help them out in every way we can through the existing government agencies. But several of the homeowners are in the following circumstance: their home, which may have had $150,000, $175,000 of equity, has been destroyed. They now have to find and live in another home.

There are several problems, and we are going to piece them together. First problem is this issue of forgiveness. A few of the lenders have said, basically, "We don't feel right continuing to charge you for your mortgage on a home that you can't live in." Quite literally, out of the goodness of their heart, they are going to forgive the mortgage. They are going to say, "You don't owe us any more money." That, under current code, as we understand it, could be constituted as a gift, and the homeowner would then have to pay taxes on a gift, which is really, for them, effectively, a valueless gift.

Mr. MCINNIS. But that in fact is happening? You know of mortgages being forgiven?

Mr. BAIRD. We know of several cases where that has happened.

The other side to this deals more with the casualty loss provision, which we would also like to address, and let me briefly raise that. Current casualty loss—these homes are completely wiped out; they are buried under mud—current casualty loss calculates your casualty basis from the value of the house when you purchased it. Many of these homeowners have owned their homes for 30 years, and obviously the current equity is quite a bit higher than that. So, we would like to also propose adjusting the casualty loss. Again, what we are trying to deal with are disasters of a sort for which you cannot readily buy insurance, because we don't want to create the Tax Code as de facto disaster insurance. This is a niche where people have been hurt and left out, and it is a way to try to help them out over time.

Mr. MCINNIS. I think your approach is very reasonable.

Mr. Chairman, I yield back the balance of my time.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Turner, I am delighted that you are here to testify. I think the proposal you have brought before us, as with Ms. Dunn's proposal, is a solid contribution to the debate on how the Tax Code could be made more environmentally friendly. I think you have already in your testimony made a strong case on how this expanded tax credit would help the forestry industry, including the one we have in western Pennsylvania. Let me ask you: beyond that advantage, would you care to comment on the environmental impact of providing this tax credit and the level of support from conservation groups for what you are proposing?

Mr. TURNER. Thank you, Mr. English, for that question. As you well know, anytime you reforest lands you improve the quality of the air; there is a very obvious relationship. The other thing that happens when you encourage reforestation is you take pressure off areas that you really should not be harvesting for timber. You are able to preserve wetlands, you are able to preserve streambeds, and you are able to manage your land better if you decrease this pressure. And, of course, in areas like we represent where there is a demand upon the forest from the forest products industry, anytime we can provide a greater supply of the raw product, we are not only going to help the environment but we are also going to lower the cost of that raw product to those mills and help them to be more competitive. Therefore, it is kind of a win-win if you encourage landowners, and, as you know, in my bill, we are basically targeting the small landowners, the ones that on the chart I had up a minute ago are not reforesting their lands as fast as they are harvesting their timber. I think it is a win-win for everybody.

Mr. ENGLISH. So, in other words, this would benefit the little guy. Sometimes tax preferences that are built in aimed at the forestry industry tend to be mischaracterized as corporate welfare. This would clearly not be a case of corporate welfare. This would be aimed at the little guy, and it would have clear and demonstrable environmental benefits; it would improve land use, and it would address the large problem of deforestation.

Mr. TURNER. No question about it. In fact, the chart—I might ask my staff to put it back up—the chart that was produced by the Texas Forest Service regarding the situation in Texas is probably very similar to other areas across the country. What it shows you is that the large industrial landowners, the timber companies, are doing a great job of reforesting the lands after they harvest the timber. On the left side of the chart you can see they are reforesting about 99 percent, but the small landowner on the right side of the chart is only reforesting 40 percent of the lands that have been harvested. Under current law you can amortize 10,000 dollars' worth of your expenses, and my bill simply moves that figure up to $25,000. That amount hasn't changed since 1986, so inflation alone would justify the increase. Then, of course, the investment tax credit remains the same at 10 percent.

What it means is that at a cost of $80 to $100 for replanting timber—replanting seedlings per acre—the average landowner can probably replant, under our expanded amount of $25,000, about 250 to 300 acres of land. Clearly, my bill is aimed at that small landowner and trying to get that number up on the right side of that chart.

Mr. ENGLISH. Mr. Turner—you have explained to us the benefits from the standpoint of the person involved in the timber industry—may I ask, what would be the overall cost of your provision, if it were included in a tax bill?

Mr. TURNER. The cost estimate on my bill over 5 years is $112 million, and over 10 years, it is $253 million—a very modest cost considering the economic benefits and the environmental benefits that would flow from it.

Mr. ENGLISH. Ms. Dunn's bill, I think, is broader and would I believe extend to a broader range of taxpayers, including the corporate taxpayers. I think your proposal is very interesting, and we appreciate your taking the time to call our attention to it.

Thank you. I yield back my time.

Mr. TURNER. Thank you, Mr. English.

Chairman ARCHER. Any other Member wish to inquire? If not, the Chair is very grateful to all of you for making your presentations today. We thank you, we excuse you, and we will go to our next panel.

Mr. Bennett, Dr. Kepple, Mr. Grayson, Dr. Gillespie, Mr. Baratta, Ms. Zedalis, will you please come to the witness table?

It's the Chair's intention to continue this hearing straight through the lunch period. So Members who wish to grab a bite of lunch need to go and then return as soon as they wish, but we will not take a break for lunch.

We are happy to have each of you before the Committee today. And, Mr. Bennett, will you please lead off? The Chair would reiterate the rules which are for you to keep your oral testimony within 5 minutes. Your entire written statement, without objection, will be printed in the record. When you are recognized, identify yourself for the record and then proceed with your testimony.

Mr. Bennett.

STATEMENT OF HON. MARSHALL BENNETT, MISSISSIPPI STATE TREASURER, AND ADMINISTRATOR, MISSISSIPPI PREPAID AFFORDABLE COLLEGE TUITION PLAN; ON BEHALF OF COLLEGE SAVINGS PLANS NETWORK

Mr. BENNETT. Thank you, Mr. Chairman. Good morning, I am Marshall Bennett, the State Treasurer of the State of Mississippi, and I am representing the college savings plans across America, the national College Savings Plans Network, and it represents each State that is represented here on the Ways and Means Committee.

I don't know how many of you read on Sunday before last, an article in The Washington Post entitled, "Students Pay Dearly for Debt." It talked about the exploding levels of debt among college students creating negative effects. Debt diverts the students' attention from academics, it creates a debt-burdened class of new graduates who have a difficult time of getting their life started in their new careers.

Well, Americans have begun to ask for relief. From 1980 to 1995, the U.S. Department of Education loan portfolio went from $20.2 billion to $11.5 billion. American families have had to rely on debt to meet the higher cost of higher education for their kids. As a result, the portion of the household income needed to pay college tuition has doubled during this same period. The soccer moms across this country are beginning to scream for solutions. the States have found a solution and that is in the Qualified States Savings Plans to encourage families to save for their children's college tuition rather than to go into debt. Many States have granted State tax deductions, State tax exemptions to encourage their citizens to have family savings.

One common feature of the Qualified State Savings Plans is that they are all statutorily created. They operate under prescribed investment policies. The savings funds are dedicated for higher education. The plans generally include a refund provision for the beneficiaries who choose not to go to college or get scholarships. Plans are national in scope and are portable to any public or private college in the Nation.

I have brought with me, Mr. Chairman, a map of the United States showing the current State plans. Forty-four States and the District of Columbia have legislative authority to create college savings programs. Twenty States operate prepaid plans, including the Texas Tomorrow Fund. Sixteen States operate college savings plans, including New York, Mr. Rangel, and California. Fifteen savings plans and one additional prepaid plan are expected to open within the next year. Already one million students have signed up for the tuition plans representing $5 billion in market value of investments.

Well, Congress has acted too in passing, in 1996, the Small Business Job Protection Act and creating section 529 of the Internal Revenue Code. You have recognized tax deferred treatment, like IRAs, for the college savings plans across the country. You have recognized the safety, security, stability, and benefits of these plans by granting this special tax treatment.

We feel that under current law, however, that even deferred taxation creates a disincentive to participate in savings because participants don't understand or are not receptive to paying taxes on income they have not personally received but which is used to pay the institutions of higher learning. The Internal Revenue Service now has created proposed rules requiring a complex accounting and reporting system and administrative burdens on the college savings plans across the country. Currently, any tax withheld from the distribution reduces the funds available for parents and students to pay for their college tuition.

What we really need is an exclusion from gross income tax of the earnings in the college savings plans. This would motivate families to save for college, encourage college attendance by providing clear and easily understood uniform tax treatment. Many of the States offer tax exemption now and tax deduction.

We have already seen that when a family purchases a contract or sets up a savings plan, the child is more likely to attend college. College attendance makes for a better trained work force which pays more taxes.

The reason that Congress has granted this special tax, 529 status to the States is that you know that the States have adequate oversight of these plans. The programs are overseen by the State legislatures, the executive branch, the higher education authorities. the State programs have strict reporting requirements. They are subject to administrative procedure laws, procurement laws, ethics laws, a variety of open meetings laws, public information sunshine laws, and State audits.

You have before Congress now a number of proposals which would expand the 529 plan to permit private colleges and universities to establish qualified tuition proposals. We generally support proposals which encourage families to save for their children's higher education. However, as administrators of current college savings plans, we are concerned about the proposals to permit private colleges and universities to establish Qualified Tuition Programs without oversight and accountability. As these proposals move forward in Congress, we urge this Committee to ensure that private plans have effective oversight to maintain financial security. We recommend that you consider a requirement that private institutions be subject to the same regulation and oversight as stringent as the oversight which State programs are subject to. It is just good basic consumer protection and accountability.

CSPN believes that the Securities and Exchange Commission regulation, for example, would ensure the contributions are soundly managed and that disclosure requirements would ensure that private programs operate soundly. Frankly, ladies and gentlemen, we are not concerned about the Princetons, the Northwesterns, the Stanfords, and the Notre Dames. What we are concerned about are schools like the El Paso Beauty School, the Chicago Truck Driving School, or the Pineville Bible College. Some may be good schools and well intended but financially marginal or even financially distressed or mismanaged. Just look at the fiasco that has happened with student grants and student loans at proprietary schools that have gone out of business creating a national crisis. The last thing that anyone wants is for even one poorly managed private college or a group of them to market a savings plan that becomes insolvent or has financial problems and the students will be left holding an empty bag.

The financial collapse of a private plan would adversely reflect on all other college savings plans across the country. If a private unpaid tuition program fails, the public would have the difficulty distinguishing between those plans that are failed and the ones that are soundly managed by State-sponsored and financially backed plans. All the State plans have State moral obligations or general obligations behind them.

We urge this Committee to amend the current tax laws to encourage family savings, eliminate the Federal income tax on accrued interest, and call for strict oversight and regulation recognizing that if people want parity in the tax provisions, you should also require parity in accountability and oversight.

Thank you, Mr. Chairman, for your opportunity granted here and your strong support of college savings across America.

[The prepared statement follows:]

Statement of Hon. Marshall Bennett, Mississippi State Treasurer, and Administrator, Mississippi Prepaid Affordable College Tuition Plan; on behalf of College Savings Plans Network

INTRODUCTION

Mr. Chairman and Members of the Committee, I am Marshall Bennett, the State Treasurer of Mississippi, Administrator of the Mississippi Prepaid Affordable College Tuition Plan ("MPACT"), and Chairman of the College Savings Plans Network ("CSPN"). CSPN was formed in 1991 as an affiliate to the National Association of State Treasurers. CSPN is a national association representing the common interests of state-operated college savings tuition plans. The primary mission of the Network is to encourage families to save ahead for college. To accomplish its mission, the College Savings Plans Network shares information among existing programs, provides information to other state agencies which are interested in starting a college savings program, and monitors federal activities and legislation affecting state programs. CSPN welcomes the opportunity to discuss sound methods to improve access to post-secondary education.

A recent headline in the *Washington Post* read "Students Pay Dearly for Debt." The article noted that "exploding" levels of debt among college students create a number of negative effects, including the diversion of students' attention from academics as they look for work to payoff school loans while in school, and debt levels which force students to drop out or file for bankruptcy. A longer-term effect is the creation of a debt-burdened class of new graduates who have a difficult time getting a start with their careers. The campus debt explosion is a function of college costs, which have risen faster than family incomes. Regrettably, debt shapes the contemporary college experience. While I cannot provide an answer to why debt levels are so high, I can offer the experience of the states in addressing this problem. There is a way to help families and students avoid burdensome debt.

The cost of attending college, whether at a public institution or a private college, continues to rise steadily. In order to send their children to college, American families have increasingly relied upon debt to meet the rising cost of a higher education. According to the National Commission on the Cost of Higher Education, between 1976 and 1996, the average tuition at public 4-year universities increased from $642 to $3,151 (390 percent) and from $2,881 to $15,581 (440 percent) at private 4-year universities. In contrast, according to the U.S. General Accounting Office, median household income rose by only 82 percent. As a result, the portion of a household's income needed to pay for college tuition nearly doubled during the period.

Rising tuition rates force families to resort to loans to fund their children's college education. From 1980 to 1995, the U.S. Department of Education's loan portfolio increased from $2.2 billion to $11.5 billion. Not only are more loans being taken out, the size of the loans has increased. GAO reports that, at the undergraduate level, the percentage of post secondary students who had borrowed by the time they graduated increased from 41 percent in 1992–93 to 52 percent in 1995–96, and the average amount of debt per student increased from about $7,800 to about $9,700 in constant 1995–96 dollars. Students attending 4-year public institutions showed the largest increase in the number of borrowers. Sixty percent of seniors graduating from these schools in 1995–96 borrowed at some point in their program, up from 42 percent in 1992–93 and about even with the percentage of borrowers at private

4-year colleges. At the same time, the value of a college education grew, increasing the demand for college enrollments. The constantly rising costs coupled with higher demand create uncertainty for families who want to send their children to college.

College Tuition Plans Promote Savings

The best answer to rising college costs is to encourage advance family savings. Student financial aid programs are facing more and more demands at a time when resources have been reduced. Over dependence on financial aid has caused the total annual cost of federal financial aid, originally targeted to help lower-income families, to rise at an unsustainable rate. Budgetary constraints force the federal government, as well as state governments, to reduce direct student financial aid. As government financial aid is reduced, the responsibility for funding college falls more directly on families. The well documented low savings rate in the U.S. also clearly indicates that additional incentives are required to get families to start saving for their children's college education.

The states recognized the need to foster saving for college, which is economically more sound, both for families and for institutions of higher education. Thus, beginning in the late 1980s, the states tuition savings programs to encourage families to save for college. Qualified state tuition programs (";QSTPs") are a convenient method for many families to fund the high costs of college. The plans encourage early college savings and promote future access to higher education for children of middle-class families. The basic premise of these programs is that they encourage families to purchase future college tuition at an actuarially determined cost based on today's prices. Thus, qualified state college tuition plans act as a catalyst for college savings. Families participating in the programs save specifically for college where otherwise they would not set aside money for this purpose. The programs also raise attention to the need to save for college. As a result, QSTPs provide a unique psychological benefit because they guarantee future college costs, providing parents with permanent assurance about their children's future.

How the College Savings Plan Programs Operate

States have long worked to identify ways to encourage citizens to attend college. For example, since 1959, New Jersey has offered college savings bonds to its citizens to encourage enrollment. As concerns about the affordability of college grew in the 1980s, states established a variety of college savings programs to assure access to higher education. Michigan established the first prepaid college tuition plan in 1986. Alabama, Florida and Ohio followed between 1988 and 1989. From 1989 to 1997, there was moderate growth in the number of programs, due principally to uncertainty over the federal tax treatment of the programs. Federal legislation approved in 1996 and 1997 under the bipartisan leadership of the Committee on Ways & Means encouraged many more states to set up these plans.

The state-sponsored college tuition programs have achieved tremendous success. Since enactment of the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997, the number of children participating in the programs has skyrocketed, and the number of states with programs has nearly doubled. All of the remaining states are studying the feasibility of establishing a qualified state tuition program. The state-sponsored college tuition programs help families save for the high cost of a college education. As a result, many more of our children will have the opportunity to gain a higher education, which benefits the entire nation through a better educated, more productive workforce.

The states have designed their college tuition programs to account for the particular circumstances of their higher education establishment. The programs are intended to promote access to higher education by providing individuals with a convenient method to fund the rising cost of post-secondary education. Each program has unique features intended to encourage its citizens to participate in the programs. However, the qualified state tuition programs may be divided into two general types. Prepaid plans and savings plans.

Prepaid Tuition Plans

The first broad type of plan is the prepaid tuition plan. These programs are analogous to a defined benefit pension plan. Under a prepaid tuition program, states enter into contracts with families, corporations or other entities that purchase contracts to acquire tuition benefits or waive costs for designated beneficiaries. Under prepaid plans, contract purchasers prepay tuition and mandatory fees, and in some states, room and board expenses, for a set number of academic periods or course units. Contracts may be for junior college, community college or for four-year undergraduate programs. A number of prepaid programs also permit the purchase of contracts for graduate school expenses. All prepaid programs permit the use of distributions for out-of-state and private institutions, although the amount of covered expenses may be based on in-state tuition.

Under a prepaid plan, the price of a contract is determined prior to purchase. The contract price depends on the type of contract purchased, the projected date of the designated beneficiary's enrollment, the current and projected cost of tuition, the overall number of years until the beneficiary enrolls in college, and the assumed rate of return. The contribution amounts are also capped, in compliance with section 529 of the Internal Revenue Code. The programs pool all payments into one large fund and invest it with the goal of achieving a rate of return that is higher than the rate of tuition increases anticipated at the participating colleges.

Various refund provisions may apply if the beneficiary cannot use the benefits due to death or disability; chooses to not go to college; or attends an out-of-state college or proprietary college. The programs generally do not guarantee that the beneficiary will be accepted for enrollment at one of the participating colleges. However, under many plans, new beneficiaries may be named in place of the original one. Finally, in the case the fund becomes actuarially unsound, most states have built an escape clause into their plans that would allow them to end the program and issue refunds to the participants.

States offer a variety of payment plans, including lump-sum payments and installment plans. Once a unit of tuition is purchased, the tuition rate is locked in. When a child is ready to go to college, the state transfers directly to the institution an amount equal to the cost of tuition at the time of enrollment. Many states guarantee that the contributions to the plans will cover future tuition costs.

Savings Plans or Savings Trusts

The second type of plan is referred to as the savings plan or savings trust, analogous to a defined contribution pension plan. Under these plans, families enter into participation agreements where they pledge to make cash contributions to an account for the beneficiary. Generally, these agreements require a minimum contribution amount, the purpose of which is to encourage participants to save on a regular basis, which is generally a more effective way to save for higher education expenses. Contributions to the savings plans are also capped, in order prevent their use as an abusive tax shelter.

Under savings programs, the state invests the funds to equal the anticipated future costs of tuition when the child goes to college. The state may directly manage the funds or may employ outside investment managers or brokers. Either way, the investments are subject to strict guidelines designed to ensure that the funds keep pace with anticipated tuition inflation. Under these plans, states do not guarantee the tuition nor a rate of return, but offer incentives, including state tax incentives, for saving. Fund investments may vary, based on the age of the designated beneficiary. The funds contributed on behalf of a younger beneficiary may be weighted more toward equities, while funds for a student nearing college enrollment are normally weighted toward fixed income investments. Most states allow these plans to be used for tuition or room and board expenses, in-state or nationally.

Common Features

Although each state's QSTP is unique, taking into account the needs and circumstances of the state, there are several features common to prepaid and savings plans:

- The plans are statutorily created;
- The plans are administered by the state and/or governed by a Board appointed by the state and comprised of state officials and others;
- State personnel operate the plans, which are governed by strict financial and program accountability requirements;
- The plans are limited to prescribed investment policies and standards;
- The savings provided by the plans are dedicated to the provision of higher education, with prescribed limitations governing the return of savings or prepayments only in the event of such circumstances as death, permanent disability; or the failure of the beneficiary to meet entrance requirements; and
- The plans generally include a refund provision for beneficiaries who choose not to matriculate.

A Current Profile of the State Plans

Forty-four states and the District of Columbia have authority to operate and manage college tuition programs. Currently, nineteen states operate prepaid plans and 16 a savings plan. Fourteen new savings plans and one additional prepaid plan are expected to begin operation within the next year. Every remaining state, except Georgia, which operates the lottery funded HOPE scholarship program, has legislation pending or is actively studying the establishment of a college tuition plan. Currently, there are nearly one million signed college tuition contracts. The estimated fair market value of these contracts is over $5 billion. The exact totals for the number of contracts and participants are not available because several of the programs are just now completing their peak spring open enrollment periods. However, the numbers of participants and contracts are expected to show healthy growth this year. These figures reflect the strong support by state residents who are diligently saving for the college education of their children or grandchildren.

Current Federal Tax Treatment

The Small Business Job Protection Act of 1996 clarified the tax treatment of contributions made to state college savings programs. Prior to the 1996 law change, the treatment of distributions from QSTPs was not clear. The Internal Revenue Service considered implementing rules which would have treated the prepaid contracts as a form of contingent debt instrument because, like bonds, they mature at a certain future date. The IRS proposed to tax participants in prepaid programs annually on "phantom" income earned on prepaid accounts. However, because the beneficiaries in most cases are children, the earnings would generally not be large enough to result in a tax liability. Moreover, the inconvenience to participants and the costly paperwork involved in annual income reporting would have substantially reduced the popularity of the plans. Indeed, the uncertainty with the law was the principal reason for the slow growth in the number of plans, as well as the slow growth in the number of plan participants.

Working closely with the College Savings Plans Network and the National Association of State Treasurers, the 104th Congress passed section 529 of the Internal Revenue Code. The new section clarified the federal tax treatment of qualified state tuition plans and outlined the qualifications required to establish the tax-exempt status of the state agencies which administer the programs. Section 529 also clarified the tax-deferred status of earnings, and set the policies and procedures related to the refund of the account if the beneficiary dies before distribution of the funds.

Under the 1996 Act, the federal income tax obligation on contributions to a qualified state college tuition plan is deferred until the contributions are redeemed. Upon redemption, the applicable tax is levied on the student who benefits from the plan, not the contributor. The federal income tax is due on the difference between the current value of the contributions and their original cost. As a result, the accrued interest income is taxed at the beneficiary's rate. The annual increase in value is not subject to annual capital gains tax.

Further, in the Taxpayer Relief Act of 1997, Congress said that deferred tax treatment applied not only to amounts used for tuition, but also funds used on room and board. The 1997 Act also clarified the estate and gift tax treatment of the programs. Under the provision, a contribution to a qualified state tuition program is a completed gift eligible for the annual gift tax exclusion and the annual generation-skipping transfer exclusion. A special rule applies to gifts in excess of the annual exclusion, under which a contributor may elect to take the contribution into account ratably over five years. The College Savings Plans Network strongly supported these changes because they make participation in the plans more attractive to families.

Proposals to Clarify the Current Tax Treatment of Qualified State College Tuition Plans

The College Savings Plans Network believes additional legislation is necessary to increase the attractiveness and marketability of the plans. Congress is currently considering a number of proposals to provide an exclusion from gross income for distributions from qualified state tuition programs.[1] The proposals properly focus on increasing the attractiveness of college tuition plans. Under current law, the taxation of distributions creates a disincentive to participate in the plans because potential participants may not understand or be receptive to paying taxes on income they had not personally received, but which is used to pay qualified education ex-

[1] H.R. 588; S. 387; H.R. 58, the College Savings Protection Act; H.R. 7, Education Savings and School Excellence Act of 1999; S. 13 and H.R. 254, Collegiate Learning and Student Savings Act; S. 1054, Savings for Scholars Act; H.R. 464, Higher Education Affordability and Availability Act; S. 14, Education Savings Account and School Excellence Act of 1999; S. 277, Educational Opportunities and Excellence Act of 1999; S. 1013, Child Savings Account Act; S. 1134, Affordable Education Act of 1999; H.R. 892, Renewing America's Schools Act; H.R. 1084, Lifetime Tax Relief Act of 1999.

penses. Program sponsors are concerned that this disincentive hinders maximizing participation in the programs. Program sponsors are also concerned that requirements to notify taxpayers of the tax on certain distributions may create costly administrative burdens for the plans.

The College Savings Plans Network believes that establishing an exclusion from gross income for distributions from the qualified state tuition programs is essential to encouraging savings and college attendance. An exclusion from gross income would recognize that contributions to the programs cannot be used for any purpose other than higher education. Any tax withheld from the distribution would reduce funds available to pay college expenses, increasing the cost to attend college. The public policy of this proposal is to enable and motivate families to save for college by providing clear and easily understood tax treatment of the qualified state tuition plans.

The basic transaction of the qualified state tuition programs is the purchase of a service to be provided in the future. After entering into a prepaid tuition contract or establishing a savings plan account, families have no control over the assets contributed to the plan. Contributions are transferred directly to the college or university when the child attends school. Thus, the accounts are not liquid and cannot be use for non-education purposes without incurring a federal tax penalty and penalties or charges issued by the state. The student will have to find other means of generating funds to pay the tax.

Congress should make the programs tax-free in order to encourage savings and college attendance. When a family purchases a contract or sets up a saving plan, the child is more likely to actually enroll in college. By encouraging savings, Congress benefits the national economy. College attendance makes for a better-trained workforce, which pays more taxes.

Oversight of the College Savings Plans

The state-sponsored college tuition programs are secured by the moral or political obligation of the states. To back this obligation, the state programs are subject to multiple levels of oversight. These oversight mechanisms protect the financial integrity of the programs, ensuring that the contributions to the programs are soundly invested and that the actuarial goals of the plans are met. Safe financial operation of the programs means that when a beneficiary enrolls in college, the program can pay out the proper amount of tuition.

The plans are administered by state entities, variously called boards, authorities, or trusts. Executive committees or trustees, subject to specific qualification requirements, are responsible for the overall direction of the programs. They generally are comprised of officials from the state legislature, executive branch, higher education authority, or from financial institutions and the public. Many of the programs also have public advisory committees. The executive entities are responsible for operation of the funds and for oversight of the strict investment policies governing the contributions to the funds.

By statute or regulation, the operating authorities are required to follow prudent investment practices to maximize the total return on investment and to ensure that the investments meet the future obligations of the funds. Generally, these investment guidelines state that the investment profile seeks to maximize return consistent with the security of principal, and subject the investments to generally accepted prudency rules. In addition, many of the funds are required to follow detailed asset allocation rules to ensure diversity of investment and liquidity of the funds.

All of the programs are subject to financial and actuarial audit and reporting requirements. Audits may be conducted internally, by legislative oversight committees, or by external auditors. National accounting firms audit many programs. By law, the reports are required to include a detailed statement of the financial condition and rates of return of the programs. Most of the reports also discuss any risks associated with the program. These reports generally are required to be distributed to the state legislature, the governor and other executive branch officials, and to program participants. All states make some form of the reports available to the public, and many post this information on Internet websites.

In most states, the qualified tuition program is subject to administrative procedure laws, procurement laws, ethics and financial disclosure rules, and a variety of open meeting and public disclosure statutes. The purpose of all of these rules is to ensure that the public has information to make an informed judgement on the financial condition of the program and to ensure that the programs are operated in the soundest financial manner possible. As public trusts, the states demand the highest degree of financial integrity of the programs. Strict oversight provides assurance that when a child enrolls in college, the funds saved for their education are available to pay for school.

A number of bills have been introduced that would expand Section 529 to permit private colleges and universities to establish qualified tuition programs. The College Savings Plans Network supports all proposals designed to encourage families to save for their children's higher education, because making it easier for families to save for college is in the long-term interest of the nation. However, as the administrators of the state-sponsored college savings plans, we are concerned about proposals to expand Section 529 to permit private colleges and universities to establish qualified tuition programs. As these proposals move forward in the legislative process, we urge the Committee to ensure that there is effective oversight and financial security of the private institution programs.

In allowing private institutions to establish qualified tuition programs, the Committee should consider a requirement that the private institutions be subject to regulation and oversight as rigorous as the oversight to which the state programs are subject. A multi-state private prepaid tuition plan, qualified under Section 529, should be subject to strict oversight and reporting requirements. CSPN believes Securities and Exchange Commission registration requirements, for example, would ensure that contributions held in common and invested by a private entity would be soundly managed, and would permit prospective participants to determine the financial soundness of such plans. The last thing anyone wants is for even one poorly managed private college to market a savings plan that becomes insolvent or has financial problems. This may result in parents and students left holding an empty bag and would adversely reflect on all the other college savings plans. If a private prepaid tuition program failed, the public would have difficulty distinguishing between the failed plan and the soundly managed state sponsored plans.

CONCLUSION

The College Savings Plans Network believes promoting greater access to higher education and encouraging savings over debt is sound public policy. The existing state sponsored college tuition programs promote savings and reduce the need for financial aid and subsidized student loans. As a result, the limited amounts of financial aid can be focused to directly benefit lower income students. Moreover, these programs enable more young Americans to go to college and secure higher paying positions, providing a better-educated workforce.

CSPN urges the Committee to amend current tax law to help encourage families to plan, prepare, and save, rather than rely on student loans or financial aid to educate their children. CSPN supports proposals to establish an exclusion from gross income for distributions from a qualified tuition program. Eliminating all federal income taxes on the accrued interest earned through the state programs would create an additional incentive for college savings. An exclusion from gross income for distributions from the qualified state tuition programs encourages innovation by the states, which can tailor the programs to meet the needs of its citizens while taking into account its unique mix of higher education institutions. CSPN commends the Committee on Ways & Means' leadership on these proposals and urges the Committee to include these provisions in the Fiscal Year 2000 Budget Reconciliation bill or any other tax legislation to be considered by the Committee in 1999.

The state tuition savings programs are subject to strict oversight and regulation in order to ensure that the programs are operated in a sound financial manner. CSPN urges the Committee to recognize the need for an equal level of oversight to ensure that private institution qualified tuition programs also operate in a manner, which guarantees that when a beneficiary enrolls in college, sufficient funds are available to cover the costs of tuition. The failure of a private institution program would reflect negatively on the successful state tuition programs.

Thank you again, Mr. Chairman, for your strong support of the state college tuition programs and the hundreds of thousands of families who participate in them. We look forward to working with you on legislation to promote advance savings for college. I would be pleased to answer any questions.

Mrs. JOHNSON of Connecticut [presiding]. Thank you, Mr. Bennett.

Dr. Kepple.

STATEMENT OF THOMAS KEPPLE, JR., Ph.D., PRESIDENT, JUNIATA COLLEGE, HUNTINGTON, PENNSYLVANIA; AND CHAIRMAN, TUITION PLAN CONSORTIUM

Mr. KEPPLE. Thank you, Madame Chairwoman. I am Tom Kepple, president of Juniata College, a liberal arts college located in central Pennsylvania. I am also the chair of the Tuition Plan Consortium, a group of 127, and growing, independent colleges and universities from across the Nation.

Our consortium has a found a way to do exactly what Congress has challenged higher education to do. That is, to significantly lower the cost of college education without sacrificing the quality of our programs which are the envy of the world. Our program is to build upon the highly successful prepaid tuition plans now operating in 20 States that Mr. Bennett has recently described. Plans that allow parents and grandparents to guarantee the future cost of in-State public colleges and universities. Our program captures all the positive aspects of these plans and adds three important new benefits.

First, the tuition plan represents the first truly nationwide prepayment tuition program. Our members represent the greatest geographic and mission diversity of any plan in existence. We already have members in 35 States and the District of Columbia. And we plan to add, perhaps triple in size over the next several years.

Let me illustrate the geographic diversity by the map you will see to my right. You will note that there are colleges all across the United States, and let me briefly mention just a few of these to indicate our diversity. And by the way, there are no truck driving schools among our group. In Texas, Rice, Austin College, Trinity University, SMU, TCU. In New York, Barnard, Ithaca, the University of Rochester. In Pennsylvania, Westminster, Grove City, Juniata College, Swarthmore. In Maryland, Goucher. In Washington, the University of Puget Sound. In Minnesota, St. Olaf. In Illinois, the University of Chicago: In Indiana Notre Dame, the University of the South in Tennessee, Eckerd College in Florida, Princeton University in New Jersey, and Birmingham Southern College in Alabama.

This diversity is a major benefit to families who understandably cannot be sure what college their children will ultimately attend.

Second, our plan guarantees the future cost of tuition at private colleges and universities across the Nation, something that individual State programs logically cannot do.

Third, and most importantly, the Consortium will offer to sell guaranteed future tuition to families at below today's tuition rates. We actually will be reducing the cost of college, thus making it more affordable for more families.

In Juniata's case, we are considering a discount as significant as 50 percent below today's tuition rates. For example, full tuition this year at Juniata College is $18,000. A parent or grandparent could purchase a full year of education 18 years from now for about $9,000 for a newborn child. Of course, this discount would be less for older children and member colleges will establish their own discount rates.

How can we guarantee a future tuition at a discount? The member institutions of Tuition Plan have years of experience in managing their own individual endowments. By applying this experience and employing sound investment safeguards, we expect to earn a rate of return in excess of tuition inflation. In fact, over 18 years, we expect to earn enough in our investments to cover the increases in tuition and offer a discount to grandparents.

You may be surprised to learn that nationally 48 percent of students attending private colleges have family incomes under $50,000. Nearly identical to the 49 percent attending public colleges. As you would expect, these families are especially concerned about being able to afford the cost of a college education. Prepaid tuition programs are designed for these middle income American families who seek to guarantee the future tuition and protection against investment risks. In our plan, investment risk is shifted from families to Consortium members.

Not only would we be required to comply with the safeguards and rules under 529, and not only is it to the public's interest that we are required, but it is also very much in our interest to provide effective oversight and financial security for prepayments since tuition plan members will bear the ultimate risks.

We know that this plan is interesting to American families. I have already had to return a $31,000 check from a grandparent who wished to begin the tuition prepayment program for his grandchildren. That is something that college presidents don't like to do.

Now we need your help. As you know, section 529 covers only plans established by States, thus omitting the opportunity for groups of private colleges and universities develop a tax advantage plan. Congress has already identified that section 529 is not consistent with other Federal higher education policies that do not distinguish between public and private institutions. Last year, a provision to rectify the situation was included in both the Chairman's bill and your alternative, Mr. Rangel. More than 80 Members of Congress, representing a bipartisan coalition, have supported this legislation.

I sincerely hope that all your effort and this broad base of support will lead to passage of this important measure, legislation that is endorsed by the statement, by the American Council for Education on this issue.

Mr. Chairman, Mr. Rangel, Members of the Committee, on behalf of the 127 member institutions of the Tuition Plan Consortium and the entire higher education community, I thank you for support and look forward to working with you to make this tremendous opportunity a reality for the benefit of millions of American families.

Thank you.

[The prepared statement and attachments follow:]

Statement of Thomas Kepple, Jr., Ph.D., President, Juniata College, Huntington, Pennsylvania; and Chairman, Tuition Plan Consortium

Mr. Chairman, Representative Rangel, distinguished members of the Committee, I am the president of Juniata College, a small independent college in Huntington, Pennsylvania with 1,200 undergraduate students. We are one of 108 independent colleges and universities in Pennsylvania. Together, independent institutions graduate over half of all students who attend four-year colleges in the state.

I also serve as Chairman of Tuition Plan Consortium, a non-profit consortium comprised of a growing group of independent colleges and universities from across the country. By the time of our planned program launch, we hope to include several hundred institutions. Ours is a diverse membership including institutions such as Rice University, a major research university in Houston, Texas, and Ithaca College, a small liberal arts college in upstate New York. Working together to help American families, we are developing a nationwide prepaid tuition plan that encourages parents, grandparents, and other family members to save now for the future college expenses of younger children.

Education is a top concern for American families. Recently, fifty eight percent of Americans surveyed by the American Council on Education (ACE) agreed that "a college degree is so important that, regardless of how much it costs, I am going to make sure that my children go to college." But when asked what they worry about most, many say they do not know how they will pay for their children's education. The tax bill this committee passed last year expanded the tax treatment for qualified state-sponsored tuition plans to include prepaid tuition programs established and maintained by non-profit, private colleges and universities. We thank you for your past support and urge that once again Congress act to help independent higher education respond to the public's anxiety over how to provide for the cost of their children's college.

Today, for many middle income families, paying for higher education means going into debt. In fact, families incurred more college-related debt during the 1990s than the previous three decades combined. In the last ten years, the number of students with student loans increased by 87%. The cost of not saving for college when children are younger and then having to rely upon loans, increases a family's burden enormously. Families must pay interest on their loans rather than having interest work for them. Congress helped borrowers in the last tax bill by restoring the tax deductibility of interest on student loans for the first 60 months of payments. We applaud your initiative, and we urge Congress to increase incentives for families to save as well as to borrow.

State governments have developed programs designed to help families pay for college. The response to long-established prepaid state tuition plans in Texas, Pennsylvania and other states indicates clearly that families respond to incentives encouraging them to save for college, especially when they can defer taxes. To date, nearly 700,000 students have prepaid tuition benefits under 21 state plans. These families lock in the cost of tuition at public colleges, and therefore no longer need to worry about future tuition increases.

Since Congress enacted Section 529 of the tax code in 1996 authorizing tuition prepayment programs, the number of state plans has increased sharply. The state-sponsored programs have helped families save for college, but they leave several important needs unmet. Fewer than half of the states currently offer prepaid tuition plans that protect families against tuition inflation. Colleges such as Juniata draw students widely from other states, which makes it difficult for families to take full advantage of state tuition plans; and tuition benefits in state plans generally are not extended to private colleges and universities. For these reasons, many private institutions want to offer prepaid tuition plans which address more fully the needs of families who wish to have their children attend private colleges and universities.

Many families prefer to send their children to independent colleges because of smaller class sizes, particular academic programs, religious affiliations, and other reasons. Nationally, nearly 20 percent of college-bound students attend an out-of-state institution. In some states, particularly those in the New England region, the percentage of students traveling out of state to attend college is as high as 67 percent. A nationwide plan is also important for families that move from one state to another while their children are young. Each year more than six million individuals in America move from one state to another. A national prepaid tuition plan gives these families the alternative of securing prepaid tuition regardless of a change in residence or attendance at an out-of-state college or university.

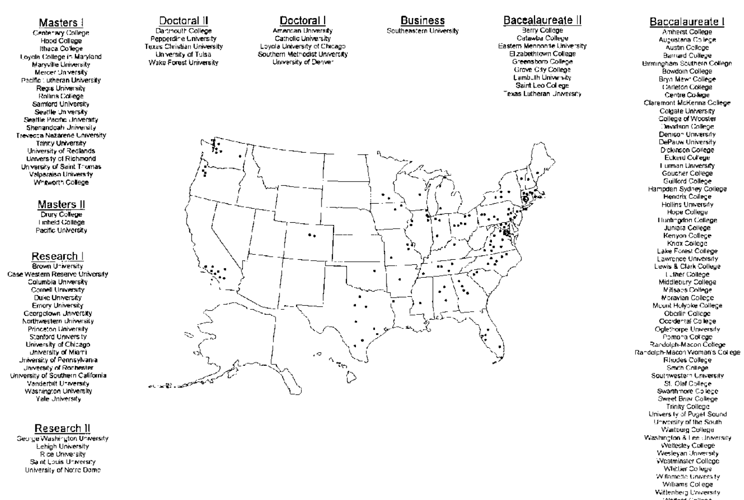
Prepaid tuition programs are designed for middle-income Americans. Our research indicates that higher income families may be less likely to participate in prepaid tuition plans. Higher income families have the resources to absorb the risk of aggressive investments and often wish to maintain control of their assets rather than purchase guaranteed tuition. The experience of existing state plans supports this and indicates that these plans appeal most highly to middle income families looking for an easy and secure way to save for college. Seventy one percent of families participating in the Florida Prepaid College Program have an income under $50,000. Families with annual incomes of less than $35,000 have purchased sixty two percent of contracts sold through the Pennsylvania Tuition Account Program. And, the average monthly contribution to a family's college savings account during 1995 in Kentucky was $43.

Nationally, forty eight percent of the dependent students attending private, not-for-profit colleges have family incomes under $50,000, nearly identical to the forty nine percent attending public colleges. In our case, at Juniata College, the majority of our students come from families with incomes under $63,000. As you might expect, these families of modest means are especially concerned with being able to afford the cost of a college education. They are most likely to purchase tuition plans that offer a guarantee of future tuition and protection against tuition inflation. In addition, in the case of Tuition Plan, participating colleges intend to offer families future tuition benefits at a price less than today's cost. Finally, we believe the benefits of tax deferral are essential to creating sufficient value for a program to meet family needs.

Including prepaid tuition plans established and maintained by non-profit, independent colleges and universities in Section 529 would be consistent with other federal higher education policies that do not distinguish between public and private institutions. Specifically, students receiving Pell and other grants, direct student loans, federally guaranteed student loans, and other forms of federal financial aid are permitted to attend any accredited institution. Also, families may claim HOPE and Lifetime Learning tax credits whether their children attend public or private college. And finally, regardless of their alma mater's affiliation, all student loan beneficiaries are able to deduct the interest expenses associated with their student loans from their taxable income. Ensuring a level playing field within Section 529 would be consistent with this important precedent set through existing federal, higher education programs. All families would get equal tax treatment regardless of their choice of a public or private college. By encouraging all families to save for college through qualified tuition plans Congress would help increase national savings and would provide private colleges an incentive to keep a close watch on long-term costs.

A bipartisan group of more than 80 Members of Congress are supporting legislation to enhance qualified tuition plans under Section 529. Mr. Chairman, Mr. Rangel, members of the Committee, private colleges have found a way to do exactly what Congress asked of the higher education community: to reduce the cost of a college degree without sacrificing the quality of instruction that remains the envy of the world. On behalf of the future students at our nation's private colleges, I thank you for your support. I look forward to working with you to make this valuable opportunity a reality to the benefit of millions of American families.

TUITION PLAN CONSORTIUM:
WORKING TO HELP FAMILIES ACHIEVE THE AMERICAN DREAM



Mrs. JOHNSON of Connecticut. Thank you very much, Dr. Kepple.

Mr. Grayson.

STATEMENT OF JERRY GRAYSON, REGIONAL DIRECTOR, DETWILER FOUNDATION COMPUTERS FOR SCHOOLS PROGRAM

Mr. GRAYSON. Thank you, Madam Chair, Mr. Rangel, Honorable Committee Members, I appreciate this opportunity to speak to you on the New Millennium Classrooms Act, which is coming before you in this legislative session.

My name is Jerry Grayson. I am regional director with the Computers for Schools Program. What we do is solicit computer donations from businesses, from institutions, from individuals, and from organizations. We have those machines refurbished. And then we place them in schools.

Two years ago, Congress passed the 21st century Classrooms Act as part of the Taxpayer Relief Act of 1997. That Act provided businesses with a tax deduction for computer donations if the machines were 2 years old or less. This was seen as a way to increase and enhance the level of technology available in schools. This Act was pushed through with the guidance of Chairman Archer and the support and sponsorship of Congressman Randy “Duke” Cunningham. We appreciate their support and their championing of this cause.

Unfortunately, the act has not lived up to the promise and intent that Congress had when it passed the Act. We found from businesses that the 2-year window of opportunity was a bit too short for their business cycle and that the tax deduction did not offset what essentially was penalization of them for donations of machines of that age.

The New Millennium Classrooms Act is an attempt to address these issues. It opens that window from 2 to 3 years for the age of equipment donated. And as opposed to the deduction, it allows for a tax credit of 30 percent for machines that are 3 years old or less. That credit is increased to 50 percent when the equipment is designated for schools in empowerment zones, enterprise zones, and on Indian reservations. There is a third element to this, the Act broadens the base with which we can draw these machines, thus making newer machines available in a higher quantity.

I believe the New Millennium Classrooms Act has the potential to have a significant impact on the level of technology available in our schools and especially in schools in empowerment zones, enterprise zones, and on Indian reservations. And these are the schools most in need of equipment upgrading. Increasingly, we are seeing what you might call a digital divide, that is, students in poorer schools having less technology available to them as they go through their computer instruction. What we now see is an average of 24 to 1, students-to-computer ratio in the average classroom of multimedia computers. But that ratio jumps to 32 students per computer when you look at schools in economically disadvantaged areas. These are the very students who by and large receive less positive feedback. They come from a less nurturing environment for the most part and computers help them the most. Computers are patient. They are persistent. They offer immediate reward for correct responses. These are the students who really need these machines.

The New Millennium Classrooms Act has the potential to have a significant effect on these students' lives.

Let me just close with a couple of anecdotes here about our program and the kind of impact New Millennium can have within a program like ours. We work with one school in northern Maryland, in north Harford County, North Harford High School. They were undergoing a project in class with a database and unfortunately before a donation of our machines, they had five, six, eight students standing around one machine trying to take part in the project. Because we donated to them, they were able to put each student at a terminal. Test scores went up as a result of it.

In New Jersey, our program works through a Welfare-to-Work Workforce Development Project and the machines we put in are refurbished by former welfare recipients who are now learning a viable skill. Computer repair skills are the skills of the future.

Finally, in Hawaii, we were able to give machines to a rural school in the big island where students were not in the position to take some college prep courses because of their isolation. Now through distance learning, using our machines, they can take college prep courses from a professor at the University of Hawaii in Honolulu.

Thank you, Madam Chair, Mr. Rangel, Chairman Archer, Congressman Portman and Congressman Becerra for your support, for your time, and we appreciate your patience and your consideration of this important legislation. Thank you.

[The prepared statement follows:]

Statement of Jerry Grayson, Regional Director, Detwiler Foundation Computers for Schools Program

Mr. Chairman, Honorable Committee Members, Staff and Guests:

Thank you for the privilege of addressing you on what I consider legislation important to the country's future.

My name is Jerry Grayson. I am regional director for the Detwiler Foundation Computers for Schools program. That means I develop our computer donation program in states and communities across the country.

The Detwiler Foundation began in 1991 when John, Carolyn and Diana Detwiler recognized the opportunity to put business computers being retired to use in schools—places where the level of technology continues to lag significantly behind the business standard. Computers for Schools started in California and, beginning in 1997, has been branching out to partner with organizations across the country. Unofficially, we are the nation's single most productive source of donated computers to schools. We have facilitated donations of more than 56,000 computers in 27 states.

The 21st Century Classrooms Act, part of the Tax Relief Act of 1997, was an attempt to enhance those donations with more and newer technology. It provides businesses with an enhanced tax deduction for donation of equipment two years old or less. We are among the many students, parents, teachers and friends of education most grateful to Congressman Randy "Duke" Cunningham for his sponsorship of this far-sighted legislation and his championing of better technology in our schools.

Unfortunately, the promise of the Act has not been fulfilled. We at Computers for Schools have received more than a thousand calls regarding the Act and have worked with dozens of companies eager to put it to use. Most could not for two primary reasons: the two-year provision did not fit their equipment use cycle and the deduction enhancement did not provide significant incentive. In general, a business buys a computer with a three-year life cycle in mind. Asking business owners to donate equipment before that cycle is complete essentially asks them to take a loss on their equipment investment. Many in a position to donate—those with accelerated equipment use patterns—still found that the deduction provisions in the Act did not adequately compensate them for the loss of revenue they could receive by getting a fair market price for the machines.

Before us today is the New Millennium Classrooms Act, which builds on the foundation laid by Congressman Cunningham's initial work. It is our opinion at Computers for Schools that the New Millennium legislation will take us closer to accomplishing the intent behind the 21st Century Classrooms Act. Several elements of the bill are key in this regard; it expands the window through which donations can be made from two years to three and it provides for a more straight-forward tax credit for eligible donations. Additionally, this credit—30 percent for donations for unspecified direction—will rise to 50 percent when the donation is designated for enterprise or empowerment zone schools. This legislation also helps us expand the group of eligible donors and thus raises the potential for the significant donations intended.

I would like to repeat something I said in opening my testimony; this is important legislation. Through the breadth and depth of our experience at Computers for Schools we have seen the kind of difference computer donations can make in our schools. But perhaps that is best illustrated by the experience of students who have been the recipients of donated computers.

Ladies and gentlemen of the committee, the legislation you are considering has the power to alter lives. I don't have to tell you we live in a world increasingly dependent on technology. Our children must be prepared for that world as thoroughly as is within our power. This is about life options—the ability and capability of students to make positive choices about who they are, what they can do and who they will become. When we have the opportunity to provide them the resources needed to make those positive choices, and we don't, we have stifled their futures.

The New Millennium Classrooms Act helps open those options. The case for computer-aided teaching and its positive impact on academic achievement grows stronger every day. Just last week in testimony before the Joint Economic Committee, Secretary of Education Richard Riley emphasized the importance of technology in education. He noted that with an expectation of 70 percent growth in computer and technology-related jobs in the next six years, students who can use technology effectively will be in the best position to build rewarding careers and productive lives.

With this trend as a backdrop, consider that children from lower income areas and many disadvantaged minority children—children less likely to have computers at home—are unfortunately also less likely to have computers in their schools. For example, schools with 81percent or more economically disadvantaged students, as defined by federal education Title I eligibility, have one multimedia computer for every 32 students while a school with less than 20 percent economically disadvantaged students will have a multimedia computer for every 22 students. Schools with 90 percent or more minority students have one multimedia system for every 30 students. Additionally, just over 50 percent of the schools with 70 percent or more poor students have Internet access compared to nearly 80 percent of schools which have less than 11 percent lower income students.

Now consider that the very students with the least technology available to them are the ones who can be helped most by its use. This was borne out by a recent City University of New York study that noted dramatic increases in test scores for disadvantaged students once computer-aided instruction was introduced or increased in their curricula. Computers are patient, persistent and operate with total equanimity. These characteristics have special relevance for disadvantaged youth growing up in tough, often less-than-nurturing surroundings. These are also the very youth helped most by this legislation because of its incentive clause to encourage equipment donations where they are needed most—to enterprise and empowerment zones. The New Millennium Classrooms Act is an act of empowerment.

Even outside the target zones delineated in the bill, our schools stand in dire need of technology upgrading. Depending on which figures you look at, students-per-computer ratio across the country can be as low as ten or eleven to one. That's about ten students for each computer. But that ratio includes millions of woefully substandard machines; 386's, 286's, Apple IIe's, even old 8086's and Commodore 64's. The best that can be said about these systems is that they're a step above typewriters, but even that statement is suspect. Getting serious, up-to-date education software installed on any of these or, in many cases Internet access, is out of the question.

While that ten-to-one ratio of students per computer may sound promising, it needs to be put in another context. Statistics by the Educational Testing Service show a much lower students per computer ratio of 24 students to one multimedia computer. Multimedia computers are the type that provide adequate access to the Internet and to the kind of software that teachers find useful as teaching tools. Keep in mind that the students-per-multimedia computer ratio increases to 32 to one for lower income school districts, and the Department of Education recommends that the optimal ratio of students per computer is five to one.

The New Millennium Classrooms Act would spur the donation of nothing older than Pentium II generation technology. This raises the bar in our schools where the average machine today is the 486SX processor, circa 1990. If enacted, New Millennium accepts nothing built prior to 1997 and keeps that standard moving forward with the calendar.

In addition to its direct impact on teaching and learning, this bill provides other benefits to help us better prepare for the next century.

The Rand Institute estimates it will cost about $15 billion to provide U.S. schools with the technology necessary to educate our children for the future. The New Millennium Classrooms Act helps us stretch the funds available, providing more opportunities for other critical technology needs such as teacher training and curricular software.

As we approach a preferable level of technology in our schools, this bill lets us do so in a cost-effective manner—easing pressure on federal and state budgets. I want to be clear; we do not advocate this legislation as a replacement to state and federal technology expenditures. This is, however, a way to limit the inflation of that spending. Many of you have already noted that a time of better budget health is also a time to be more mindful of spending. From a cost-benefit perspective, New Millennium helps keep the pulse of spending more even and secures more for less in the process.

New Millennium also triggers more business interest and involvement in our communities and our schools. I am not here to discuss the extent and nature of that involvement—that is for local schools and communities to decide. But the Act gives businesses another tool through which they can contribute to their communities. In the process those businesses are not penalized financially and, when they concentrate their giving on empowerment and enterprise zones, they may—I emphasize may—they may see a slight benefit. The Act also encourages the most environmentally sensitive of recycling options re-use.

This Act also has Welfare to Work and workforce development implications. In our work, Computers for Schools is partnered with numerous refurbishing facilities where trainees are the chronically underemployed or unemployed. To give one example, our donations in New Jersey, which go through four state community colleges, are refurbished and outfitted for schools by former welfare recipients. They are learning skills that can move them so far ahead it turns welfare checks into distant specks in their rear-view mirrors.

Other trainees through our program include inmates at correctional facilities, students in vocational and technical schools and those in high schools and even middle schools. For all of them, the equation is the same; exposure to the latest technology only enhances their training, making them more ready for key certifications such as A+ and MCSE or Microsoft Certified Systems Engineer. These skills are in high demand. They can make the transition from welfare to work, or crime to work, permanent. But it doesn't happen without the opportunity.

As we see it at Computers for Schools, opportunity is what the New Millennium Classrooms Act is all about. First and foremost, it opens a world of opportunity to students and teachers in the classroom. It gives local, state and federal budget makers the opportunity to extend their tight dollars. For business, it's an opportunity to contribute to students and communities without being penalized in the process. And we have just noted how this legislation can help trainees.

In every case we are talking about the impact this Act can have on people's lives. Our children face a daunting world of constant change. It's the least we can do to give them all the positive tools at our disposal to help them meet that change. The New Millennium Classrooms Act does that.

Thank you.

Mrs. JOHNSON of Connecticut. Thank you, Mr. Grayson.

Dr. Gillespie.

STATEMENT OF CHRISTINA GILLESPIE, M.D., RECENT GRADUATE, TUFTS UNIVERSITY SCHOOL OF MEDICINE; AND RECIPIENT, NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP

Dr. GILLESPIE. Good afternoon. Thank you for the opportunity to testify. I am Christina Gillespie, a recent medical school graduate and a recipient of the National Health Service Corps Scholarship.

This morning, I would like to address the taxation of the National Health Service Scholarship. I will be sharing the ways in which the taxes affected me personally and the potential long-term consequences of the tax on the health of our Nation's most needy communities.

I started medical school with a clear professional goal. Having worked extensively with the homeless during my undergraduate years, I knew I wanted to be a primary care physician working in a community with limited access to health care. As you probably know, completing a medical education is no small feat. But I was surprised to find that the biggest barriers were financial. My first year of medical school would cost me $45,000. For even a middle-class or an upper-class family, the cost is prohibitive. I, like many of classmates, turned to loan programs to finance my education. My projected debt at graduation was $200,000, and I was told by my financial aid counselor that a career in primary care was an unrealistic goal because I would not be able to afford my loan payments. And a career in primary care working with underserved populations? Get real.

It is no exaggeration to say that the National Health Service Corps Scholarship Program was a dream come true. The National Health Service would pay for my tuition and fees, books, and provide me with a monthly stipend. In return for each year of funding, I would spend 1 year working in what is known as a Health Professional Shortage Area, or a medically underserved community. The program was a way to meet my personal and professional goals without being crippled by $200,000 of interest-accumulating debt.

In the summer of 1997, half way through my medical training, I received notice that I would be taxed on the full amount of my scholarship. I had always been taxed on my stipend payments, but now I would also need to pay taxes on my tuition and fees, about $45,000 a year, as if it were income. The reason for the new taxation was that section 117FE of the Internal Revenue Code had been misinterpreted. The IRS had taken the position that the scholarship amount was compensation for future services. This position is erroneous. I am not and never will be an employee of the National Health Service. While in medical school, I was a full-time student receiving a scholarship. While in residency training, I will be employed by my residency program. And when I begin my National Health Service commitment, I will be employed by the clinic in which I am working.

I would like to share with you some numbers to make this issue more concrete. Before the taxation, I was receiving $915 a month in stipend payments. After the tax went into effect, I received only $254 a month. This was not nearly enough to cover the cost of rent, food, utilities, and transportation. I had only a few months forewarning and scrambled to borrow additional money in loans. To add insult to injury, I had to borrow even more money to pay State taxes, which were not automatically withheld. My service commitment, of course, remains unchanged despite my additional loan burden.

The National Health Service Corps Scholarship Program is an innovative way to encourage health care providers to work in areas which otherwise would have no access to care. Unfortunately, the new tax has made the program less attractive to students. It would certainly be a shame to see some of our Nation's most dedicated health care professionals lose their enthusiasm for underserved communities simply because of an unfair tax.

Hopefully, I have impressed upon you the importance of reversing the National Health Service tax. This is an issue about access to higher education for low- and middle-income families. This is an issue about unfair taxation. And, finally, this is an issue about providing quality health care to America's most needy communities.

Please support H.R. 1414, a bill which seeks to reverse the taxation of the National Health Service Corps Scholarship.

Thank you for your attention.

[The prepared statement follows:]

Statement of Christina Gillespie, M.D., Recent Graduate, Tufts University School of Medicine; and Recipient, National Health Service Corps Scholarship

Good Morning. Thank you for inviting me to speak before you today. I am Christina Gillespie, a recent graduate of Tufts University School of Medicine, and a recipient of the National Health Service Corps Scholarship. This morning I would like to address the taxation of the NHSC Scholarship. I will be sharing the ways in which the tax has affected me personally, and the potential long-term consequences of the tax on the health of our nation's most needy communities.

I started medical school with a clear professional goal. Having worked extensively with the homeless during my undergraduate years, I knew I wanted to be a primary care physician working in a community with limited access to health care. Four years later, my commitment is unwavering.

As you probably know, completing a medical education is no small feat. But I was surprised to find that the biggest barriers were financial. My first year of medical school would cost me $45,000 (that was in 1995, today a year of education at my medical school is approximately $52,000). For even middle class and upper-middle class families, the cost is prohibitive. I, like many of my classmates, turned to loan programs to finance my education. My projected debt at graduation was $200,000, and I was told by my financial aid counselor that a career in primary care was an unrealistic goal, because I would not be able to afford my loan payments. And a career in primary care, working with under-served populations? Get real.

It is no exaggeration to say that the National Health Service Corps Scholarship program was a dream come true. The NHSC would pay for my tuition and fees, books, and provide me with a monthly stipend. In return for each year of funding, I would spend 1 year working in what is known as a Health Professional Shortage Area—a medically under-served community. I would also commit to specializing in a primary care field. This program was a way to meet my personal and professional goals of providing health care for the nation's most needy populations, without being crippled by $200,000 of interest-accumulating debt.

In the summer of 1997, half way through my medical training, I received notice that I would be taxed on the FULL amount of my scholarship. I had always been taxed on my stipend payments, but now I would also need to pay taxes on my tuition and fees, about $45,000 a year, as if it were income. The reason for the new taxation was that section 117 (c) of the Internal Revenue Code had been misinterpreted. The IRS had taken the position that the scholarship amount was compensation for future services. This position is erroneous. I am not, and never will be an employee of the NHSC. While in medical school, I was a full time student receiving a scholarship, not an employee. While in residency training, I will be employed by my residency program. And when I begin my National Health Service commitment, I will be employed by the clinic in which I am working.

I would like to share with you some numbers, to make this issue more concrete. Before the taxation, I was receiving $915.00 per month in stipend payments. After the taxation went into effect, $661.00 was withheld monthly, and I received only $254.00 per month. As a medical student, I was used to living on a small budget, but two hundred and fifty dollars was not nearly enough to cover the cost of rent, food, utilities, and transportation. I had only a few months forewarning, and scrambled to borrow additional money in loans. To add insult to injury, I had to borrow even more money to pay state taxes, which were not automatically withheld. My service commitment remains unchanged, despite my additional loan burden. I will be working as a family practitioner, and will take a position with less compensation than I might earn in a more wealthy community.

The National Health Service Corps scholarship program is an innovative way to encourage health care providers to work in areas which otherwise would have no access to care. Unfortunately, the new tax has made the program less attractive to health professional students. It would certainly be a shame to see some of our nation's most dedicated health care professionals lose their enthusiasm for underserved communities simply because of an unfair tax.

Hopefully I have impressed upon you the importance of reversing the NHSC tax. This is an issue about access to higher education for lower and middle-income families. This is an issue about unfair taxation. And finally, this is an issue about providing quality health care to America's most needy rural and inner city communities.

Please support H.R. 1414, a bill which seeks reverse the taxation of the NHSC scholarship. Thank you for your attention. I would be happy to answer any questions at this time.

Mrs. JOHNSON of Connecticut. Thank you very much, Dr. Gillespie.

Mr. Baratta.

STATEMENT OF JEFFREY A. BARATTA, INVESTMENT BANKER, STONE & YOUNGBERG LLC; AND MEMBER, CALIFORNIA-FEDERAL SCHOOL INFRASTRUCTURE COALITION

Mr. BARATTA. Yes, good afternoon, Madam Chair and Mr. Rangel. Thank you very much for this opportunity. I look forward to hopefully providing some information that can help here.

My name is Jeff Baratta and I am an investment banker with Stone & Youngberg, a broker-dealer in California. I am also a member of the *California-Federal School Infrastructure Coalition*. I first would like to thank Chairman Archer for his comments on such a national pressing need as school facilities earlier this morning. I would also like to thank Chairman Rangel for his development of the tax credit bond issue through the QZAB bond program just several years ago. And also to you, Madam Chair, for your authoring of H.R. 1760.

My purpose for being here today is to discuss with you the expansive facility needs within the State of California for school construction and also to discuss with you the enhancements made, as outlined in H.R. 1660, that clearly will help the tax credit bond program. the State of California is currently in need of $20 billion in funds for school facilities, new construction and for modernization projects over the next 5 years.

In November 1998, the State passed a statewide bond measure totaling $60.2 billion for K–12 education. Just to give you an idea of how quickly that is going to be spent, a 600-student elementary school will cost approximately $7.75 million. A 1,000-student middle school will cost $13.75 million. And a 2,000-student high school will cost approximately $36 million. Now there are many, many school districts in the State of California that will need more than just one of those schools a year. So the money will go quickly.

There is a process in the State of California where statewide construction dollars can be combined with local general obligation bond debt to help build and rehab school facilities. The issue surrounding that is that the local school district must first get a two-thirds super majority vote to get the bond passed. Since 1986, there have been 711 school districts that have attempted this type of election. Only 378 of those districts have passed for a 53 percent passage rate. On top of the 330 school districts that failed over that time period, there were many other school districts that didn't even bother to take the expense of the election and try it out because they had no hope. And, quite frankly, they had no hope because the tax rates on the local GO bonds were too high and the voters would just say no.

The Qualified School Construction Bond Program, outlined in H.R. 1660 can help reduce the local GO bond tax rates by 25 to 30 percent thereby allowing more funds to go directly to the school district and get more of those facility needs taken care of.

This truly is a three-pronged approach to facility funding. We need local dollars out of the general obligation bonds. We need State dollars through the statewide bond program, and we need Federal dollars through the tax credit bond program.

The tax credit bond program, through the Qualified School Construction Bond, H.R. 1660, has truly been enhanced and it has been done in six different ways that I would like to touch on. The move from annual tax credit allocations to quarterly allocations will actually help the end investor match up the credit against when their tax liabilities are due. The ability to carry over the unused tax credits into the next year will help the end investor again focus on the fact that they can use those tax credits in any year and not put a penalty cost against the security itself because they may not be able to use the tax credit in 1 year or the next.

The ability to strip the security, the principal portion of the security, away from the tax credit portion is a very large piece as well. You then get two securities and you can market them to two different buyers. The increase investor base into the retail funds, the new construction component and the elimination of the private contribution will also help in the pricing. If the price goes up, the yield goes down and effectively what you want to do is move the investment moneys from the investment community over into the schools and the school sites to meet their facility needs.

In today's world, school construction financing is a very expensive way to meet the need, so the country needs participation on all three levels. They need the local, State, and Federal Government to provide those needs. I truly believe that H.R. 1660 can accomplish the goals of enhancing the marketability of the bonds and increasing the ease of use for schools.

Madam Chair, you authored H.R. 1760 and it encompasses the same tax credit mechanisms as H.R. 1660. There are many other proposals on the table today, but none like H.R. 1660 and 1760 that will provide the most resources in the most efficient and timely fashion. Schools can receive approximately $25 billion with a calculated cost of $3.1 billion. The need is now and this is an incredible opportunity to leverage the most dollars for the least cost.

I thank you for this opportunity and would request a letter be entered into the record from the Cal-Fed Coalition to the California delegation.

Mrs. JOHNSON of Connecticut. So ordered, Mr. Baratta.

[The information follows:]

CAL-FED SCHOOL INFRASTRUCTURE COALITION
SACRAMENTO, CA 95814
June 8, 1999

The Honorable Randy Cunningham
US House of Representatives
2238 Rayburn House Ofc. Bldg. Washington, D.C. 20515

Dear Representative Cunningham:

Cal-Fed School Infrastructure Coalition is writing to ask your support and cosponsorship for two important bills addressing the need to assist local communities in the rebuilding of California's schools. These bills are HR 1660, The Public School Modernization Act introduced by Congressman Charles Rangel (D) of New York and HR 1760 introduced by Congresswoman Nancy Johnson (R) of Connecticut.

The Cal-Fed School Infrastructure Coalition is a coalition of local school districts, architects, financial firms, developers and school suppliers working to support federal tax and other incentives to help California and local communities address the pressing need to renovate, modernize and build schools. The school facilities problem in California has reached critical proportions and necessitates partnerships among local, state and federal governments.

California's school facility needs for 1995–96 through 2005–2006 are:

Growth (including $3 billion for land costs and backlog) $15.0 billion

Modernization $10.0 billion

Deferred Maintenance $5.0 billion

HR 1660 would allocate $3.029 billion in school bonds to California, while HR 1760 would allocate $2.927 billion in school constructions bonds to our state.

The national need for repair and renovation of schools, estimated by the Government Accounting Office (GAO) in 1996 to exceed $112 billion requires federal partnerships with states and local communities. Today, the cost of projected repairs, renovations and technology additions surpasses the GAO 1996 estimate. In addition, more than $70 billion will be needed to build new schools to meet record enrollments.

The School Modernization Act of 1999 (HR 1660) will provide $22 billion in zero interest bonds for the construction and renovation of public school facilities at a five-year cost of $3.7 billion. Representative Rangel's bill also will expand the Qualified Zone Academy Bonds (QZAB) program.

Established in the Taxpayer Relief Act of 1997, QZABs provide the equivalent of zero interest bonds for a variety of activities including school renovation and repair. Underway in a number of states, QZABs are financing innovative school renovations to support new education programs.

The America's Better Classroom's Act (HR 1760) also will provide federal assistance to states and local communities through tax credits to underwrite $25 billion in school modernization bonds.

The major difference between these two bills is the allocation of the bonds. HR 1660 allocates $25 billion to the States, half ($12.5 billion) based on the existing Title I formula, and the other half ($12.5 billion) to the 100 school districts with the largest number of low-income students. HR 1760 bases the allocation on Title I and the school aged population and allocates all the bonds directly to the States for allocation to local communities.

A federal investment of $3.1 billion will generate $25 billion in school construction bonds. Under both HR 1660 and HR 1760 the federal government provides a tax credit in lieu of interest and the responsibility for the bond principal will be at the state and local level. All decision-making prerogatives related to the actual school renovation and construction remains a local community decision.

We look forward to working with the members of the California delegation to enact bipartisan provisions to help local communities build the schools their children will need to succeed in the 21st century.

We hope you can join as a cosponsor on HR 1660 and HR 1760 to assist communities in California build and modernize their schools.

Sincerely yours,

MIKE VAIL
President

MV/ad
California Cosponsors to HR 1660
(Rangel bill)

5 MATSUI (D–CA)
6 WOOLSEY (D–CA)
8 PELOSI (D–CA)
13 STARK (D–CA)
16 LOFGREN (D–CA)
17 FARR (D–CA)
24 SHERMAN (D–CA)
29 WAXMAN (D–CA)
30 BECERRA (D–CA)
31 MARTINEZ (D–CA)
32 DIXON (D–CA)
33 ROYBAL–ALLARD (D–CA)
35 WATERS (D–CA)
37 MILLENDER–MCDONALD (D–CA)
42 BROWN, GEORGE (D–CA)
46 SANCHEZ (D–CA)
50 FILNER (D–CA)

California Cosponsors to HR 1760 (Johnson bill)

38 HORN (R–CA)

Mr. BARATTA. Thank you.
[The prepared statement follows:]

Statement of Jeffrey A. Baratta, Investment Banker, Stone & Youngberg LLC; and Member, California-Federal School Infrastructure Coalition

Mr. Chairman and Members of the Ways and Means Committee:

I appreciate the opportunity to address you on this very important issue of new financing techniques for school construction. Mr. Chairman we greatly appreciate your attention and support on this pressing national issue of school facilities. It is important to thank Mr. Rangel as well for his role in developing the Qualified Zone Academy Bond (QZAB) program and the concept of using federal tax-credits to help school facility needs.

I am here today to provide testimony to the expansive facility needs of school districts and the enhanced market viability of the Qualified School Construction Bond (QSCB) program, school modernization bonds, as outlined in H.R. 1660.

As we are all painfully aware, school facility needs increase every day as our school age population continues to grow. In the State of California alone school facility needs top $20 billion for the next five years. For example the cost of one 600 student elementary school is $7.75 million. A 1,000 student middle school will cost $13.75 million and a 2,000 student high school will cost $36 million. Student enrollment is increasing at such a rapid rate that many communities will have to build more than one elementary school, more than one middle school and more than one high school per year.

In November 1998, California voters approved a $6.2 billion state-wide bond measure for K–12 education. Although this will help many schools it is woefully short of meeting the current needs.

Through a two-thirds majority vote election, school districts throughout California can avail themselves to locally secured general obligation bonds. From 1986 through the present time, 711 school districts have attempted local general obligation bond elections. Of that number approximately 53% or 378 school districts have been successful. On top of the 333 unsuccessful campaigns there are many more districts that knew they did not have a chance and therefore did not spend the money to try an election. Local communities are constantly struggling to balance local tax rates with the need to modernize existing schools and to build new schools to meet rapidly rising enrollments.

One of the main reasons school districts lose elections is that the tax rates are more than the voters are willing to pay. H.R. 1660 will provide some relief to those districts that have been unsuccessful and also to those districts who have been unable to try an election. Zero interest bonds through the QSCB program can reduce the tax-rate associated with the repayment of the bonds. This federal program will give school districts another option to fund school facilities.

H.R. 1660 is another piece of the puzzle named “School District Capital Funding.” Through the proper financing structure, local districts can be helped in their overall attempt to receive local general obligation bond approval. The zero-interest tax-credit program will allow school districts to lower tax rate estimates and ultimately get approval from their local voters.

Districts will start to be able to meet the growing school facility need through the combination of local general obligation bond financing, California construction dollars, from the recently approved state-wide bond measure, and federal tax-credit bonds.

Mr. Rangel has done an excellent job, through H.R. 1660 of combining the most pressing needs of school districts and the requirements of the traditional tax-exempt bond markets.

The current QZAB program has been used in certain situations and has been very successful for those districts able to participate. As with any new program, interest starts slowly and then builds. Every day more and more districts are looking to the QZAB program for help.

H.R. 1660 has taken the primary aspects of the tax-credit bonds in the QZAB program and increased their ease of use for schools.

H.R. 1660 provides six distinct enhancements that will greatly increase the marketability and trading value of the QSCB program to the bond market. These enhancements will immediately create new capital funding strategies for schools to meet their increasing facility needs.

The six market enhancements are as follows:

- Quarterly tax-credit payments versus annual tax-credit payments.
- The ability to carry-over unused tax-credits from year to year.
- The ability to strip the principal and tax-credit components apart and make two separate securities.
- The increased investor base (i.e. retail investor funds)
- The addition of new construction to the list of possible uses of the proceeds.
- The elimination of private contributions.

Mr. Chairman, let me please take a few moments to discuss the price and yield relationship within the bond market. In the bond market prices and yields move in an inverse relationship to each other. As prices for a security increase the yield on that security decreases. Therefore, a security worth $100 (par amount) that sells above the par amount, (at a premium) will provide greater proceeds to the issuer and a lower yield to the investor. So, if a security sells at a price below par (at a discount) the issuer receives less proceeds and the investor receives a higher yield.

The following is an expanded discussion of the above listed enhancements:

Quarterly Tax-credits

The move from annual tax-credit payments in the QZAB program to quarterly tax-credit payments in the QSCB program allows the investors to match up their tax liability, which is due quarterly, with the earned tax-credit. Waiting for one full year to realize any return from the investment is difficult and therefore costly in the pricing of the investment. This is one reason why a discount is attached to the QZAB program.

Tax-credit Carry-over

Allowing unused tax-credits to carry-over into the following year is a great enhancement. In the QZAB program an increased discount was associated with the loss of tax-credits when the investor could not use them. Therefore, investors were calculating a total return based on approximately 80% usage of the tax-credits. Having the ability to transfer credits into the following year when the investors tax liability comes back eliminates the need to attach a higher discount to the security.

Stripability of the Security

The ability to strip the principal component of the security from the tax-credit component will lower the discount of the overall security. This stripping mechanism allows for the capturing of the two distinctly different credits. The principal component will carry the credit of the issuing agency, while the tax-credit component will carry the credit of the United States government. This difference means a higher price is paid for the tax-credits (which means a lower yield), while a somewhat lower price will be paid for the principal maturity (which means a higher yield). The two separate prices will be better than that of the single priced security. Another reason for this situation is that investors differ as to their end requirements. To a tax-credit investor the need to receive principal re-payment is far less than the current need to receive a quarterly tax-credit or benefit. To an investor looking for no current income a single principal maturity in the future fits perfectly. Because of these differences school districts through their financial team can market the securities to the absolute best buyers thereby receiving the most proceeds for their projects.

Increased Investor Base

Any time you can increase the competition (willing buyers), you can typically decrease the costs associated with selling the product. The decreased yield, which translates into a higher price for the security will provide more proceeds to schools and further help the capital funding requirements.

NEW CONSTRUCTION COMPONENT

This enhancement is a major change for school districts. New construction is a very important piece for growing school districts. With many school districts building at least one school per year and sometimes even more, including new construction as an authorized use is paramount. The bonds will benefit in the market because of the increased presence. As the securities become more prevalent in the market place the liquidity problems will decrease and a secondary market will appear.

PRIVATE CONTRIBUTION ELIMINATION

By eliminating the private contribution component the small suburban and rural school districts can participate. Sometimes it is difficult to get businesses to look to these smaller districts when a larger district is located in the same geographic area. Small school districts are squeezed further with lower fiscal resources. A zero interest loan program, such as the QSCB program, can help those districts meet their facility needs.

OTHER ISSUES

Two other issues are important to discuss. The first issue is that H.R. 1660 will utilize a different tax-credit calculation than what is currently in place for the QZAB program. This new rate will capture the volatility of the market by fluctuating on a daily basis, until the pricing day of the bonds. This is different than the old QZAB rate which is calculated monthly based on a prior month's market.

The second issue deals with the size of the program. A multi-billion dollar bonding program will cause the market to take notice. With a $25 billion program the liquidity issue associated with the QZAB program should effectively be removed. Investors will no longer be faced with an illiquid or non-tradable security. These two issues will greatly help the bonds be priced closer to their original par value.

It is important to remember that school district capital needs are greater than the resources that can be provided from one or two government entities, such as the local governments or the state governments or even the federal governments. In today's world building schools is so expensive participation by local, state and federal governments is the only way we will develop the resources to build and modernize the schools our country needs to serve all our children in the future. H.R. 1660 will augment local and state resources to help provide needed capital facilities to school districts throughout the Nation. The changes, as discussed above, will enhance the market viability of the tax-credit bonds. This will in turn provide greater proceeds to construct and modernize more schools.

Congresswoman Nancy Johnson has recently authored H.R. 1760. This bill encompasses the same mechanisms for facility funding as the QSCB program, as defined in H.R. 1660. There are many other proposals on the table today as well. All of the proposals can be viewed as beneficial to schools, but in what magnitude and how quickly? H.R. 1660 and H.R. 1760 provide the most resources in the most efficient and timely fashion. H.R. 1660 has been calculated as providing $25 billion for school facilities at a cost of $3.1 billion over the next five years. The need is now and this is an incredible way to leverage the most dollars for the least cost.

It is time for the Federal government to partner with local agencies to help provide facilities for our children. Both H.R. 1660 and H.R. 1760 can help provide for this national facility need. I urge your support and thank you for your time and consideration.

Mrs. JOHNSON of Connecticut. Thank you for your testimony.

Ms. Zedalis.

STATEMENT OF LEWIS H. SPENCE, DEPUTY CHANCELLOR FOR OPERATIONS, NEW YORK CITY BOARD OF EDUCATION; AS PRESENTED BY PATRICIA ZEDALIS, CHIEF EXECUTIVE, DIVISION OF SCHOOL FACILITIES, NEW YORK CITY BOARD OF EDUCATION

Ms. ZEDALIS. Thank you, Madam Chair, Mr. Rangel, and Members of the Committee. Please convey my thanks also to Chairman

Archer for giving me the opportunity to address you today on the issue of how the Federal Government can play a meaningful and positive role in rebuilding America's schools. My name is Patricia Zedalis and I am head of School Facilities for the New York City Board of Education, the largest public school system in the country with 1.1 million school children and over 11,000 individual school buildings.

I especially want to thank Congressman Charles Rangel for his leadership on this issue. Congressman Rangel initiated congressional activity in this area when he authored the Qualified Zone Academy Bond legislation in 1997. He followed through on his commitment to improve our Nation's schools by introducing H.R. 1660, the Public School Modernization Act of 1999, which is before this Committee.

I also want to thank Congressman Joe Crowley for his efforts to focus attention on this very important issue in this session of Congress.

Finally, I want to commend Congresswoman Nancy Johnson for her efforts to bring the issue of school construction to the attention of her colleagues on this Committee. It is the New York City Board of Education's sincere hope that the consensus that exists between Representatives Rangel and Johnson on the need to address this issue will lead to a bipartisan bill that is passed by the 106th Congress. Congresswoman Johnson's bill is substantively identical to Congressman Rangel's proposal, as both proposals provide the same form and level of tax credits to pay the interest on State and local school construction bonds. However, the Board prefers Congressman Rangel's legislation because its allocation formula is more targeted at high-need communities and New York City is certainly a high-need community.

Across America, urban, rural, and high-growth suburban school districts all face difficult school modernization problems. The one thing they hold in common is the struggle to find the resources to modernize their existing school facilities and to build new schools for rapidly rising student enrollment. The need has been well-established by the General Accounting Office.

Just to give you an idea of New York City's needs, we have had explosive enrollment growth in the nineties, which has begun to taper off. Our enrollment growth was in excess of 20,000 a year. One of the largest other school systems in the New York is Yonkers. It only has around 22,000 students. So we replicated the school district of Yonkers every year for most of the nineties.

School facility problems negatively impact the safety and learning of school children everywhere. The average school building in America is 50 years old. These buildings were not designed to meet the demands of current and future technology. The GAO also reports that 38 percent of urban school districts, 29 percent of suburban, and 30 percent of rural school districts have at least one building needing extensive repair or total replacement. In New York City, we have 280 schools that require complete exterior modernization and many of those schools also need complete interior modernization. The issues of school replacement and extensive repair affect over 14 million students nationwide. I am here today to ask you to make an investment in these 14 million children. That investment begins with the fundamental right of every child to a safe and adequate learning environment that supports achievement at the most challenging levels. Where students learn what really matters.

In 1993, New York City took the lead in our State by setting rigorous graduation standards that were eventually adopted statewide. This year's eighth graders will be the first high school class required to take an all-regions curriculum developed by the New York State Board of Regents. We are asking these students to take 3 years of science, 2 of those years in laboratory sciences, though there are not adequate facilities to support their learning. Without significant investment in the physical infrastructure of the New York City public schools, we are setting these children up to fail. At the moment, we have over $100 million in our current capital plan to take care of upgrading science labs. That will only handle approximately 50 schools. We have 200 high schools in New York City.

We as adults lack credibility when we tell children that we have high expectations for their achievement and that literacy, math, and science are paramount while at the same time we shunt them into outdated and overcrowded classrooms with meager laboratories and decrepit laboratories. The environment in which we place our children speaks volumes about what we really expect from them. It is the children in our schools who face the real building and capacity issues everyday. It is our students who must cope with leaking roofs, peeling plaster, and overcrowded classrooms. The lack of adequate facilities takes its greatest toll on instruction and hampers our ability to effectively implement early intervention strategies, such as reducing class size and critical grades, which is an extremely important initiative in New York City and we are definitely constrained in achieving our goals of class-size reduction unless we can provide new facilities.

In addition, school districts must be able to provide adequate air conditioned space for its most at-risk students who will attend summer school classes in an effort to perform at grade level and ultimately acquire the tools needed to lead our Nation into the 21st century.

This is not a call for massive federalization of school construction, which is and should remain a primary responsibility of States and localities. However, it is recognition that the infrastructure needs of public schools have out-paced the ability of State and local governments to meet these demands by themselves. New York, like many localities, is doing its part in school construction. The City is addressing the board's school infrastructure needs with a $7 billion capital plan over the next 5 years. As you just heard, California has a $60.2 billion statewide program. Our capital plan's main goals are to expand our program to bring our existing facilities to a state of good repair, increase program accessibility, upgrade or provide new speciality spaces, and to increase capacity to relieve overcrowding, provide universal pre-K, and class-size reduction. This $7 billion doesn't achieve everything that we need to do in terms of technology and modernizing our existing buildings. It just gets us further along.

We need partners at the Federal level to meet all of our pressing needs. The idea of the Federal Government assisting localities and addressing their critical needs is not a novel concept. You have acted decisively in many other areas, transportation being one of them because it is considered important to the national economy. I am sure that no one here questions the importance of schools to our economic competitiveness in the 21st century. We believe that schools deserve the same attention that many other areas such as transportation receive.

As Congress considers the broad range of school construction proposals that have been introduced in this Congress, New York City hopes that Congress will ultimately enact legislation that addresses the magnitude of the nationwide need for construction assistance. H.R. 1660 does that.

First and foremost, Congress must pass legislation that offers substantial and immediate assistance to local schools. Given the $200 billion in construction needs nationwide, the Board strongly supports H.R. 1660. H.R. 1660 will provide meaningful support——

Mrs. JOHNSON of Connecticut. Ms. Zedalis, could you conclude your remarks since the red light has been on for a while now?

Ms. ZEDALIS. Yes, thank you very much. H.R. 1660 will provide $1.8 billion to New York City schools. The $1.8 billion will help us to begin to start working on the interior of our buildings. It will help us to provide much needed new seats. Our current plan provides 32,000 with a need of over 75,000 seats.

[The prepared statement follows:]

Statement of Lewis H. Spence, Deputy Chancellor for Operations, New York City Board of Education; as presented by Patricia Zedalis, Chief Executive, Division of School Facilities, New York City Board of Education

Mr. Chairman and Members of the Committee:

Thank you Chairman Archer for the opportunity to address the issue of how the federal government can play a meaningful and positive role in rebuilding America's schools.

I especially want to thank Congressman Charles Rangel for his leadership on this issue. Congressman Rangel initiated congressional activity in this area when he authored the Qualified Zone Academy Bonds program in 1997. He followed-through on his commitment to improving our nation's schools by introducing H.R. 1660, the School Infrastructure Modernization Act of 1999. As the committee is aware, this legislation would provide tax credits to pay the interest on nearly $25 billion in state and local bonds over the next two years to build and modernize up to 6,000 public schools.

I also want to thank Congressman Joe Crowley for his efforts to focus attention on the need for school construction legislation in this session of Congress. While he is not a member of the Ways and Means Committee, he has been a strong advocate in Washington for the needs of New York City's public schools and we are grateful for his work in this area.

Finally, I want to commend Congresswoman Nancy Johnson for her efforts to bring the issue of school construction to the attention of her colleagues on the Ways and Means Committee. It is the New York City Board of Education's sincere hope that the consensus that exists between Representatives Rangel and Johnson on the need to address this issue will lead to a bipartisan bill that is passed by the 106th Congress. Congresswoman Johnson's bill is substantively identical to Congressman Rangel's proposal as both proposals provide the same form and level of tax credits to pay the interest on state and local school construction bonds. However, the Board prefers Congressman Rangel's legislation because its allocation formula is more targeted at high-need communities.

Across America, urban, rural, and high-growth suburban school districts all face different and difficult school modernization problems. Yet, the one thing that they hold in common is the struggle to find the resources to modernize existing school facilities and to build new schools for rapidly rising student enrollments. The national need for repair and renovation of schools, estimated by the Government Accounting Office in 1996 to exceed $112 billion, requires federal partnerships with states and local communities. Today, the cost of projected repairs, renovations and technology additions surpasses the GAO 1996 estimate. In addition, more than $70 billion will be needed to build new schools to meet record enrollments.

School facility problems negatively impact the safety and learning of school children everywhere. The average school building in America is 50 years old. These buildings were not designed to meet the demands of current and future technology. The GAO also reports that 38% of urban schools, 29% of suburban schools, and 30% of rural schools have at least one building needing extensive repair or total replacement. This affects over 14 million students throughout the nation.

I am here today to ask Congress to make an investment in these 14 million children. That investment begins with the fundamental right of every child to a safe and adequate learning environment that supports achievement at the most challenging levels.

In 1993, New York City took the lead in our state by setting rigorous graduation standards that were eventually adopted statewide. This year's eighth graders will be the first high school class required to take an all-Regents curriculum developed by the New York State Board of Regents. Students will need four years of English, three years of math and three years of science to graduate. They will have to pass five Regents exams, including a Regents exam in Lab Science. We are asking these students to take three years of science, two of those years in laboratory sciences, though there are not adequate facilities to support their learning. Without significant investment in the physical infrastructure of the New York City public schools, we are setting these children up to fail.

We as adults lack credibility when we tell children that we have high expectations for their achievement and that literacy, math and science are paramount while at the same time we shunt them into outdated and overcrowded classrooms with meager libraries and decrepit laboratories. The environment in which we place our children speaks volumes about what we really expect from them. It is the children in our schools who face the real building and capacity issues every day. It is our students who must cope with leaking roofs, peeling plaster and overcrowded classrooms. The lack of adequate facilities takes its greatest toll on instruction and hampers our ability to effectively implement early intervention strategies such as reducing class size in critical grades. In addition, school districts must be able to provide adequate, air-conditioned space for its most at-risk students who will attend summer school classes in an effort to perform at grade-level and ultimately acquire the tools needed to lead our nation into the 21st century.

This is not a call for massive federalization of school construction, which is, and undoubtedly will remain, a primary responsibility of states and localities. However, it is recognition that infrastructure needs of public schools have outpaced the ability of state and local governments to meet these demands by themselves. New York City, like many localities, is doing its part on school construction. The City is addressing the Board's school infrastructure needs; $7 billion has been committed to our five-year capital plan, which will:

- Expand our program to bring our existing facilities to a state of good repair;
- Increase program accessibility to achieve compliance with the Americans with Disabilities Act;
- Upgrade or provide new specialty spaces, such as science laboratories, to meet expanded graduation requirements; and
- Increase capacity to relieve existing overcrowding and accommodate enrollment growth, and reduce class size in pre-kindergarten and early grades.

Of course, much more needs to be done, and New York City and other school systems around the nation cannot do it alone. We need partners at the federal level to meet all these pressing needs.

The idea of the federal government assisting localities address their critical needs is not a novel concept. Last year, Congress acted decisively to provide federal support to our state and local communities as a partner in building America's roads, highways, and transit system. In 1998 Congress authorized spending of $250 billion for these purposes. I do not question the wisdom of these investments, given their importance to our national economy. However, I do question the rationale of those who claim that we cannot afford to invest ten cents for every highway dollar on schools given *their* relationship to our economic competitiveness in the 21st century marketplace.

As Congress considers the broad range of school construction proposals that have been introduced in the 106th Congress, the New York City Board of Education hopes that Congress will ultimately enact legislation that addresses the magnitude of the nationwide need for construction assistance.

First and foremost, Congress must pass legislation that offers substantial and immediate assistance to local schools. Given the $200 billion in construction needs nationwide, the Board strongly supports H.R. 1660, which was authored by Congressman Rangel earlier this year and is awaiting consideration by this committee.

H.R. 1660 will provide meaningful support to local communities by providing a tax credit to the holder of the school modernization bonds in lieu of interest paid by the school district. This financing scheme wisely maximizes a relatively small federal investment of $3.1 billion by leveraging $25 billion in local school construction and modernization. Local communities, such as New York City, would benefit from the savings and by the investment in the public school infrastructure. We would also benefit from the bill's flexibility since it involves no federal interference in local school decisions. The design and selection of the construction and modernization projects will be totally within the discretion of state and local public school officials, a concept that has always enjoyed bipartisan support.

We appreciate Chairman Archer's interest in assisting local schools through changes in the current arbitrage requirements, and do not argue that it could be of some benefit to certain schools with less-immediate capital needs. However, the proposal to extend the rebate period from two to four years would be of little value to New York City's public schools. New York City's practice is to issue general obligation bonds to reimburse cash flow expended on capital projects. Bond proceeds, therefore, do not earn any interest that would be subject to increase from the proposed legislation.

From New York City's perspective, H.R. 1660 offers the most meaningful form of federal assistance because the interest-free subsidy really adds up. We estimate that the school modernization bond program contained in this legislation will allow New York City to issue $1.8 billion in bonds and save up to $890 million in interest payments. With $1.8 billion in additional funds, New York City would expand its program to upgrade many of its 1,100 buildings, particularly to undertake critical work on interior systems; not investing in these buildings means we will lose capacity. With these additional funds we would also dedicate a portion for adding new seats. Under our five-year plan we project that we will add over 32,000 new seats in our classrooms, but our total need is actually in excess of 75,000 seats. We could also begin the rebuilding of our physical education facilities, such as gymnasiums, because education doesn't just occur in the traditional classroom setting. Clearly, this is a significant incentive for us to improve our school infrastructure that can really make a difference in our ability to improve learning spaces for our children.

As we approach the new millennium, America must invest the resources needed to improve school facilities and to provide our students with greater numbers of well-equipped classrooms to accommodate smaller class sizes and to enhance learning environments. We must send a message to our children that they matter to us, that they deserve state of the art schools, that they are an integral part of the health of our communities. Unfortunately, many of our nation's children live in poor urban and rural neighborhoods, isolated from the economic, cultural and civic life of America. Yet they are as bright, full of potential, and precious to our future as the most privileged children growing up in affluence. We need these and all children to succeed if our nation is to thrive economically and socially in the next century. Therefore, I respectfully request the committee to approve H.R. 1660 and bring it to the House floor for full debate and consideration.

Thank you Mr. Chairman and members of the Committee for your time and consideration of the New York City Board of Education's views on school construction.

Mrs. JOHNSON of Connecticut. Thank you.

Ms. ZEDALIS. Thank you.

Mrs. JOHNSON of Connecticut. I certainly appreciate your point about the needs of the cities, but I have been increasingly impressed with the needs of the rural areas. They have a very, very small tax base to shoulder any of these costs, as you all pointed out, school construction costs have absolutely zoomed. If we are going to provide modern, high-tech environments, they are much more costly. If you do not help rural communities in the same way, then you will have, in a sense, the kids from the country backward. Any agricultural enterprise now, I mean Dearing, in my part of the country, requires very sophisticated computer knowledge and attritional knowledge. And not to have those kids have classrooms that are sophisticated is really a disadvantage to them. So that is why my bill is different in that it takes half of the money and allocates on the basis of student population. I don't think we can afford to, as important as it is to rebuild the inner-city schools, I don't think we can afford to disadvantage the rural schools.

Dr. Gillespie, I wanted you to go through in a little more detail, but not long because other people have questions too, why your stipend of $915 a month was reduced to $254 a month just by the IRS making the decision that your stipend was taxable? Now they did not make a similar decision in regard to all other stipends. And one of the reasons I think this has to be addressed legislatively is that it wasn't fair to single out one program and treat it differently than other programs. But I don't understand why the stipend would have been quite so dramatically impacted, less than 25 percent remaining. Could you go through your calculation there a little more precisely?

Dr. GILLESPIE. Yes, the decrease in the stipend was so dramatic because the tuition at my medical college was so high. So because the tuition was being considered income, the tuition is about $35,000 a year and all of that was being considered income in addition to my stipend payment. So when taxes were withheld from the monthly stipend only $254 was left.

Mrs. JOHNSON of Connecticut. So they withheld FICA taxes for the first time?

Dr. GILLESPIE. What?

Mrs. JOHNSON of Connecticut. Did they withhold FICA taxes for the first time from the $35,000 portion?

Dr. GILLESPIE. Actually, FICA taxes were not withheld. They withheld Federal Income taxes.

Mrs. JOHNSON of Connecticut. And then also income taxes?

Dr. GILLESPIE. Right. They were withheld as income, as if it were income.

Mrs. JOHNSON of Connecticut. I think the thing that is hard for people to see is that this money had no FICA tax on it either so that is 15 percent between FICA and Medicare and then income taxes over and above that. Fifteen percent for FICA and Medicare taxes. And then over and above that the income tax. Otherwise, you couldn't account for such a heavy load.

Dr. GILLESPIE. Income taxes accounted for the entire withholding.

Mrs. JOHNSON of Connecticut. Yes, Social Security taxes. OK, thank you.

Mr. Rangel.

Mr. RANGEL. Madam Chairwoman, you will be pleased to know that our bills really are compatible when it comes to allowing the rural areas to participate in the bond issues. The major difference is that mine concentrates more of its benefits on areas of need than yours does. I think that is very important because of the diversity in formulas that we have in our major States. The amazing thing is that we never have a problem with the budget for construction of prisons. I just never understand why that budget is so easy to enact and an adequate education budget is not.

But I want to thank the supporters of this approach, including Mrs. Johnson because Mrs. Johnson is a breath of fresh air when it comes to innovative ideas. The Majority thinking on her side of the aisle is that we should remove all requirements by States and local governments for Federal aid. There is an article in today's New York Times which states that Governors should be able to determine what they want to do with the money rather than to have it earmarked toward improving education. The Chairman has said he believes that the approach of Senator Coverdell, which would allow individual savings accounts to accumulate tax-free interest earnings if the accounts are dedicated for the child's education. Also, more and more Republicans talk about vouchers. Many parents prefer to send their children to private schools, but I am impressed that more and more people recognize the fact that the education of our children in the public school system is a national issue that cannot be ignored. And I really want to thank you for your support.

Last week, Madam Chairwoman, the Conference of Mayors voted their overwhelming support for this approach. I am anxious to work with you and Chairman Archer to make our bills even more compatible so that we do not cause damage to our budget as we encourage people, local and State governments, to invest in education.

I want to thank the entire panel. Dr. Gillespie, I will be working with the Chairwoman to see what remedy we can have for the problems that you had to endure personally and, of course, Mr. Grayson—where is your foundation located, Mr. Grayson?

Mr. GRAYSON. We are in La Jolla, California, but we, as I noted, serve the entire country. We operate in 27 States at this time.

Mr. RANGEL. Well, I wish you would send some additional information as to what you do and where you do it because——

Mr. GRAYSON. I have got some with me and you are welcome to it.

Mr. RANGEL. I appreciate the fact that it is targeted to the areas where it is most needed. I want to thank the entire panel.

I yield back the balance of my time.

Mrs. JOHNSON of Connecticut.

Mr. English.

Mr. ENGLISH. Thank you, Madam Chair. Mr. Bennett, welcome. I appreciate your coming here to offer such eloquent testimony for Qualified State Tuition Plans, which have been in the case of Pennsylvania very successful. It is my privilege to work with your counterpart and colleague, Barbara Hafer, in Pennsylvania on expanding the tax breaks. I notice here specifically you encourage the Committee to consider the exclusion from gross income for distributions from Qualified Tuition programs and also eliminate all Federal income taxes on accrued interest. I wonder, knowing as you undoubtedly do, that there was an attempt by this Committee to write a much broader tax break for these plans and that in 1997 when we did our tax bill, we were faced with a violent reaction, that's the best way I can describe it, from the Treasury, which opposed the extent of the tax break we had written and charged that we were creating an opportunity for tax breaks for the rich and specifically abuses by high-income taxpayers.

Mr. Bennett, can you put us at ease on this? Are these programs the sorts of programs that are utilized by plutocrats. I mean is Bill Gates' kid going to be in this program?

Mr. BENNETT. Well, of course, the programs are open to all citizens regardless of income. We find from the results of the million students that are enrolled in it now, the great majority, over 55 percent are in the middle-income bracket, family income between $20,000 and $70,000.

Mr. ENGLISH. And you don't see any way that high-income taxpayers could somehow structure this to be a special tax break or exclusion for income?

Mr. BENNETT. No, because if they use it for anything other than higher educational expenses, then it is taxable.

Mr. ENGLISH. That is wonderful. That puts me at ease.

Now can you tell me how many qualified State tuition plans currently allow participation by private colleges or allow a break that is comparable to that for State institutions be extended over to private colleges?

Mr. BENNETT. All plans, all prepaid plans of the 20 allow for public or private institutions to participate. A student can choose wherever they want to go and the tuition will be paid to that institution. The savings plan States obviously have a program where the proceeds that are earned while it is in the invested plan can be spent anywhere. And, of course, those are market-driven and it very well could produce enough income to pay for any private institution's tuition, no matter what the cost.

Mr. ENGLISH. I have not seen a formal study on this, Mr. Bennett, but my impression is that the tax break allowable for a private institution in some of the State programs, and I applaud them for including private schools, the break for private institutions is really not as great as the one for public institutions. And that is where I would like to bring Dr. Kepple in. Welcome and thank you very much for representing our smaller institutions in Pennsylvania, which I have a number of within my congressional district.

Mr. KEPPLE. Yes, you do, sir.

Mr. ENGLISH. Mr. Bennett in his testimony makes the point that there needs to be some sort of regulatory regime for private prepaid tuition plans if we end up creating a tax incentive for those. Would you care to comment on what you think would be appropriate. And I take it you don't really object to that?

Mr. KEPPLE. We do not object at all. We believe that is an appropriate move, and we certainly support the 529 section and would follow those basic rules.

Mr. ENGLISH. Well, I think that is outstanding. As both of you gentlemen know, I have legislation in currently that you have referenced in your testimony that would allow for a level tax playingfield for both kinds of institutions. I hope both kinds of programs ultimately are available and flourish because I think it is a great way for middle-class families to save. I am running out of time, but I want to thank both of you for highlighting these points before our Committee and providing eloquent testimony.

Mr. KEPPLE. Thank you.

Mr. ENGLISH. Thank you, gentlemen.

Chairman ARCHER [presiding]. Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. I am constrained to make a quick comment to my friend from New York, and I don't know if this puts me in the open-minded Republican category or some other characterization that he chooses to make. There are some of us, most of us, who do not believe that there is a one-size-fits-all regarding education. If we are truly sincere about helping our kids learn and get a world-class education, we should look at a variety of things. The gentleman from New York talked about vouchers. And, clearly, low-income scholarships allowing parents make those choices is one facet. I spent some time this morning talking about the Savings for Student Accounts, which really does provide the flexibility and puts it in the hands of the parents because I don't believe any American student should be discriminated against because he or she goes to a public school or private school or is home-schooled. So I make that remark.

I also applaud Mr. English, your efforts, which you talked about. What we tried to do in H.R. 7 was take many of these free-standing bills and roll them into one. For instance, Dr. Gillespie, you will be happy to know that we do in H.R. 7, you talk about 1414, which is a free-standing bill, we incorporate that idea in this comprehensive Education Savings and School Excellence Act because we have heard the stories of people just like you. So we want to make sure that not only the National Health Corps Scholarship program but the F. Edward Abare Armed Forces Health Profession Scholarship and Financial Assistance Program, which is a mouthful, also gets the same treatment. So that is in H.R. 7.

Mr. Baratta, let me ask you a question and to preface the question, let me tell you that I posed this same identical question to the former Secretary of the Treasury, Mr. Rubin, and if it is any consolation to you, he didn't have the answer for me that day either. So having said that, especially regarding the Qualified Zone Academy Bond Program, do you have any idea how many school districts across the country have utilized QZABs to help provide additional construction?

Mr. BARATTA. Yes, sir, I can answer that with the knowledge that I have today. There may be a couple out there that I am not aware of. The State of California had two school districts combined for a $12 million issue. And the Chicago public schools did one also, I believe it was $14 million. In the State of Oklahoma, there were 10 rural school districts that participated in the program. I have contacts with Milwaukee public schools and some others in Kansas City. And I believe Texas is moving along as well.

Mr. HULSHOF. So as far as those here today who have taken advantage, I think you speak correctly, so let me first commend you for having the answer that the Secretary did not. Can you tell me, since you have the information, let me go one step further and ask you specifically those, the QZABs used, I think for the Fresno and Clovis school districts in your home State of California, what percent of par those issues sold for?

Mr. BARATTA. The Fresno-Clovis transaction actually sold at a $91 price, which means 91 cents on the dollar came to the school district.

Mr. HULSHOF. OK. Let me move on and really continue the questioning that Mr. English asked. And, again, we incorporated his idea, Mr. Bennett and Dr. Kepple, of the Qualified Tuition programs, and, Mr. Bennett, let me ask you the reverse question that Phil asked Dr. Kepple regarding being willing to embrace oversight. With that caveat—and I read your testimony—would you be supportive of allowing private prepaid tuition plans were the private institutions to have some similar type of oversight that you have?

Mr. BENNETT. Well, I think we support any effort to broaden the accessibility across the country. The difference is that the IRS regulation under 529 is really not enough oversight as far as the investment portfolio is concerned, as far as the financial stability. It penalizes the participant and protects the Federal Government in the Treasury from tax fraud, but it doesn't protect the consumer from purchasing a plan that is mismanaged, whereas SEC regulation would require filings and disclosure and management requirements and criteria before they could even sell the plans to the public.

Mr. HULSHOF. I appreciate that. Thank you, each of you, for your presence and testimony today.

Chairman ARCHER. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. I thank the witnesses for taking time to come and visit with us today. I apologize for the fact that I was not able to be here earlier. I had another markup so I couldn't hear all of your comments.

Mr. Baratta, specifically to you, I am interested in your assessment of H.R. 1660. And I am concerned about provisions that incorporate Davis-Bacon into this legislation, into the whole question of school construction. Won't inclusion of Davis-Bacon needlessly increase the cost of school construction under this bill?

Mr. BARATTA. Only being able to respond to the California issue, the answer to that is, no, it won't. We have a prevailing wage in the State of California for schools currently and that will not affect us in any way.

Mr. HAYWORTH. What is interesting, you mentioned prevailing wages in the State of California because, as you do in your profession, I wonder if you may have done an independent analysis of the impact of expanding Davis-Bacon requirements on this bill, that is, its impact on project cost and small business and also minority contractors and women? Has anyone done that type of analysis within California?

Mr. BARATTA. None that I have seen.

Mr. HAYWORTH. OK. So really we don't really have empirical data to show us that it doesn't adversely impact those contractors and those folks?

Mr. BARATTA. None that I can provide you today, yes.

Mr. HAYWORTH. Well, I hope that at the Federal level such an analysis I think would be helpful, especially when we are trying to assess just what transpires with wages. You mentioned California specifically and our concerns at the Federal level, this would be the first Federal tax bill that would incorporate Davis-Bacon in such a manner. And as we prepare, I guess the question would be why should we make such a drastic change in policy at a time when the Department of Labor has admitted it is not capable of accurately surveying wages for purposes of issuing the required wage determinations under the act?

Mr. BARATTA. I will have to beg off on that question, sir, not necessarily being in that area.

Mr. HAYWORTH. OK, sir, well, again, if anyone on the panel would care to address it? I just believe we have some real concerns if the idea is to, in fact, improve school facilities and I welcome State initiatives and, indeed, at the national level, just 2 weeks ago, my Education Land Grant Act was passed unanimously on the floor of the House of Representatives that will help rural areas in terms of land costs and free up a great deal of government-controlled, federally controlled land for rural school districts. Its impact will be great, but before we take such a drastic step in terms of federalizing, if you will, school construction, I am very concerned about school construction costs, and I think that if we include Davis-Bacon, we are looking at an inflation in costs in terms of construction by 5 to 38 percent. So those would be my concerns.

Again, I thank all of you for taking time, and I yield back the balance of my time.

Chairman ARCHER. The Chair would like to inquire briefly, and I apologize that I did not get to listen to the testimony of each one of you, but I do thank each of you for coming. The Members on the Committee on both sides of the aisle have a strong desire to do everything we can to improve the educational structure of the country. You have that same desire, perhaps in different ways, but the same desire. After we have done appropriate within the Tax Code, the Tax Code cannot solve the problems. When we talk about the debt that our young people have today to go to college, it is a matter of great, great concern. But the Tax Code cannot solve all of that problem.

As I look at the numbers, the cost of a public, 4-year college education in the last 10 years has more than doubled, more than doubled. What are we going to do to restrain the cost? We are terribly concerned about health care costs outstripping the rate of inflation, and we feel that we just cannot continue on that path. What are we going to do about education? Are they receiving twice the education today in their colleges as we did 10 years ago? I don't think so. Does anyone have a suggestion as to what we do about lowering cost so that young people can afford education and do not have so much debt?

Mr. KEPPLE. Mr. Chairman.

Chairman ARCHER. Dr. Kepple.

Mr. KEPPLE. Mr. Chairman, I think we mentioned some of these things while you were out, but under our private prepaid program, we expect to actually reduce the cost of higher education, and we are doing it by investing those funds, prepaid early and giving a discount to parents and grandparents who have prepaid those funds. So, indeed, we hope to in fact reduce the costs over time of our programs. But at the same time not reduce the quality that, in fact, is the envy of the world. It is a very important part of this formula.

Mr. BENNETT. Mr. Chairman, what happens in the qualified plans is that the tuition is locked in at today's price so no matter how high the tuition cost increases at the colleges, the investments cover that increase. So that to the American family who is paying for college, they are only paying at 1999 prices when their kid may not even go to college until 2010. The other thing you are seeing some of the State legislatures do, such as in Virginia and in our State, is they have put a moratorium for 2 years or 3 years on the increase in tuition at the public universities in the State, which give families an opportunity to at least plan for the next 2 to 3 years on the inflation factor of college costs.

Chairman ARCHER. I think the prepaid tuition program is a wonderful program that so many colleges have gone into, which guarantees to young couples their children will be able to go to school at the fixed price at whatever time they decide to fund it. But that is only one side of the ledger. That has nothing to do with the cost of the education. Ultimately that cost must be recovered. If it is not recovered from the prepaid tuition parents, it will be recovered somewhere else. I don't know whether any of you get into that, but I just wonder what, if any, efforts are underway in the colleges today to restrain the costs?

Mr. KEPPLE. Mr. Chairman, I can't speak for every college and university in the country but I have been at three different institutions over the last 25 years, and I can't tell you of a board meeting at any of those institutions where this topic was not discussed with our board. It is an issue that we all try to grapple with at every meeting and seek different ways, innovative ways we hope, to reduce the cost. We are seeing I think a reduction in the increase in tuition certainly at most private institutions, and I suspect also at public institutions as well. So the cost inflation rate that you have seen in the last several years is in fact being reduced, but we have not solved the problem.

Chairman ARCHER. OK. Thank you very much. You are excused and we will get to our next panel.

Mr. Baroody, Mr. Capps, Mr. Bloomfield, Mr. McCants, Mr. Greenberg, and Mr. Leonard, if you will come to the witness table.

Welcome, gentlemen. You are encouraged to keep your oral testimony within 5 minutes and, without objection, your entire written statement will be inserted in the record. And after identifying yourself, each of you may proceed.

Mr. Baroody, will you lead off, please?

STATEMENT OF MICHAEL E. BAROODY, SENIOR VICE PRESIDENT, POLICY, COMMUNICATIONS AND PUBLIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. BAROODY. Yes, sir, and thank you very much. I would like to thank the Chairman and the Members of the Committee for giving us the opportunity to testify and for holding these very important hearings. My name is Michael Baroody, and I am here to testify on behalf of the National Association of Manufacturers, our 14,000 members, large, medium, and small, and our 350 member associations, and especially the 18 million people who make things in America. And I am here to testify in favor of progrowth and——

Chairman ARCHER. Mr. Baroody, will you suspend for a moment?

Mr. BAROODY. Yes, sir.

Chairman ARCHER. The Chair encourages all of our guests and staff to take seats. If they wish to converse, to do so outside the Committee room.

Now, Mr. Baroody.

Mr. BAROODY. Thank you, Mr. Chairman. I am here to testify in favor of progrowth and proworker tax relief.

America's economy has expanded impressively over the past 18 years, with only one relatively mild downturn in that entire period. At the NAM, we are proud of the disproportionately large contribution American manufacturers have made to that expansion. Coupled with fiscal restraint in recent years, our booming economy has filled Federal coffers beyond expectations and yielded the first Federal budget surplus in a generation.

Throughout the past decade, the NAM has been an advocate for growth, I would say for "more growth." And against the widespread common wisdom in the early nineties that growth rates of 2 percent or so were the best we could expect, the NAM insisted we could do better with growth rates of 3 percent or more. Over the past 3 years, this economy has averaged noninflationary growth of about 4 percent, and we believe it has proven us right.

The fiscal 2000 budget resolution approved by Congress with its projections for a 10-year budget surplus of almost $800 billion, not including Social Security revenues, rests on the assumption of continued growth. We strongly agree the surplus should be returned to taxpayers through tax relief, but believe just as strongly that a substantial portion of the total tax cut should take the form of an insurance policy for continued growth. Last December, the NAM announced our advocacy for across-the-board reductions in tax rates for just that reason. We thought such tax rates balanced between individuals and corporations would give us a balanced growth stimulus. We thought then and think now that it would be the best insurance policy for growth. But if such a broad-based tax cut seems for the time out of reach, we nonetheless continue to believe that growth-oriented tax cuts should be included in the package for the sake of maintaining our expansion and realizing Congress's current revenue projections.

As the Chairman knows, because the NAM has carried on a much-appreciated dialog with him over the years, we believe that the Federal Tax Code is the single largest current obstacle to economic growth. It needs to be reformed and replaced with a Progrowth Code, but until it is, we believe that certain provisions, such as repeal of the corporate AMT and the estate tax, a permanent extension of the R&D tax credit, and simplification of international tax provisions are essential pro-growth incentives that need to be incorporated into an otherwise Antigrowth Code.

I would say also that such progrowth provisions should account in our view for about a third of the total tax cut. This was the proportion that went to businesses in the tax cuts of the sixties and the currently unsettled state of the world economy we think justifies a similar portion now. That would translate into a 10-year total of about $250 billion, more than enough to accommodate the four provisions I have mentioned. And, importantly, to ensure the prospects for continued expansion.

The NAM believes that additional relief from the corporate alternative minimum tax, the AMT, is a critical component of ensuring long-term sustained economic growth in the United States. And we note, Mr. Hayworth, the work you have been doing to put together a bill that would improve the implementation. And we, on behalf of the NAM and the coalition we represent, express our gratitude to you for that. Despite the relief that was enacted in 1997, many of our member companies, particularly those in distressed industries, continue to be burdened by the unfair AMT. The NAM believes that the best solution is repeal. Short of repeal, we strongly support legislative changes to allow corporate taxpayers to use AMT credits more quickly, Mr. Hayworth, than they can under current law. It is also important to ensure that companies that have paid the AMT are not further penalized by losing any of the value of these credits. These credits represent assets on the books of AMT companies. We also support eliminating arbitrary limits on net operating losses and foreign tax credits under the AMT.

Also, a permanent extension of the R&D tax credit would provide an effective economic stimulus. Increased productivity, new product development, and process improvements are direct results of technological advancements that occur from R&D activities. Two-thirds of the growth in manufacturing is attributable to productivity improvements from technological advance derived primarily from U.S.-based R&D. The manufacturing sector performs 77 percent of all private industrial R&D in the United States and the R&D tax credit is a key factor in promoting that. The tax credit has been particularly effective in spurring incremental R&D that probably would not have been conducted without additional funds provided by this incentive. Also, the R&D tax credit is a job creator. More than three-quarters of the credit dollars are used for the salaries of American workers performing R&D in the United States.

The temporary tax credit is scheduled to expire a week from today on June 30. Its history of lapses and temporary extensions stymies planning for R&D activities and exacerbates tax compliance difficulties. We strongly urge enactment of a permanent R&D tax credit, including a modest increase in the alternative incremental research credit, as proposed in the bill introduced by Committee Members Nancy Johnson and Bob Matsui.

Another powerful and effective progrowth tax policy would be elimination of the death tax imposed on a business when an owner dies. The estate tax burden is the leading reason why more than two-thirds of family-owned businesses are sold or liquidated by heirs. Eliminating this burden would allow small business owners to invest more money in expanding their companies and hiring additional workers. They could make long-range plans based on rational business issues and not tax policy concerns. Simplification of the current international tax regime would also provide an effective economic stimulus by reducing compliance burdens and helping to level the playingfield between U.S.-based companies and their foreign competitors.

The NAM believes the international tax rules are overly complex, arbitrary, and, in many cases, unfair. We will provide more expansive comments on international tax issues in conjunction with this Committee's hearing scheduled for next week, June 30.

There are also, finally, a number of more targeted tax cuts supported by the NAM that would have a positive impact on growth and our economy. They certainly include education incentives, such as a permanent exclusion for employer-provided tuition assistance and an expansion of this benefit to cover graduate education, as well as additional incentives for training, lifelong learning, and school donations.

We also support tax rate relief for small businesses operating as S corporations and additional capital gains tax relief for individuals. In addition, capital gains tax relief for corporations is important. Lowering the capital gains tax rate reduces the cost of capital and promotes U.S. economic growth and job creation. Legislators began the job in 1977 by lowering the top rate on individual capital gains from 28 percent to 20 percent, we hope that efforts will continue by enacting similar reductions in capital gains tax rates for corporations.

Clearly, the robust economic growth experienced by the United States during most of the past decade has benefited businesses and workers alike. We believe it is critical to continue this growth and welcome the opportunity to work with this Committee to develop progrowth tax policies.

Thank you for this opportunity.

[The prepared statement follows:]

Statement of Michael E. Baroody, Senior Vice President, Policy, Communications and Public Affairs, National Association of Manufacturers

Chairman Archer, members of the Committee, my name is Michael Baroody. I am here to testify on behalf of the National Association of Manufacturers; our 14,000 member companies, large, medium and small; our 350 member associations; and the 18 million people who make things in America.

And I am here to testify in favor of pro-growth and pro-worker tax relief.

America's economy has expanded impressively over the past 18 years, with only one relatively mild downturn in the entire period. At the NAM, we are proud of the disproportionately large contribution American manufacturers have made to that expansion. Coupled with the fiscal restraint of recent years, our booming economy has filled federal coffers beyond expectations and yielded the first federal budget surplus in a generation. This made possible a budget resolution, passed by Congress earlier this year, which provides for $778 billion in tax cuts over the next ten years.

Throughout the past decade, the NAM has been an advocate for growth. Against the widespread common wisdom of the early '90s that growth rates of 2 percent to 2.5 percent were all we could expect and all we should strive for—and that growth rates in excess of that would reignite inflation—the NAM insisted we could and should do better, with growth rates of 3 percent or more. Regardless of whether we were in a new economy, we said, the old formulas and the old certainties needed a new look. Over the past three years, this economy has averaged non-inflationary growth of about 4 percent. We believe we've been proven right.

The budget resolution I cited—with its projections for a 10-year budget surplus of almost $800 billion, not including Social Security revenues—rests on the assumption of continued growth. We strongly agree that the surplus should be returned to taxpayers through tax relief—but we believe just as strongly that a substantial portion of the total tax cut should take the form of an insurance policy for continued growth. Without continuing growth, of course, the entire tax-relief plan will be frustrated.

Last December, the NAM announced our advocacy of across-the-board reductions in tax rates. We called for rate cuts that were balanced between individuals and businesses. In that way, both the growth stimulus and the tax relief would also be balanced—in NAM's terms—between our 14,000 manufacturing member companies and the 18 million people who make things in America, between America's working families and the companies they work for, between the supply side and the demand side. We thought then, and think now, that this would be the best insurance policy for growth. But if such a broad-based tax cut seems for the time out of reach, we nonetheless continue to believe that growth-oriented tax cuts should be included in the package, for the sake of maintaining our expansion and realizing Congress' current revenue projections.

As you also know, Mr. Chairman, because the NAM has carried on a much-appreciated dialogue with you over the years, we believe that the federal tax code is the single largest current obstacle to economic growth. It needs to be reformed and replaced with a pro-growth code. Until it is, we believe that certain provisions—such as repeal of the corporate AMT and the estate tax, a permanent extension of the R&D tax credit and simplification of international tax provisions—are essential pro-growth incentives that need to be incorporated into an otherwise anti-growth tax code.

As a final point of preface, Mr. Chairman, we believe that such pro-growth provisions should account for about a third of the total tax cut. This was the proportion that went to businesses in the tax cuts of the '60s and the currently unsettled state of the world economy justifies a similar portion now. That would translate into a 10-year total of about $250 billion—more than enough to accommodate the four provisions I have mentioned and, importantly, to ensure the prospects for continued expansion.

Corporate AMT

The NAM believes that additional relief from the corporate alternative minimum tax (AMT) is a critical component of ensuring long-term sustained economic growth in the United States. AMT relief enacted in 1997 significantly reduced the cost of capital for AMT payers by conforming AMT depreciation lives with regular tax lives for property placed in service after 1998. Nonetheless, the AMT, sometimes known as the anti-manufacturing tax, remains an impediment to economic growth and job creation in the United States, particularly in the capital-intensive manufacturing sector of the economy.

The NAM strongly opposed enactment of the corporate AMT in 1986, arguing that the AMT would have a negative impact on U.S. manufacturing. Unfortunately, this proved to be true. During the early 1990's, many companies, particularly in the manufacturing sector, reported large losses to their shareholders and were forced to reduce employment. At the same time, because of the way the AMT works, these companies were forced to make large AMT payments to the federal government.

Mr. Chairman, the NAM welcomed your proposal in 1995 to repeal the corporate AMT and worked vigorously for enactment of this proposal. Although this effort was not successful, our members appreciated your leadership in advancing the more limited depreciation reforms enacted in 1997.

Despite the changes enacted in 1997, many of our member companies, particularly those in distressed industries, continue to be burdened by the unfair AMT. In order to improve this situation, the NAM strongly supports legislative changes to allow corporate taxpayers to use AMT credits more quickly than they can under current law. It also is important to ensure that companies that have paid the AMT are not further penalized by losing any of the value of these credits. These credits represent assets on the books of AMT companies. The NAM also supports eliminating arbitrary limits on net operating losses and foreign tax credits under the AMT.

A Permanent R&D Tax Credit

A permanent extension of the research and experimentation tax credit, commonly referred to as the R&D tax credit, also would provide an effective economic stimulus. The contribution of research and development to economic growth cannot be overstated. Increased productivity, new product development and process improvements are direct results of technological advances that occur from R&D activities. In fact, two-thirds of the growth in manufacturing is attributable to productivity improvements from technological advances derived primarily from U.S.-based R&D. According to the National Science Foundation, the manufacturing sector performs 77 percent of all private industrial R&D in the United States. The R&D tax credit is a key factor in promoting increased research spending by manufacturers.

The tax credit has been particularly effective in spurring *incremental* R&D that probably would not have been conducted without additional funds provided by this incentive. A number of small businesses, which account for $20 billion or 14 percent of total industrial R&D spending in 1996, also benefit from the credit. Moreover, many smaller companies that do not conduct enough R&D to benefit from the credit experience a "spillover benefit" when R&D performed by another company generates additional business for them and gives them access to new technology to improve their productivity.

The R&D tax credit is also a job creator and an investment in our greatest asset: people. More than 75 percent of the credit dollars are used for the salaries of American workers performing U.S.-based R&D. These trained and skilled workers performing R&D enjoy greater economic security and higher wages. Without these workers, we would not have the innovative ideas that are the genesis of many R&D activities.

The temporary tax credit is scheduled to expire, once again, a week from today on June 30. A history of lapses and temporary extensions of the credit, since its initial enactment in 1981, stymies business planning for R&D activities and exacerbates tax-compliance difficulties. The NAM strongly urges enactment of a permanent R&D tax credit, including a modest increase in the alternative incremental research credit (AIRC) rates, as proposed in the bill (H.R. 835) introduced by committee members Nancy Johnson (R–CT–6) and Bob Matsui (D–CA–5). In addition to extending the credit permanently, the AIRC rate increase will provide greater parity for those companies that do not qualify for the regular credit.

The Johnson/Matsui bill enjoys wide bipartisan support. The bill's 143 cosponsors include half of the Ways and Means Committee members. A companion bill in the Senate (S. 680), has 43 cosponsors, including half of the Senate Finance Committee members.

Death Tax Repeal

Another powerful and effective pro-growth tax policy is elimination of the death tax imposed on a business when an owner dies. The estate tax burden is the leading reason why more than two-thirds of family-owned businesses are sold or liquidated by heirs. Under the current system, closely held businesses devote significant resources to costly and complicated planning to minimize the estate tax, diverting major financial resources from hiring and business expansion. In short, federal estate taxes take a toll on economic growth and job creation. Eliminating this burden would allow small business owners to invest more money in expanding their companies and hiring additional workers. They could make long-range plans based on rational business issues and not tax policy concerns.

Just last week, an NAM member and small business owner, Ron Sandmeyer Jr. from Sandmeyer Steel Company in Philadelphia, appeared before this committee to discuss the difficulties his company faces today as it prepares for the transition to a new generation of ownership and ask you to eliminate the estate tax burden. His testimony reflects the concerns and problems faced by many of our 10,000 small and medium manufacturers in trying to plan for and pay this onerous tax.

International Tax Simplification

Simplification of the current international tax regime would also provide an effective economic stimulus by reducing compliance burdens and helping to level the playing field between U.S.-based companies and their foreign competitors.

The NAM believes that the international tax rules in the federal tax code are overly complex, arbitrary, and, in many cases, unfair. U.S. companies are facing increased competition from counterparts in other countries that have the distinct advantage of a more rational tax policy. Furthermore, U.S. trade and tax policies are at odds. Trade is essential to expand our markets, but our current tax system penalizes foreign source income by taxing it even more severely than domestic source income, and by requiring enormous amounts of additional recordkeeping.

The NAM will provide more expansive comments on international tax issues in conjunction with the committee hearing scheduled for June 30.

Conclusion

Clearly the robust economic growth experienced by the United States during most of the past decade has benefitted businesses and workers alike. The NAM believes that it is critical to continue this growth and welcomes the opportunity to work with this committee to develop progrowth tax policies. Undoubtedly, the current tax system represents a major drag on the economy and should be replaced with a simpler and fairer system that encourages work, investment and entrepreneurial activity. Pending reform, there are a number of tax cut proposals that fit within the current budgetary constraints and that will stimulate job creation and economic growth. These pro-growth tax incentives include corporate AMT repeal, a permanent R&D tax credit, elimination of the death tax and international tax simplification.

There also are a number of more targeted tax cuts, supported by the NAM, which would have a positive impact on our economy. Those proposals include education incentives such as a permanent exclusion for employer-provided tuition assistance and an expansion of this benefit to cover graduate education, as well as additional incentives for training, lifelong learning and school donations. The NAM also supports tax-rate relief for small businesses operating as S-corporations and capital gains tax cuts for individuals and corporations.

We applaud you, Mr. Chairman, for holding these hearings and for your commitment to meaningful tax relief for American families and businesses. Our members agree with you, Mr. Chairman, that if the surplus is not returned to taxpayers through tax cuts, it will likely go towards more government spending.

Chairman ARCHER. Thank you.

Mr. Capps.

STATEMENT OF R. RANDALL CAPPS, CORPORATE TAX DIRECTOR AND GENERAL TAX COUNSEL, ELECTRONIC DATA SYSTEMS CORPORATION; ON BEHALF OF R&D CREDIT COALITION

Mr. CAPPS. Good afternoon, Mr. Chairman and Members of the Committee. My name is Randy Capps. I am corporate tax director for Electronic Data Systems. I would like to thank you for this opportunity to speak to you about the research and experimentation tax credit.

I am here on behalf of my company, EDS, and the R&D Credit Coalition. EDS has been a leader in the global information technology services industry for more than 35 years. Our 140,000 employees deliver management consulting, electronic business solutions, and systems and technology services to improve the performance of more than 9,000 businesses and government clients in approximately 50 countries.

The R&D Credit Coalition is comprised of 53 trade and professional organizations and approximately 1,000 companies of all sizes who rely on the credit to reduce the cost of high-risk research. The Coalition supports a permanent extension of the credit and a 1-percent increase in the rates of the alternative incremental research credit, as called for in H.R. 835. Introduced by Congresswoman Nancy Johnson and Congressman Robert Matsui, the bill currently has 143 cosponsors. An identical bill, S. 680, has 43 cosponsors in the Senate.

The first point I would like to address with the Committee is why the credit is so important. It is important because it offsets the tendency to under invest in R&D. The single biggest factor driving productivity growth is innovation. However, companies cannot capture fully the rewards of their innovations because they can't control the indirect benefits of their technology on the economy. As a result, the rate of return to society from innovation is twice that which accrues to the individual company.

The credit is important because it helps U.S. business remain competitive in a world marketplace. And, unfortunately, our Nation's private sector investment in R&D, as a percentage of GDP, is far below many of our major foreign competitors. Foreign governments are competing aggressively for research investments by offering substantial tax and other financial incentives. Companies that do research in the United States are at a disadvantage when competing with foreign-based multinationals who have lower research costs.

The credit is also important because R&D spending is very responsive to the incentive it provides. Economic studies of the credit have found that a $1 reduction in the aftertax price of R&D stimulates approximately $1 of additional private R&D spending in the short-run and about $2 of additional R&D in the long-run.

The credit is important because research and development is about jobs and people. Investment in R&D is ultimately an investment in people, their education, their jobs, their economic security, and their standard of living. Dollars spent on R&D are primarily spent on salaries for engineers, researchers, and technicians. At EDS, over 90 percent of the expenses qualifying for the R&D credit go to salaries for employees directly involved in research.

The second point I would like to address with the Committee is that the credit should be permanent to have the maximum incentive value. Research projects cannot be turned off and on like a light switch. If the credit is to achieve its maximum return in increased R&D activity, the practice of extending the credit for short periods and allowing it to lapse must be eliminated and the credit must be made permanent. Only then will the full potential of its incentive be felt across all the sectors of our economy.

The final point I would like to address with the Committee is that the alternative credit rate should be increased. In 1996, the elective alternative incremental research credit was added, making it available to R&D intensive industries which could not qualify for the credit under the regular criteria. The alternative credit adds flexibility to address changes in business models and R&D spending patterns.

In addition to making the credit permanent, H.R. 835 provides for a modest increase in the alternative credit rates to bring the incentive effect more in line with that provided by the traditional credit. It is important to note that the increase in the alternative credit rates is low cost, does not affect the structure of the current credit, and is the only change endorsed by the Coalition.

In conclusion, making the R&D credit permanent promotes the long-term economic interests of the United States. It will encourage investments that lead to innovative products and processes that contribute to economic growth, increased productivity, new and better U.S. jobs, and higher standards of living for all Americans.

Thank you.

[The prepared statement follows:]

Statement of R. Randall Capps, Corporate Tax Director and General Tax Counsel, Electronic Data Systems Corporation; on behalf of R&D Credit Coalition

Good morning. Mr. Chairman and members of the committee, my name is Randy Capps, and I am Corporate Tax Director for Electronic Data Systems. I would like to thank you for the opportunity to speak with you about the research and experimentation tax credit and to thank you and all the members of the committee who have supported the credit over the years.

I am here this morning on behalf of my company and the R&D Credit Coalition. EDS has been a leader in the global information technology services industry for more than 35 years. Our 140,000 employees deliver management consulting, electronic business solutions, and systems and technology expertise to improve the performance of more than 9,000 business and government clients in approximately 50 countries. EDS reported revenues of $16.9 billion in 1998.

The R&D Credit Coalition is comprised of 53 trade and professional organizations and approximately 1,000 companies of all sizes who rely on the credit to reduce the cost of high risk research. The coalition supports a permanent extension of the credit and a one percentage point increase in the rates of the alternative incremental research credit as called for in H.R. 835. Introduced by Congresswoman Nancy Johnson and Congressman Robert Matsui, this bill currently has 143 cosponsors. An identical bill, S. 680, has 43 cosponsors on the Senate side.

The companies in the Coalition represent a broad range of industries including the information technology, electronics, chemicals, pharmaceuticals, biotechnology, automotive, and manufacturing industries. We are united by our conviction that extending the credit is critical to our companies, our economy, and an enhanced quality of life for all Americans.

My own industry, information technology services, was born out of basic research and is driven by the applied research of hundreds of innovative corporations. This corporate R&D produces a growing range of products and services that are generating productivity increases throughout the economy. The technological revolution that is occurring in my industry is replicated in other industries that participate in the coalition. These industries are reinventing themselves and in the process are creating a broad range of high-paid, high-skilled jobs in the United States.

Last week, the Joint Economic Committee held a high tech summit that included three days of hearings and a hands on demonstration of products and services made possible by corporate R&D. Sixteen companies, including EDS, were part of the R&D exhibit. EDS showcased our Interactive Billing Services which are part of a suite of electronic business applications developed by EDS. The cost of this development was reduced by the credit. We believe the end result will be productivity increases and substantial cost savings for EDS' customers and for our customers' customers.

R&D is the primary source of technological innovation. According to the U.S. Office of Technology Policy, technological innovation has accounted for up to half of U.S. economic growth during the past five decades.

I. R&D CREDIT LEGISLATIVE HISTORY

The R&D credit was enacted in 1981 to provide an incentive for companies to increase their U.S. R&D activities. As originally passed, the R&D credit was to expire at the end of 1985. Recognizing the importance and effectiveness of the provisions, Congress decided to extend it. In fact, since 1981 the credit has been extended nine times. In addition, the credit's focus has been sharpened by limiting both qualifying activities and eligible expenditures. With each extension, the Congress indicated its strong bipartisan support for the R&D credit. Most recently, the Congress approved a one year extension of the credit, until June 30, 1999.

In 1996, the elective Alternative Incremental Research Credit (";AIRC") was added to the credit, increasing its flexibility and making the credit available to R&D intensive industries which could not qualify for the credit under the regular criteria. The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns which are a normal part of a company's life cycle. The sponsors of H.R. 835 and S. 680 recognize the importance of the AIRC. Their legislation, in addition to making the credit permanent, provides for a modest increase in the AIRC rates that will bring the AIRC's incentive effect more into line with the incentive provided by the regular credit to other research-intensive companies.

According to the conference report of the Tax Reform Act of 1986, the R&D credit was originally limited to a five-year term in order "to enable the Congress to evaluate the operation of the credit." It is understandable that the Congress in 1981 would want to adopt this new credit on a trial basis. The credit has long since proven over the seventeen years of its existence to be an excellent, highly leveraged investment of government resources to provide an effective incentive for companies to increase their U.S.-based R&D.

The historical pattern of temporarily extending the credit reduces the incentive effect of the credit. The U.S. research community needs a stable, consistent R&D credit in order to maximize its incentive value and its contribution to the nation's economic growth and sustain the basis for ongoing technology competitiveness in the global arena.

II. WHY DO WE NEED AN R&D CREDIT?

A. *The credit offsets the tendency for under investment in R&D*

The single biggest factor driving productivity growth is innovation. As stated by the Office of Technology Assessment in 1995: "Much of the growth in national productivity ultimately derives from research and development conducted in private industry." Sixty-six to eighty percent of productivity growth since the Great Depression is attributable to innovation. In an industrialized society, R&D is the primary means by which technological innovation is generated.

Companies cannot capture fully the rewards of their innovations because they cannot control the indirect benefits of their technology on the economy. As a result, the rate of return to society from innovation is twice that which accrues to the individual company. This situation is aggravated by the high risk associated with R&D expenditures. As many as eighty percent of such projects are believed to be economic failures.

Therefore, economists and technicians who have studied the issue are nearly unanimous that the government should intervene to increase R&D investment. The most recent study, conducted by the Tax Policy Economics Group of Coopers & Lybrand, concluded that "absent the R&D credit, the marketplace, which normally dictates the correct allocation of resources among different economic activities, would fail to capture the extensive spillover benefits of R&D spending that raise productivity, lower prices, and improve international trade for all sectors of the economy." Stimulating private sector R&D is particularly critical in light of the decline in government funded R&D over the years. Direct government R&D funding has declined from 57% to 36% of total R&D spending in the U.S. from 1970 to 1994. Over this same period, the private sector has become the dominant source of R&D funding, increasing from 40% to 60%.

B. *The credit helps U.S. business remain competitive in a world marketplace*

The R&D credit has played a significant role in placing American businesses ahead of their international competition in developing and marketing new products. It has assisted in the development of new and innovative products; providing technological advancement, more and better U.S. jobs, and increased domestic productivity and economic growth. This is increasingly true in our knowledge and information-driven world marketplace.

Research and development must meet the pace of competition. In many instances, the life cycle of new products is continually shrinking. As a result, the pressure of getting new products to market is intense. Without robust R&D incentives encouraging these efforts, the ability to compete in world markets is diminished.

Continued private sector R&D is critical to the technological innovation and productivity advances that will maintain U.S. leadership in the world marketplace. Since 1981, when the credit was first adopted, there have been dramatic gains in R&D spending. Unfortunately, our nation's private sector investment in R&D (as a percentage of GDP) lags far below many of our major foreign competitors. For example, U.S. firms spend (as a percentage of GDP) only one-third as much as their German counterparts on R&D, and only about two-thirds as much as Japanese firms. This trend must not be allowed to continue if our nation is to remain competitive in the world marketplace.

Moreover, we can no longer assume that American companies will automatically choose to site their R&D functions in the United States. Foreign governments are competing aggressively for U.S. research investments by offering substantial tax and other financial incentives. Even without these tax incentives, the cost of performing R&D in many foreign jurisdictions is lower than the cost to perform equivalent R&D in the U.S.

An OECD survey of sixteen member countries found that thirteen offer R&D tax incentives. Of the sixteen OECD nations surveyed, twelve provide a R&D tax credit or allow a deduction for more than 100% of R&D expenses. Six OECD nations provide accelerated depreciation for R&D capital. According to the OECD survey, the U.S. R&D tax credit as a percentage of industry-funded R&D was *third lowest* among nine countries analyzed.

Making the U.S. R&D tax credit permanent, however, would markedly improve U.S. competitiveness in world markets. The 1998 Coopers & Lybrand study found that, with a permanent credit, annual exports of goods manufactured here would increase by more than $6 billion, and imports of good manufactured elsewhere would decrease by nearly $3 billion. Congress and the Administration must make a strong and permanent commitment to attracting and retaining R&D investment in the United States. The best way to do that is to permanently extend the R&D credit.

C. *The credit provides a targeted incentive for additional R&D investment, increasing the amount of capital available for innovative and risky ventures*

The R&D credit reduces the cost of capital for businesses that increase their R&D spending, thus increasing capital available for risky research ventures.

Products resulting from R&D must be evaluated for their financial viability. Market factors are providing increasing incentives for controlling the costs of business, including R&D. Based on the cost of R&D, the threshold for acceptable risk either rises or falls. When the cost of R&D is reduced, the private sector is likely to perform more of it. In most situations, the greater the scope of R&D activities, or risk, the greater the potential for return to investors, employees and society at large.

The R&D credit is a vital tool to keep U.S. industry competitive because it frees-up capital to invest in leading edge technology and innovation. It makes available additional financial resources to companies seeking to accelerate research efforts. It lowers the economic risk to companies seeking to initiate new research, which will potentially lead to enhanced productivity and overall economic growth.

D. *Private industrial R&D spending is very responsive to the R&D credit, making the credit a cost effective tool to encourage economic growth*

Economic studies of the credit, including the Coopers & Lybrand 1998 study, the KPMG Peat Marwick 1994 study, and the article by B. Hall entitled: "R&D Tax Policy in the 1980s: Success or Failure?" *Tax Policy and the Economy* (1993), have found that a one-dollar reduction in the after-tax price of R&D stimulates approximately one dollar of additional private R&D spending in the short-run, and about two dollars of additional R&D in the long run. The Coopers & Lybrand study predicts that a permanent R&D credit would lead U.S. companies to spend $41 billion more (1998 dollars) on R&D for the period 1998–2010 than they would in the absence of the credit. This increase in private U.S. R&D spending, the 1998 study found, would produce substantial and tangible benefits to the U.S. economy.

Coopers & Lybrand estimated that this permanent extension would create nearly $58 billion of economic growth over the same 1998–2010 period, including $33 billion of additional domestic consumption and $12 billion of additional business investment. These benefits, the 1998 study found, stemmed from substantial productivity increases that could add more than $13 billion per year of increased productive capacity to the U.S. economy. Enacting a permanent R&D credit would lead U.S. companies to perform significantly more R&D, substantially increase U.S. workers' productivity, and dramatically grow the domestic economy.

E. *Research and Development is About Jobs and People*

Investment in R&D is ultimately an investment in people, their education, their jobs, their economic security, and their standard of living. Dollars spent on R&D are primarily spent on salaries for engineers, researchers and technicians.

When R&D results in new products and services, the incentives that support R&D translate into salaries of employees in manufacturing, administration and sales. Successful R&D also means salaries to people in the distribution channels who bring new products to customers and service providers and developers of complementary products. Finally, customers benefit from advances in technology that improve their productivity and ability to compete. By making other industries more competitive, research within one industry contributes to preserving and creating jobs across the entire economy.

At EDS more than 90 percent of expenses qualifying for the R&D credit go to salaries for employees directly involved in research. These are high-skill, high-wage jobs that employ U.S. workers. Investment in R&D, in people working to develop new ideas, is one of the most effective strategies for U.S. economic growth and competitive vitality. Indeed, the 1998 Coopers & Lybrand study shows improved worker productivity throughout the economy with the resulting wage gains going to hi-tech and low-tech workers alike. U.S. workers' personal income over the 1998–2010 period, the 1998 study predicts, would increase by more than $61 billion if the credit were permanently extended.

F. *The R&D credit is a market driven incentive*

The R&D credit is a meaningful, market-driven tool to encourage private sector investment in research and development expenditures. Any taxpayer that increases their R&D spending and meets the technical requirements provided in the law can qualify for the credit. Instead of relying on government-directed and controlled R&D spending, businesses of all sizes, and in all industries, can determine what types of products and technology to invest in so that they can ensure their competitiveness in the world marketplace.

III. THE R&D CREDIT SHOULD BE MADE PERMANENT TO HAVE MAXIMUM INCENTIVE EFFECT

As the Joint Committee on Taxation points out in the Description of Revenue Provisions in the President's Fiscal Year 2000 Budget Proposal (JCS–1–99), "If a taxpayer considers an incremental research project, the lack of certainty regarding the availability of future credits increases the financial risk of the expenditure.” Research projects cannot be turned off and on like a light switch. If corporate managers are going to take the benefits of the R&D credit into account in planning future research projects, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and extended gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital.

In order to increase their R&D efforts, businesses must search for, hire, and train scientists, engineers and support staff. They must often invest in new physical plants and equipment. There is little doubt that a portion of the incentive effect of the credit has been lost over the past seventeen years as a result of the constant uncertainty over the continued availability of the credit.

If the credit is to provide its maximum potential for increased R&D activity, the practice of periodically extending the credit for short periods and then allowing it to lapse, must be eliminated, and the credit must be made permanent. Only then will the full potential of its incentive effect be felt across all the sectors of our economy. No one has said this more forcefully than Federal Reserve Chairman Alan Greenspan who testified at last week’s high technology summit. Chairman Greenspan was emphatic in his conclusion that, if there is a credit, it should be permanent.

IV. CONCLUSION

Making the R&D credit permanent promotes the long-term economic interests of the United States. It will eliminate the uncertainty over the credit’s future and enable businesses to make better long-term decisions regarding investments in research. Private sector R&D leads to innovative products and processes that contribute to economic growth, increased productivity, new and better U.S. jobs, and higher standards of living for all Americans. By creating an environment favorable to private sector R&D investment, a permanent credit will make it easier for U.S. companies to compete effectively in the global economy and help to ensure the growth of high-skill jobs in the United States.

EDS strongly supports the permanent extension of the R&D credit and increasing the AIRC rates by 1 percentage point. The credit expires on June 30, 1999. I urge you to provide a seamless and permanent extension as soon as possible.

Chairman ARCHER. Thank you.
Mr. Bloomfield.

STATEMENT OF MARK BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. BLOOMFIELD. Mr. Chairman, thank you for the opportunity to be here today. For the record, I am Mark Bloomfield, president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our senior vice president and chief economist.

Mr. Chairman, the subject of today’s hearing is tax relief to strengthen the family and sustain a strong economy. A strong economy is necessary to strengthen the family and I will therefore focus my remarks on tax policy to promote competitiveness, growth, and retirement security.

The American Council proposes that if Congress decides to enact a multi-year tax cut, a substantial portion should be dedicated to savings and investment initiatives. We offer as a model two well thought out initiatives enacted since World War II that moved this country toward a tax system suitable for the first post-war period. One was proposed by a Democratic president, the other by a Republican. In our view, the striking characteristic of the Kennedy-Johnson tax cuts of the sixties and the Reagan tax cuts of the eighties is that they were not confined to tax cuts and taxes on consumption, but provided liberal reductions in tax rates on growth-producing savings and investment. Both plans fueled economic growth in succeeding years.

As with the past generations, a major responsibility of today's generation is to lay a strong economic basis for the future.

The question then before all of us is which tax cuts are most effective in enhancing competitiveness, increasing economic growth, and promoting retirement savings? To try to answer that question in anticipation of today's hearing on a 1999 tax bill, the American Council for Capital Formation commissioned five new studies:

One, an analysis of the macroeconomic impact of the 1997 capital tax cuts;

Two, an international survey of death taxes in 24 countries;

Three, an analysis of the impact of the death tax on investment, entrepreneurship, and employment;

Four, an international comparison of the taxation of savings in 24 countries; and

Five, an analysis of pension reform.

We summarized the results of these studies in our written testimony, but would be pleased to discuss them with you in the question period which will follow. Our new studies confirm and our recommended tax cuts address the deleterious impact of the current U.S. Tax Code on savings and investment. Economists agree that the U.S. tax system is strongly biased in favor of consumption and against savings and investment, thus raising capital costs. Indeed, the United States taxes both savings and investment, including U.S. corporate investment and foreign source income, as well as capital gains, dividends, and interest much more harshly than do most of our competitors. This impairs U.S. competitiveness in the world markets.

Also, take note that experts predict that today's Federal budget surpluses may be relatively short-lived. The long-term prosperity of the United States remains threatened by the prospect of looming budget deficits arising from the need to fund the retirement of the baby boom generation in the next century.

Remember, the U.S. savings rate continues to compare unfavorably with those of other countries, as well as with our own past experience. Thus, the American Council for Capital Formation recommends a menu of tax options for you to consider that taken either together or singularly could enhance competitiveness, increase economic growth, and promote retirement security. We have organized this menu into tax cuts for individuals and tax cuts for business. Economically sound tax cuts for individuals include increasing the deductible IRA contribution limit or raising the income level; repealing the death tax; providing a tax-free rollover for reinvested savings; reducing the capital gains tax and providing an annual exclusion for capital gains; increasing pension affordability; establishing personal retirement accounts; providing a deduction for dividends and interest.

Sound tax cuts for business include phasing in expensing for plant and equipment outlays, providing more favorable tax treatment for investment to promote environmental goals, providing relief from the corporate AMT, reforming the foreign tax provisions of the U.S. Tax Code, reducing the corporate capital gains tax, and liberalizing employer-sponsored pension plans.

In conclusion, persistently low U.S. savings rates and investment that in recent decades has lagged behind our industrial competitors, despite continued economic growth and low unemployment, provide real challenges to our country. It is in that context that we strongly urge this Committee to dedicate a significant amount of any multiyear tax cut for competitiveness, growth, and retirement security.

Thank you.

[The prepared statement follows:]

Statement of Mark Bloomfield, President, American Council for Capital Formation

INTRODUCTION

My name is Mark Bloomfield. I am president of the American Council for Capital Formation and I am accompanied by Dr. Margo Thorning, the ACCF's senior vice president and chief economist.

The ACCF represents a broad cross-section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, and well-known business leaders. Our affiliated public policy think tank, the ACCF Center for Policy Research, includes on its board leading mainstream scholars from America's most prestigious universities, as well as prominent public finance experts from the private sector.

Mr. Chairman, we commend you for this timely hearing on tax relief to strengthen families and sustain a strong economy as we prepare to enter the next millennium. The question then becomes which taxes should be cut. For example, some experts are calling for using the surplus to promote social goals such as relief of the "marriage penalty" that often results in married couples paying more federal tax than two single people with the same income levels. Other experts support using the budget surplus to reduce death taxes, capital gains, or marginal income tax rates.

The central theme of the ACCF's testimony is that if the Congress does indeed approve a tax cut, any such cut should enhance competitiveness, increase economic growth, and promote retirement saving.

We would also like to use the opportunity of this hearing to showcase several new research projects that our Center for Policy Research commissioned especially in anticipation of the Ways and Means Committee hearings on this year's tax bill. Specifically, our Center's new research focuses on:

- An analysis by David Wyss, chief economist, DRI, on the macroeconomic impact of the 1997 capital gains tax cuts;
- A new international survey by Arthur Andersen LLP comparing "death" taxes in 24 major industrial and developing countries, including most of the United States' major trading partners;
- An analysis by Professor Douglas Holtz-Eakin, chairman of the Department of Economics at Syracuse University, which analyzes the impact of the current estate tax on capital accumulation, saving, capital costs, investment, and employment, especially employment in the small business sector;
- A comparison by Arthur Andersen LLP of the tax treatment of retirement savings, insurance products, social security, and mutual funds in 24 major industrial and developing countries.
- An analysis of pension reform by Dr. Sylvester Schieber, director of Watson Wyatt Worldwide Research and Information Center and a member of the Social Security Advisory Council.

For our part, if Congress decides to consider a major multi-year tax cut, we offer as a model two well-thought-out tax initiatives enacted since World War II that moved this country toward a tax system suitable for the post-war period. We have the opportunity today to emulate the Kennedy-Johnson tax cuts of the 1960s and the Reagan tax cuts of the early 1980s and, in so doing, put in place a tax system appropriate for the challenges of the new century.

In our view, the striking characteristic of the Kennedy-Johnson and Reagan plans for tax cuts today is that they were not confined to cuts in taxes on consumption but provided liberal reductions in tax rates on growth-producing saving and investment. To be sure, these earlier tax plans included badly needed cuts in marginal income tax rates, but in addition both included sharp reductions in capital gains tax rates. Moreover, the first Kennedy tax cuts (1961–1962) liberalized some business depreciation rates and, of primary importance, created for the first time a tax credit for business investment in equipment. The Reagan tax plan included similar components and also liberalized Individual Retirement Accounts (IRAs).

Both plans fueled economic growth in succeeding years. The Kennedy-Johnson initiative opened the way for the golden economic era of the 1960s, with 4 percent productivity growth until economic overheating set in as a result of sharp increases in deficit spending. Similarly, the Reagan tax cut set the stage for strong economic performance in succeeding years and laid the base for growth in the U.S. economy in the 1990s. One may quarrel about the financing of the Reagan tax cuts and whether there was sufficient balance in the form of spending cuts. Our point is that the tax cuts recognized the essentiality of stronger individual saving and lower business capital costs for investment to foster economic growth.

As with past generations, a major responsibility of today's generation is to lay a strong economic base for future generations. To do so, we should follow the wisdom of these earlier, brilliantly conceived tax plans and ensure that a significant proportion of any tax cut is dedicated to saving and investment initiatives. If we are genuinely concerned about our children, grandchildren, and generations beyond, we should have the discipline to deny a reasonable amount of consumption to ourselves today in order to enhance prospects for growth in the future and to provide retirement security for all. *It is in that context that we strongly urge the Congress to dedicate a significant amount of any multi-year tax cut for competitiveness, growth, and retirement security.*

In advocating this position we do not at all deny the merits of other tax proposals currently advanced. The marriage tax penalty should be corrected over time, and marginal tax rates are far too high and should be reduced. Indeed, lower marginal tax rates will foster economic growth but with less leverage than more direct tax cuts on individual saving and productive business investment. To this end, our testimony suggests a menu of a dozen direct tax cuts to promote pro-growth saving and investment (including investments to reduce pollution and increase energy efficiency in order to address the potential threat of global warming and other environmental concerns).

In essence, the U.S. tax code treats saving (including retirement saving) and investment very harshly. Since saving is essential to investment and growth, this harsh taxation of saving in the United States works against higher living standards for coming generations and may also impair the economic strength that underlies our world leadership position. In addition, our tax code hits saving and investment harder than those of many of our international competitors. The foreign-source income of U.S. multinationals is also subject to higher taxes than that of many of our competitors. All of these facts are of increasing concern as globalization continues.

Tax reform can be carried out through a broad-based restructuring in which consumption, rather than income, becomes the tax base, or it can be accomplished through incremental changes to the current income tax base which reduce the tax burden on various types of saving and on investment. Either type of tax restructuring would enhance U.S. productivity and economic growth and could promote the achievement of environmental goals. Tax reductions, we want to stress, should not come at the expense of fiscal responsibility or reforming social security.

As a predicate to our tax cut proposal to promote competitiveness, economic growth, and retirement security, we would like to set out the intellectual framework for such a plan by first discussing the impact of the current U.S. tax code on saving and investment.

IMPACT OF THE U.S. TAX CODE ON SAVING AND INVESTMENT

TAXATION OF U.S. BUSINESS INVESTMENT

Economists are in broad agreement that the cost of capital for investment is significantly affected by tax policy. The "user cost of capital" is the pretax rate of return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm would be willing to start a new capital project. Stanford University Professor John Shoven, an internationally renowned public finance scholar, estimates that in the United States about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they otherwise would be due to the tax liability on the income produced by the investment. Quite clearly, therefore, the higher the tax on new investment, the less investment that will take place.

Several measures show that the United States taxes new investment more heavily than most of our international competitors. For example, according to a study by the centrist Progressive Policy Institute (the research arm of the Democratic Leadership Council), the marginal tax rate on domestic U.S. corporate investment is 37.5 percent, exceeding that of every country in the survey except Canada (see Figure 1). The tax rate calculations include the major features of each country's tax code, including individual and corporate income tax rates, depreciation allowances, and whether the corporate and individual tax systems are integrated.

Tax rates on foreign-source investment, which are indicators of how much encouragement domestic firms are given to enhance their economic viability by expanding operations abroad, again show the United States falling behind. The U.S. tax rate is 43.4 percent versus an average of 36.7 percent in the other G–7 countries (see Figure 2).

Prior to the 1986 Tax Reform Act (TRA), the United States had one of the best capital cost recovery systems in the world. For example, the present value of the deductions for investing in machinery to produce computer chips and in modern and competitive continuous casting equipment for steel production were close to 100 percent under the strongly pro-investment tax regime in effect from 1981 to 1985, according to a study by Arthur Andersen LLP (see Table 1). In contrast, under current law the present value of the capital cost recovery allowance for that same investment today for computer chips is only 85 percent and for continuous casting equipment is only 81 percent.

The Arthur Andersen study also shows that the United States lags behind many of our major competitors in capital cost recovery for equipment that is technologically innovative, is crucial to U.S. economic strength, or helps prevent pollution. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was approximately 100 percent prior to TRA '86. Under TRA '86, the present value for wastewater treatment facilities dropped to 81 percent. Allowances for scrubbers used in the production of electricity were 90 percent prior to TRA '86; the present value fell to 55 percent after TRA '86. As is true in the case of productive equipment, both the loss of the investment tax credit and lengthening of depreciable lives in TRA raised effective tax rates.

While the Taxpayer Relief Act of 1997 substantially improved cost recovery allowances for corporate alternative minimum taxpayers (AMT), those firms are still disadvantaged relative to firms paying the regular corporate income tax (see Table 1). The AMT limits or delays the benefit of tax code provisions that are based on investment in plant, equipment, research and development, mining, energy exploration and production, pollution abatement, and many others. Companies that have been subject to the AMT since its enactment have accumulated numerous AMT credits. These credits reflect cash that is not available for new productivity-improving investment.

Taxation of U.S. Multinational Firms

A tax reduction plan should also focus on the need of U.S. multinational companies (especially in the industrial and financial sectors) to be competitive and gain market share, both at home and abroad. Such a tax cut could enhance the ability of U.S. firms to compete in global markets by reducing the competitive disadvantages that they face. For example, as a 1997 study sponsored by the ACCF Center for Policy Research showed, U.S. financial service firms face much higher tax rates on foreign-source income than do their international competitors when operating in a third country such as Taiwan (see Figure 3). A 12-country analysis shows that U.S. insurance firms are taxed at a rate of 35 percent on income earned abroad compared to 14.3 percent for French-, Swiss-, or Belgian-owned firms. As a consequence of their more favorable tax codes, foreign financial service firms can offer products at lower prices than can U.S. firms, thereby giving them a competitive advantage in world markets.

Capital Gains Taxation

The ACCF's first new 1999 study, which is on capital gains taxation, was prepared by Dr. David Wyss, chief economist of Standard & Poor's DRI and a top public finance expert, finds that the Taxpayer Relief Act of 1997, which reduced the long-term individual capital gains tax rate from a top rate of 28.0 percent to 20.0 percent has had several favorable impacts on the U.S. economy in the intervening two years. First, the net cost of capital for new investment fell by about 3 percent; other things being equal, this will raise business investment by 1.5 percent per year. Over a 10-year period, the capital stock will rise by 1.2 percent and productivity will increase by 0.4 percent relative to the baseline forecast. Second, a significant share of the increase in stock prices since 1997 (about 25 percent) is due to lower taxes on individual capital gains realizations. Third, Dr. Wyss's analysis shows that when a dynamic rather than a static analysis is used, the stronger growth of the economy adds to total federal tax revenues in the long run. Finally, Dr. Wyss rebuts several new studies which attempt to debunk the importance of lower capital gains tax rates in encouraging start-ups and venture capital.

In spite of the 1997 tax reductions whose favorable economic impacts are documented by Dr. Wyss's new analysis, U.S. capital gains tax rates, which affect the cost of capital and therefore investment and economic growth, are still high compared to those of other countries. In fact, most industrial and developing countries tax individual and corporate capital gains more lightly than does the United States, according to a 1998 survey of 24 industrialized and developing countries that the ACCF commissioned from Arthur Andersen LLP.

Both short- and long-term capital gains on equities are taxed at higher rates in the United States than in most of the other 23 countries surveyed. Short-term gains are taxed at 39.6 percent in the United States compared to an average of 19.4 percent for the sample as a whole. Long-term gains face a tax rate of 20 percent in the United States versus an average of 15.9 percent for all the countries in the survey. Thus, U.S. individual taxpayers face tax rates on long-term gains that are 26 percent higher than those paid by the average investor in other countries. In addition, the United States is one of only five countries surveyed with a holding period requirement in order for the investment to qualify as a capital asset.

Similarly, short- and long-term corporate capital gains tax rates are higher in the United States than in most other industrial and developing countries surveyed. Both short- and long-term gains are taxed at a maximum rate of 35 percent in the United States, compared to an average of 22.8 percent for short-term gains and 19.6 percent for long-term gains in the sample as a whole. In other words, U.S. corporations face long-term capital gains tax rates almost 80 percent higher than those of all but two of the other countries surveyed (Germany [45 percent] and Australia [36 percent], and only four of the 24 countries surveyed impose a holding period in order to be eligible for preferential corporate capital gains tax rates.

TAXATION OF INTEREST AND DIVIDENDS

Interest and dividends received by individuals also are taxed more heavily in the United States than in many other countries, according to the 1998 Arthur Andersen survey of 24 countries. High tax rates on dividends and interest received raise the cost of capital for new investment and slow U.S. economic growth. The top marginal income tax rate is 39.6 percent in the United States compared to an average of 32.4 percent in the countries surveyed as a whole. Nearly 40 percent of the countries surveyed tax interest income at a lower rate than ordinary income; for example, Italy taxes ordinary income at a top rate of 46 percent while its top tax rate on interest income is only 27 percent.

In several countries surveyed, small savers receive special encouragement in the form of lower taxes or exemptions on a portion of the interest they receive. For example, in Germany, the first $6,786 of interest income for married couples filing a joint return ($3,393 for singles) is exempt from tax; in Japan, interest on saving up to $26,805 is exempt from tax for individuals older than 65; in the Netherlands, the first $987 of interest income for married couples ($494 for singles) is exempt from tax; and in Taiwan, the first $8,273 of interest received from local financial institutions is exempt from tax.

Similarly, dividend income is also taxed more heavily in the United States than in the other countries surveyed; the U.S. tax rate is 60.4 percent (combined corporate and individual tax on dividend income) compared to an average of 51.1 percent in the surveyed countries as a whole. Of the countries surveyed, 62.5 percent offset the double taxation of corporate income (the income is taxed at the corporate level and again when distributed in the form of dividends) by providing either a lower tax rate on dividend income received by a shareholder or by providing a corporation with a credit for taxes paid on dividends distributed to their shareholders.

In the case of dividends received, small savers receive preferential treatment in about one-fourth of the countries surveyed. In France, for example, the first $2,661 of dividends on French shares received by a married couple is exempt from tax ($1,330 for singles); in the Netherlands, the first $987 of dividend income for married couples ($494 for singles) is exempt from tax; and in Taiwan, the first $8,273 of dividends from local companies is exempt from tax.

DEATH AND THE U.S. TAX CODE

Many top academic scholars and policy experts conclude that the estate tax should be repealed or reduced because it adds to the already heavy U.S. tax burden on saving and investment. For example, analysis by MIT's Professor James Poterba shows that the U.S. estate tax can raise the cost of capital by as much as 3 percent. The estate tax also makes it harder for family businesses, including farms, to survive the deaths of their founders. The ACCF's second new study, which was compiled by Arthur Andersen LLP, surveys 24 industrialized and developing countries and shows that the top U.S. federal marginal death tax rate is higher than that of all other countries surveyed except for Japan (see Figure 4). Death tax rates imposed on estates inherited by spouses and children average only 21.6 percent for the 24 countries in the study, compared to 55 percent in the United States. (Tax rates are often higher on assets inherited by more distant relatives or by non-relatives). Seven countries Argentina, Australia, Canada, China, India, Indonesia, and Mexico have no death or inheritance taxes. The average marginal top tax rate in the 17 countries with a death tax is only 30.5 percent, which is slightly more than one-half of the U.S. top federal estate tax rate. Not only are U.S. death tax rates higher than those in most of the industrialized and developing world, but the value of the estate where the top tax rate applies is lower. The average value of the estate where the top tax rate applies is over $4 million compared to only $3 million in the United States.

The third new ACCF-sponsored study, prepared by Professor Douglas Holtz-Eakin, chairman of the Department of Economics at Syracuse University, analyzes the impact of the current death tax on capital accumulation, saving, capital costs, investment, and employment.

First, using a sample of data collected by the Public Policy Institute of New York State in May, 1999, Professor Holtz-Eakin notes that there is a negative relationship between anticipated death tax liability and growth in employment, particularly for growing firms. His analysis suggests that at least 15,000 jobs will be lost in New York State over the next five years due to the effect of the estate tax on small firms. Second, the death tax reduces U.S. annual investment by sole proprietors in the range of 2 to 10 percent or almost $45 billion in 1996. Third, the death tax hits hard at entrepreneurs; of the total number of people liable for the estate tax, 48 percent are entrepreneurs. Professor Holtz-Eakin states that the death tax should not be viewed as hitting all savers equally. Instead, the tax hits especially hard at entrepreneurs who are trying to put money into their business. For these individuals, their saving is their investment.

Professor Holtz-Eakin concludes that his study suggests that the estate tax is shifted—forward in time to the business operation and onto factors of production (capital and labor). Since most incidence studies suggest that labor supply bears the incidence of labor taxes and that slower capital accumulation hurts productivity and real wages, this suggests that the estate tax on the "rich and dead" small business owners and entrepreneurs may be in part paid by their far-from-rich and very alive employees.

THE U.S. TAX CODE AND RETIREMENT SECURITY

Experts predict that today's federal budget surpluses may be relatively short-lived phenomena. The long-term prosperity of the United States remains threatened by the prospect of looming budget deficits arising from the need to fund the retirement of the baby boom generation in the next century. In addition, the U.S. saving rate continues to compare unfavorably with that of other nations, as well as with our own past experience; U.S. net domestic saving has averaged only 4.8 percent of GDP since 1991 compared to 9.3 percent over the 1960–1980 period (see Table 2). Though the U.S. economy is currently performing better than the economies of most other developed nations, in the long run low U.S. saving and investment rates will inevitably result in a growth rate short of this country's true potential.

The ACCF's fourth new study is a survey of the tax treatment of retirement savings, insurance products, social security, and mutual funds in 24 major industrial and developing countries, including most of the United States' major trading partners. The survey (also compiled for the ACCF by Arthur Andersen LLP) shows that the United States lags behind its competitors in that it offers fewer and less generous tax-favored saving and insurance products than many other countries. For example:

- Life insurance premiums are deductible in 42 percent of the surveyed countries but not for U.S. taxpayers; for many individuals life insurance is a form of saving;
- Thirty-three percent of the sampled countries allow deductions for contributions to mutual funds for retirement purposes while the United States does not;
- More than half of the countries surveyed allow a mutual fund investment pool to retain earnings without current tax, a provision which increases the fund's assets; the United States does not;
- Thirty percent of the countries with social security systems allow individuals to choose increased benefits by increasing their contributions during their working years; and
- Canada, for example, provides a generally available deduction of up to $9,500 (indexed) yearly for contributions to a private retirement account, compared to a maximum deductible IRA contribution of $2,000 for qualified taxpayers in the United States.

The ACCF's study demonstrates that many countries have gone further than the United States to encourage their citizens to save and provide for their own retirement and insurance needs.

Reform of the Private Pension System

The ACCF's fifth new study, "Improving the Retirement Security System in the United States Through Mechanisms for Added Savings," by Dr. Sylvester Schieber and his colleagues, Richard Joss and Marjorie M. Kulah of Watson Wyatt Worldwide, a prominent pension consulting firm, contends that the U.S. private pension system should be expanded and reformed, particularly for small employers who are responsible for much of the growth in employment in recent years. Pension policy experts contend that long-service, high-income employees of large firms benefit most from the current system. The public interest would be better served, they argue, if pension rules were simpler and easier to administer. For example, complicated and costly rules to prevent "discrimination" discourage employers, especially small ones, from offering pension plans.

Dr. Schieber concludes that all of the elements of the retirement system need to be shored up in order to anticipate the claims the baby boomers will make beginning next decade. In the case of employer sponsored pension plans, most of the policy initiatives undertaken during the last two decades have led to restricted saving through these plans. The long-term implication of this result is that plan sponsors are either going to face higher contribution costs in the future than if they had been allowed to contribute to their plans at historical rates, or they will curtail benefits.

The potential curtailing of benefits from employer-sponsored plans is a direct threat to the retirement security of today's workers. First, Dr. Schieber states it is imperative that employers begin to more effectively communicate to workers the importance and necessity of saving for retirement. Employers should be encouraged to expand existing communications efforts. Second, in the case of employer-sponsored plans, Dr. Schieber advocates further simplification of the multiple funding and contribution limits to which these plans are subject. The funding biases that have skewed plan sponsors toward defined contribution plans should be eliminated. The inconsistencies in public policy that result from a given level of funding resulting in tax penalties for overfunding, on the one hand, and government penalties for underfunding, on the other, should be resolved. Although Dr. Schieber is a strong advocate of employer-sponsored plans and their expanded availability, he recognizes that not everyone has an opportunity to participate in such a plan. For such workers, the playing field should be leveled so they can effectively save on their own through tax-preferred retirement plans.

A TAX MENU FOR COMPETITIVENESS, GROWTH, AND RETIREMENT SECURITY

Those who favor a truly level playing field to encourage saving and investment by individuals and businesses, stimulate economic growth, and create new and better jobs, believe savings (including capital gains) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today. The fact is however that an income tax hits saving more than once—first when income is earned, and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The playing field is tilted away from saving and investment because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no saving took place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in output and living standards is impaired.

While fundamental reform of the U.S. federal tax code continues to interest policymakers, the public, and the business community, the key question is whether a totally new system would be worth the inevitable disruption, cost, and confusion the switch would create. Several recent analyses by academic scholars and government policy experts including University of California Professor Alan Auerbach, Boston University Professor Laurence Kotlikoff, the Joint Committee on Taxation, and the Congressional Budget Office conclude that substituting a broad-based consumption tax for the current federal income tax would have a positive impact on economic growth and living standards. A consumption tax exempts all saving and investment from tax; all income saved is tax-free and all investment is written off, or "expensed," in the first year. As a result, the cost of capital for new investment would fall by about 30 percent.

If, instead of fundamental tax reform, political reality requires an incremental approach to tax reform, the ACCF recommends a menu cut of tax options that, taken either together or singly, could enhance competitiveness, increase economic growth, and promote retirement security. We have organized the menu into tax cuts for individuals and tax cuts for business.

TAX CUTS FOR INDIVIDUALS

- *Increase the deductible IRA contribution and/or raise the income limit*. This step would make IRAs more accessible to middle and upper-middle income individuals and families. Many academic analyses by top public finance scholars indicate that IRAs do produce new saving that would not otherwise take place. An increase in the $2,000 deductible contribution for each employed person to $4,000 and/or raising the income ceiling for deductible contributions to $120,000 for married couples, for example, would tend to raise the personal saving rate.
- *Repeal the federal estate (death) tax*. Many public finance scholars support its elimination because it is a tax on capital and thus reduces the funds available for productive private investment, especially in family-run businesses. The ACCF's two new analyses on the death tax indicate that the death tax is higher in the United States than elsewhere and that the entrepreneurial sector and small businesses are particularly hard hit by the tax.
- *Provide a tax-free "rollover" for reinvested mutual funds, interest, dividends, and capital gains.* Allowing individual savers to make tax-free investments from the proceeds from transactions of this type would significantly increase the mobility of capital and would be a powerful incentive to save.
- *Reduce the individual capital gains tax rate and provide an exclusion*. A significant reduction from the current maximum tax rate of 20 percent would reduce the cost of capital, stimulate investment, and encourage the entrepreneurial activity that is a major source of U.S. economic growth. In addition, an annual exclusion of $5,000, for example, would help encourage saving and reduce the complexity of the tax code by allowing middle income investors to realize a relatively modest amount of capital gains without paying tax.
- *Increase pension portability and access to tax-preferred saving plans*. These reforms would make it more attractive for workers to take part of their compensation in the form of a "nest egg" for retirement than under current law. For example, easing rollover rules to allow employees to transfer between different types of plans and easing benefit transfer rules between qualified plans so employees can move benefits to their new employers' plans would not only increase retirement security but also help productivity growth through not hindering workers from changing jobs among firms and industries. Greater access to and higher ceiling on tax preferred saving accounts such as IRAs would also increase retirement security.
- *Establish personal retirement accounts*. Both the Clinton Administration and members of Congress have proposed using part of the budget surplus to fund personal retirement accounts. Chairman Bill Archer (R–TX) and Rep. Clay Shaw (R–FL) have introduced a proposal that both reforms social security and allows for the creation of individual accounts and the purchase of individual annuities for workers.
- *Provide a deduction for dividends and interest received by individuals*. Exempting, for example, the first $2,000 of dividends and interest received by married taxpayers ($1,000 for singles) is an approach used in many other countries.

TAX CUTS FOR BUSINESS

Comprehensive tax reform, to shift the federal tax base from income to consumption and thus permit the expensing of all investment, would have the strongest impact on capital costs and economic growth. However, more modest tax cuts on investment would also stimulate capital formation and growth.

- *Phase in expensing for plant and equipment outlays*. Scholars agree that expensing is the most efficient way of reducing the cost of capital for new investment. In the period 1981–1985, the United States had one of the best tax treatments for new investment in the world. In today's global economy, U.S. firms need tax parity with foreign firms in order to compete effectively.
- *Provide more favorable tax treatment for investment to promote environmental goals*. Tax credits or other provisions for environmental expenditures required to meet federal, state, and local standards or to enhance energy efficiency would ease the compliance costs facing U.S. industry. In addition, such tax measures would make it easier for capital-intensive manufacturing firms to continue operating their U.S. facilities.
- *Provide relief from the corporate AMT*. Eliminating the myriad of investment-based AMT preference items is essential. Additionally, providing for accelerated use of AMT credits will help alleviate the competitive disadvantage faced by commodity-based industries that are suffering low world prices. It will allow and ensure the long-term growth and competitiveness of basic U.S. industry. Relief efforts must take care not to diminish the value of the credits that have accrued in the past.
- *Reform the foreign tax provisions of the U.S. tax code*. Moving to a consumption tax in which all foreign-source income is exempt from tax (a "territorial" tax) would have a strong positive impact on the international competitiveness of U.S. firms. However, such a fundamental shift in tax policy is not now "on the table." Still, firms' ability to compete abroad could be enhanced through a variety of reforms to U.S. foreign tax provisions. U.S. industrial and financial service firms face higher taxes on their foreign-source income than do their international competitors (see Figures 2 and 3). Reducing the tax burden on the foreign-source income of U.S. firms would be beneficial by allowing them to be more competitive in foreign markets. For example, making permanent the one-year provision that reforms Subpart F of the Internal Revenue Code for financial service firms such as securities firms, insurance companies, banks, and finance companies would be an important step. As a matter of sound tax policy, U.S.-based financial service firms should be able to defer U.S. tax on the active income of their foreign subsidiaries until those earnings are returned to the U.S. parent company.

It is equally important not to impose stringent new tax policies that make U.S. industrial and financial firms less competitive. For example, proposed changes that tighten the foreign tax credit and deferral would put U.S. firms at a further disadvantage.

- *Reduce the corporate capital gains tax rate*. A corporate capital gains tax cut would reduce capital costs and increase investment. Sound tax policy as well as economic considerations argue for a reduction in the U.S. maximum corporate capital gains rate of 35 percent, which is now the same as the top regular corporate tax rate. This would reinstate the historical U.S. treatment of corporate capital gains; an alternative corporate capital gains tax was part of the Internal Revenue Code from 1942 until its repeal by the Tax Reform Act of 1986. Reducing corporate capital gains tax rates would also help move the U.S. tax code toward a consumption tax base by lightening the burden on income from investment.
- *Liberalize employer-sponsored pension plans*. Improvements to employer-sponsored pension plans would increase saving and enhance retirement security. Small employers are often unable to provide pensions for their employees because of the cost and complexity of the system. A tax credit for businesses establishing new plans would be especially helpful to small employers. Creating a simplified defined benefit plan for small employers would promote the retirement security of small-firm employees.

CONCLUSION

Persistently low U.S. saving rates, and investment that in recent decades has lagged behind our industrial competitors despite continued economic growth and low unemployment, underline the need for pro-growth tax policies as a substantial part of any tax bill approved by this Committee. Given the projected budget surplus and the desire of many in Congress to enact a major tax cut for Americans, there is clearly an opportunity to move the U.S. tax system in a pro-growth direction.

We therefore urge Congress to give the most careful consideration to the pro-growth tax provisions discussed here.

Table 1.—International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution Control Equipment

[As a percent of cost]

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crankshafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States:									
1985 Law	100.1	100.1	100.1	100.1	100.1	100.1	100.1	100.1	89.7
MACRS [1]	85.2	85.2	80.8	80.8	80.8	80.8	85.2	80.8	54.5
DAMT [2]	83.0	83.0	77.9	77.9	77.9	77.9	83.0	78.0	54.5
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	76.9	75.9	74.0	73.8	74.2	73.6	85.3	85.3	85.3
Germany	83.6	83.0	82.7	83.9	82.2	83.9	71.8	69.7	68.9
Japan	87.1	86.2	83.4	83.9	81.4	83.7	84.6	83.7	82.4
Korea	88.7	84.3	82.6	80.1	77.7	79.6	95.2	93.9	92.2
Singapore	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7
Taiwan	83.9	78.0	79.0	64.3	63.5	63.7	147.0	147.0	147.0

Notes: 1. MACRS = Modified Accelerated Cost Recovery System (current law) for regular taxpayers.
2. AMT = Alternative minimum tax (current law, Taxpayer Relief Act of 1997).

Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad?" in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, September 1991). Updated by Arthur Andersen LLP, Office of Federal Tax Services, Washington, D.C., January 1998.

Table 2. Flow of U.S. Net Saving and Investment

Percent of GDP in current dollars; national income accounts basis

	Average 1960–1980	Average 1981–1985	Average 1991–1999***
Net private domestic saving	8.1%	8.0%	5.4%
State and local government surpluses	2.1%	1.9%	1.5%
Subtotal of private and state saving	10.2%	9.9%	6.9%
Less: Federal budget deficit	−0.8%	−3.8%	−2.1%
Net domestic saving available for private investment	9.3%	6.1%	4.8%
Net inflow of foreign saving*	−0.4%	1.2%	1.4%
Net private domestic investment	8.9%	7.4%	6.2%
Gross private domestic investment	16.0%	16.9%	14.3%
Nonresidential fixed investment	10.4%	12.2%	9.9%
Producers' durable equipment	6.6%	7.4%	7.1%
Information processing, related equipment, computers, and peripheral equipment	1.6%	3.1%	3.2%
Industrial equipment	1.9%	1.8%	1.6%
Producers' durable equipment less info processing and related equipment	5.2%	5.0%	4.7%
Personal saving	5.4%	5.8%	2.5%
Net business saving**	2.7%	2.2%	2.9%

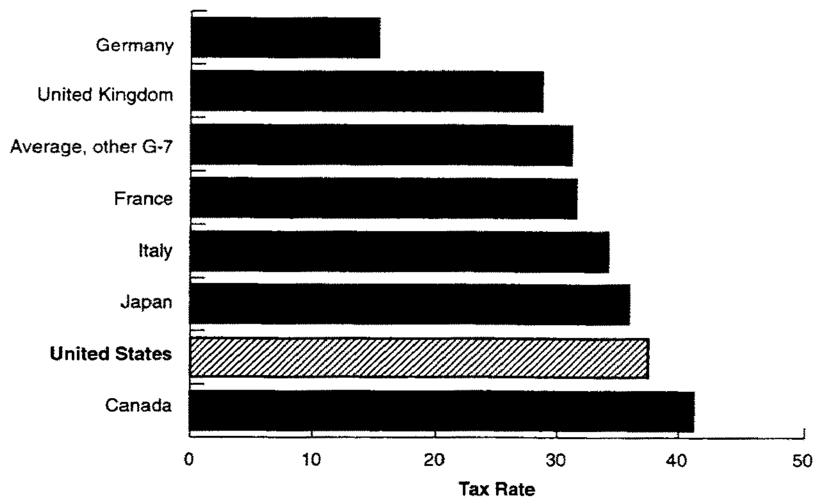
*In the 1960−1980 period, the United States sent more capital abroad than it received; thus net inflow was negative during this period.

**Net business saving = gross private saving − personal saving − corporate and noncorporate capital consumption allowance.

***Preliminary estimates for first quarter of 1999.

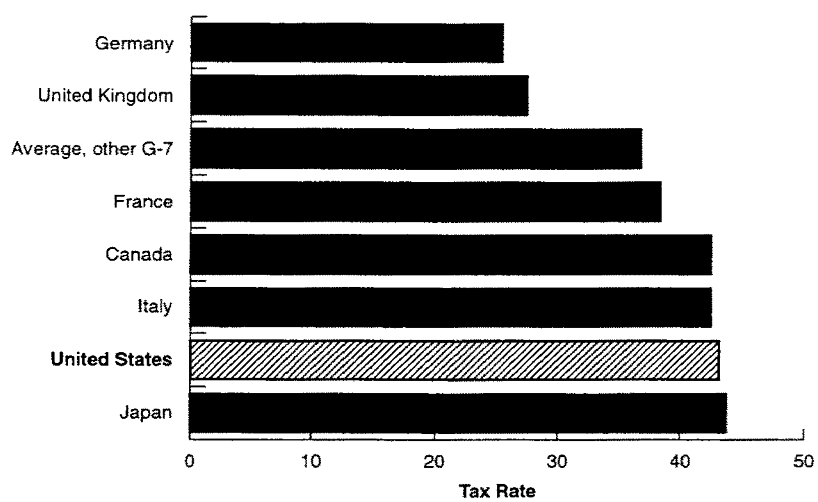
Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by American Council for Capital Formation Center for Policy Research, June 1999.

Figure 1 Effective Tax Rates on Domestic Corporate Investment



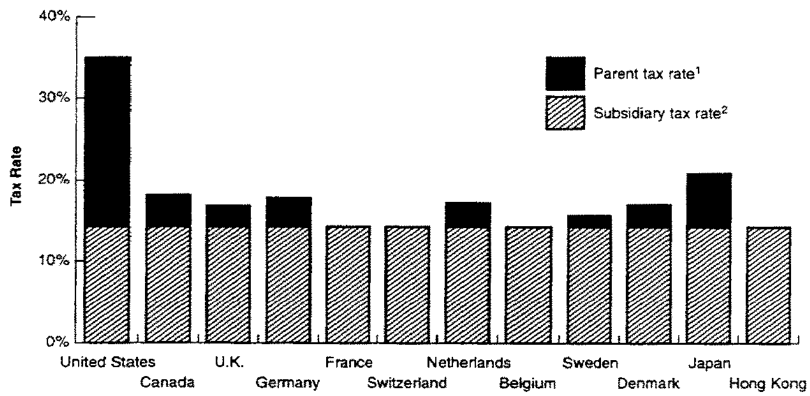
Note: Tax rates include both the corporate and personal income tax on investment.
Source: *Enterprise Economics and Tax Reform* (Washington, D.C.: Progressive Foundation, Progressive Policy Institute, October 1994).

Figure 2 Effective Tax Rates on Foreign Source Investment



Note: Tax rates include both the corporate and personal income tax on investment.
Source: *Enterprise Economics and Tax Reform* (Washington, D.C.: Progressive Foundation, Progressive Policy Institute, October 1994).

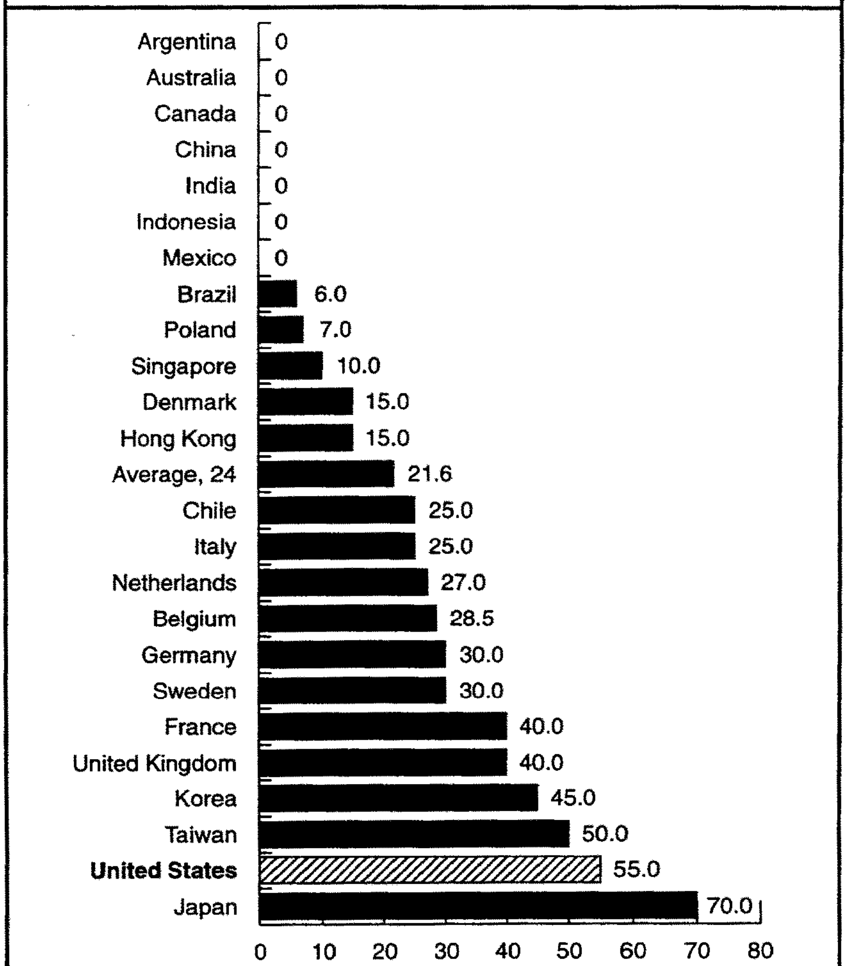
Figure 3 International Comparison of Tax Rates on Foreign Income Earned by Insurance Companies Operating in a Third Country Such as Taiwan
By country of residence of parent company



1. "Parent" means residence country income tax on parent company.
2. "Subsidiary" means local income tax on foreign subsidiary.

Source: Thomas Horst, "The Impact of the U.S. Tax Code on the Competitiveness of Financial Service Firms" (Washington, D.C.: American Council for Capital Formation Center for Policy Research, July 1997).

Figure 4 · International Comparison of Top Marginal Death Tax Rates



Source: "An International Comparison of Death Tax Rates" (Washington, D.C.: American Council for Capital Formation Center for Policy Research, June 1999)

Chairman ARCHER. Thank you, Mr. Bloomfield.
Mr. McCants.

STATEMENT OF LARRY MCCANTS, PRESIDENT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FIRST NATIONAL BANK, GOODLAND, KANSAS; ON BEHALF OF AMERICAN BANKERS ASSOCIATION

Mr. MCCANTS. I would like to commend this Committee and the Chairman for holding hearings to focus attention on domestic tax incentives. As a community banker—first of all, my name is Larry McCants. I am from the First National Bank in Goodland, Kansas, and I am representing the American Bankers Association. And as a community banker, I must point out many of the proposals will help level the playingfield between small taxpaying community banks and tax-exempt credit unions and the farm credit system. I have submitted my full written statement for inclusion in the record and will limit my comments today to that portion pertaining to subchapter S banking.

In order to survive this intensely competitive financial service market, community bankers, such as myself, continue to look for ways to improve efficiencies. Nonbank competitors, such as the farm credit system lenders and the credit unions, enjoy significant tax advantages which make it even more difficult for community banks to compete in their local markets. Therefore, proposals such as improvement and expansion of the subchapter S tax laws for banking institutions are of particular interest to community banks.

The American Bankers Association would like to commend Representatives Scott McInnis, Jim McCrery, and J.D. Hayworth for introducing H.R. 1994, which would further remove unreasonable burdens placed on S corporations.

Our bank, which is an employee-owned bank through our ESOP elected subchapter S status in January 1998. Although over 1,200 FDIC-insured banking institutions and savings institutions have elected subchapter S status. It is important to note that potential tax burdens and strict eligibility standards continue to exist. We strongly urge you to remove many of the competitive barriers and unreasonable burdens placed on S corporation banking institutions in the next tax bill.

We consider the following legislative proposals most significant to community banking:

Number one, tax relief for S corporation banking institutions should include a provision to clarify that interest in dividends on investments held by a bank should not be considered passive investment income. An S election will terminate if, for 3 consecutive years, 25 percent or more of the gross receipts consist of passive investment income. For bank regulatory purposes, a bank must maintain certain types of investments for liquidity. Banks must pledge securities to secure municipal deposits. At certain times of the year, banks may be required to hold excess securities and double pledge for the same deposits as deposits are transferring between municipalities. Bonds issued under H.R. 1660 would be considered passive investment.

The IRS requires an ambiguous and controversial reasonable liquidity needs standard to be met. As a former bank examiner, I can't define "reasonable liquidity," and I can't imagine an IRS agent attempting to make that determination because each bank is different based on its own role in the community. It is unnecessary and inappropriate to impose this limitation on subchapter S banks.

National banking laws and several State statutes also require directors of banks to own certain percentages of bank stock. Legislation is needed to ensure that director qualifying shares will not be considered a second class of stock.

Number three, the proposal to raise current shareholder limit from 75 shareholders to 150 would significantly enhance and promote a healthy small business and banking environment. The current 75-shareholder limit restricts participation in S corporations by local community investors and restricts the ability to raise capital.

I personally had to ask several of my shareholders to sell their shares back to the bank, to our bank holding company in order to qualify for subchapter S treatment.

Number four, S corporation tax relief should expand the category of permitted shareholders to include family limited partnerships and IRAs to assist in retirement and estate tax planning.

And, number five, finally, tax relief is sorely needed to require the Treasury to modify existing regulations to allow bad debt deductions to offset built-in gains income.

I appreciate this opportunity to present the ABA's views, and I would be pleased to answer any questions that you may have later.

And, Congresswoman Johnson, I would specifically like to thank you for your assistance in trying to keep taxes imposed ESOPs.

Thank you.

[The prepared statement follows:]

Statement of Larry McCants, President, Chairman and Chief Executive Officer, First National Bank, Goodland, Kansas; on behalf of American Bankers Association

Mr. Chairman and members of the Committee, I am Larry McCants, Chairman, President and CEO of First National Bank, Goodland, Kansas. I am pleased to appear before you today to present the views of the American Bankers Association (ABA) on providing tax relief to strengthen the family and sustain a strong economy.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

At the outset, I would like to commend you for holding this hearing to focus attention on domestic business tax incentives. There are a number of proposals currently of interest to banking institutions. As a community banker, I must point out that any proposals that help to level the playing field between small, tax paying community banks and ever expanding tax-exempt credit unions are particularly attractive. Banking institutions play a variety of important roles in many of the proposals being discussed in this series of hearings.

My comments today will address a few of the more direct domestic tax proposals with particular emphasis on Subchapter S banking.

SUBCHAPTER S

In order to survive in this intensely competitive financial services market, community bankers, such as myself, must continually look for ways to improve efficiencies, operations and tax savings. Non-bank competitors, such as farm credit system lending institutions and credit unions, continue to enjoy significant tax advantages, which makes it even more difficult for banks to compete in their local communities. Therefore, tax relief measures, such as the improvement and expansion of the subchapter S tax laws for banking institutions, is of particular interest to the community banking industry.

The ABA would like to commend Representatives Scott McInnis (R–CO), Jim McCrery (R–LA) and J.D. Hayworth (R–AZ) for introducing legislation that would help subchapter S banking institutions to compete with tax-exempt and ever expanding credit unions. H.R. 1994, the Subchapter S Reform Act of 1999, would further remove unreasonable burdens placed on S corporations, consistent with congressional intent. We would also like to commend Representative Marge Roukema (R–NJ) for introducing legislation that would improve and expand the subchapter S banking industry.

As you are aware, the Small Business Job Protection Act of 1996 permitted eligible banks, for the first time, to become S corporations beginning in January 1997. My bank, First National Bank of Goodland, Kansas, was one of the first banking institutions to elect subchapter S status in 1997.

The subchapter S tax laws provide a method of taxation for eligible corporations that reduces burdens associated with the imposition of corporate-level taxes. Under the subchapter S regime, shareholders are taxed in a manner that is similar to the taxation of a partnership. Shareholders are taxed on the earnings of the corporation, whether or not such earnings are distributed. Data recently released by the FDIC shows that over 1,200 FDIC-insured banking and savings institutions have elected subchapter S status. This number represents over 10% of the banking industry—primarily community banks seeking to survive in an extremely competitive financial services environment. It is important to note that potential tax burdens and strict eligibility standards continue to exist, thus preventing many banking institutions from taking advantage of this unique tax status. We strongly urge you to include provisions to remove many of the competitive barriers and unreasonable burdens placed on S Corporation banking institutions in the next tax package you enact.

Increase Shareholder Limit From 75 To 150

The ABA supports raising the subchapter S shareholder limit to 150. The Small Business Job Protection Act of 1996 increased the number of eligible subchapter S shareholders from 35 to 75. Many small businesses and banks with 75 or more shareholders are unable to take advantage of subchapter S tax benefits. Raising the shareholder limit to 150 would not only help expand subchapter S to many otherwise eligible small businesses, but would help community banks compete on a level playing field with non-bank competitors. Such a change would significantly enhance and promote a healthy and competitive small business and banking environment.

Allow Individual Retirement Account Shareholders

The ABA supports the expansion of eligible subchapter S shareholders to include individual retirement accounts (IRAs). Under the current tax laws, IRAs are not permissible subchapter S shareholders. The Small Business Job Protection Act of 1996 permitted qualified plans (including ESOPs) and certain tax-exempt entities to become eligible S corporation shareholders. Consistent with Congress' policy of expanding S Corporation ownership to certain tax advantaged plans or entities, IRAs (including Roth IRAs) should be eligible subchapter S shareholders.

Allow Family Limited Partnership Shareholders

The ABA supports allowing limited family partnerships to become eligible subchapter S shareholders. Family limited partnerships are commonly utilized by community bank shareholders. This arrangement is utilized primarily to generate valuation discounts (for estate and gift tax purposes) on the transfer of a limited interest in the partnership. Under current law, partnerships, including limited partnerships, are impermissible subchapter S shareholders. Allowing a specific type of family limited partnership as an eligible subchapter S shareholder would greatly benefit family-owned community banks wishing to convert to subchapter S status.

Exclude Bank Investment Securities From The Passive Income Rules

The ABA supports the proposal to clarify that interest and dividends on investments held by a bank shall not be considered passive investment income. Under current law, an S election will terminate if, for three consecutive years, 25% or more of the gross receipts of an S corporation consists of passive investment income. Further, a corporate-level tax (currently 35%) is imposed on an S corporation on any such excess passive investment income. For bank regulatory purposes, a bank must maintain certain types of investment assets for liquidity and other purposes. Though the IRS addressed subchapter S bank passive income issues in previous regulatory guidance (Notice 97–5) and excluded certain bank assets from the passive income limitations, we believe that it did not go far enough. An ambiguous and controversial "reasonable liquidity needs" standard will be applied by the IRS in determining whether assets not specifically listed are exempt from the passive income tax rules. Such a standard not only undermines a banking regulator's authority to examine and enforce safety and soundness laws, but is unnecessary given the limited amount of investment assets banks are permitted to hold under existing statutes. This provision would exclude bank investment securities from the subchapter S passive income limitations.

TREATMENT OF DIRECTOR QUALIFYING STOCK

The ABA supports the proposal clarifying that qualifying bank director stock shall not be treated as a second class of stock. Under the national banking laws and several state statutes, a director of a national bank is generally required to own a certain percentage of stock in the bank. The OCC allows such stock to be preferred and held through various plans, such as IRAs. Under the subchapter S laws, any stock that confers different economic rights than stock issued to other shareholders is considered an impermissible second class of stock. This provision would ensure that stock that is required to be owned by bank directors will not be considered a second class of stock for subchapter S eligibility purposes.

BAD DEBT CHARGEOFFS TO OFFSET LOAN LOSS RESERVE RECAPTURE

The ABA supports the proposal requiring Treasury to modify existing regulations to allow bad debt deductions to offset built-in gains income during the entire 4-year bad debt reserve recapture period. Under a subchapter S regime, a bank must use the specific chargeoff method of accounting for bad debts. Banks that switch from the reserve method of accounting for bad debts to the specific chargeoff method must take the reserve into income over 4 years (section 481 adjustment). The amount taken into income is treated as an item of built-in gain and subject to a corporate-level built-in gain tax under section 1374 of the Code. A bank's bad debt reserve recapture built-in gain can only be offset by built-in losses realized in the same tax year. Treasury regulations currently only allow bad debt chargeoff deductions to offset built-in gain income in the first year of an S election.

INCLUDE BANKS IN THREE-YEAR RULE UNDER SECTION 1363(B)(4)

The ABA supports the proposal to modify the applicability of the 3-year rule under section 1363(b)(4). Under section 1363(b)(4), corporate preference items under section 291 (including special bank disallowance or cutback items) apply only during the first three years of an S corporation that converted from a C corporation. The tax laws do not specify whether this three-year rule applies to banks that are treated as QSubs. The Small Business Job Protection Act of 1996 permitted S Corporations to hold QSub subsidiaries. Under the subchapter S tax laws, QSubs are disregarded for tax purposes and treated as a division of the parent. Most subchapter S banks operate in a holding company structure and elect QSub status for their bank subsidiaries. A technical reading of the statute excludes QSubs because it only refers to S corporations (or any predecessor) that was a C corporation.

CAPITAL GAINS

The American Bankers Association supports the enactment of legislation to reduce the tax rate on capital gains. We believe that capital gains tax relief is necessary in order to increase capital formation, stimulate saving and investment, raise real wages for U.S. workers and boost economic growth in the U.S.

A reduction in capital gains tax rates would encourage domestic investment, particularly venture capital investments by financial institutions, by lowering the excessively high cost of capital. A broad based reduction would benefit a wide variety of income groups and economic sectors, including retirees, middle income families, large and small investors, businesses, farmers, and entrepreneurs. The banking industry continues to promote savings and investment. Reducing the capital gains tax rate would "unlock" capital assets, lower interest rates and spur the economy, resulting in raising federal revenues.

LOW-INCOME HOUSING TAX CREDIT

The ABA supports the proposal to raise the $1.25 per capita cap to $1.75 per capita. This dollar value has not been increased since it was first set in the 1986 Act. Since that time the Consumer Price Index for All Items has increased by 50%. That is, $1.25 in 1986 dollars is worth only $.63 today. Adjustment for inflation would yield an amount slightly in excess of $1.75. Raising the cap would assist in the development of much needed affordable rental housing in all areas of the country.

EDUCATIONAL ASSISTANCE

The ABA supports the permanent extension of tax incentives for employer provided education. The banking and financial services industries are experiencing dramatic technological changes. This provision will assist in the retraining of employees to better face global competition. Employer provided educational assistance is a central component of the modern compensation package and is used to recruit and retain vital employees.

RESEARCH AND EXPERIMENTATION TAX CREDIT

The ABA supports the permanent extension of the tax credit for research and experimentation. The banking industry is actively involved in the research and development of new intellectual products and services in order to compete in an increasingly sophisticated and global marketplace. The proposal would extend sorely needed tax relief in this area.

QUALIFIED ZONE ACADEMY BONDS

The ABA supports the proposals to authorize the issuance of additional qualified zone academy bonds and school modernization bonds and to modify the tax credit bond program. The proposed changes would facilitate the usage of such bonds by financial institutions in impacted areas.

CONCLUSION

The ABA appreciates having this opportunity to present our views on providing tax relief to strengthen the family and sustain a strong economy. We look forward to working with you in the future on these most important matters.

Chairman ARCHER. Thank you, Mr. McCants.
Mr. Greenberg.

STATEMENT OF ARTHUR GREENBERG, COUNSEL, EQUITY GROUP INVESTMENTS, CHICAGO, ILLINOIS, ON BEHALF OF NATIONAL REALTY COMMITTEE, NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, NATIONAL ASSOCIATION OF REALTORS, NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PROPERTIES, INTERNATIONAL COUNCIL OF SHOPPING CENTERS, NATIONAL MULTI-HOUSING COUNCIL/NATIONAL APARTMENT ASSOCIATION, AND BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Mr. GREENBERG. Thank you, Mr. Chairman. Mr. Chairman, Members of the Committee, my name is Arthur Greenberg. I am associated with Equity Group Investments, a real estate investment company headquartered in Chicago, Illinois. I also serve on the Tax Policy Committees of the National Realty Committee and the National Association of Real Estate Investment Trusts. I am also testifying today on behalf of the National Association of Realtors, the National Association of Industrial and Office Properties, the International Council of Shopping Centers, the National Multi-Housing Association, the National Apartment Association, and the Building Owners and Managers Association International.

Real estate is a critically important sector of our economy, generating almost 20 percent of the nation's gross domestic product and accounting for nearly nine million jobs. The aggregate value of the Nation's real estate stock, land, buildings, and improvements is over $20 trillion. Economic growth and real estate go hand-in-hand. Clearly, real estate should be included in any consideration of tax relief legislation designed to sustain economic growth.

The real estate industry is not here seeking tax incentives today. Rather, we are seeking tax changes that reflect the economics of today's real estate transactions and treat real estate fairly relative to other investments.

Our written statements present a number of tax changes we support, but because of the time, let me highlight three of them in this presentation.

The first is H.R. 844, legislation to provide a 10-year depreciation class life for leasehold improvements, sponsored by Mr. Shaw and 34 other Members of the Committee. Leasehold improvements are the build-outs an owner does in order to customize leased space for a business tenant. Most leases, and the improvements made pursuant to them, typically last less than 10 years. Writing off the cost of these improvements over 39 years, while the rental income is received over the lease term, increases the cost to the owner providing these improvements. The result is the amount and quality of the improvements will be compromised.

Who would benefit as a result of H.R. 844? Certainly, the tenant, who would receive the most efficient and modern space available for his business, as all businesses rely on their business space to be productive and competitive. In addition, small business would benefit because their space needs to evolve extremely rapidly and almost 80 percent of building owners are small businesses themselves. In addition, H.R. 844 would also aid community revitalization by removing a tax impediment to improving and revitalizing the buildings that make up that community.

The second issue I want to highlight is H.R. 1616, the REIT Modernization Act, sponsored by Representatives Thomas and Cardin and cosponsored by over two-thirds of the Committee's Members. This bill would modernize the REIT rules to allow REITs to remain competitive by permitting a REIT to establish a fully taxable service subsidiary. The real estate industry has been evolving rapidly into a consumer-oriented service business. The current REIT rules make it difficult for REITs to compete with others in the marketplace by limiting a REIT's ability to provide leading edge services to its tenants and use its expertise to serve as third parties. H.R. 1616 allows REITs the ability to respond to the evolving needs of their tenants and importantly, the bill contains a number of rules designed to ensure that the income generated by the service subsidiary is taxed at the level before being passed on to the REIT.

The third issue I would like to address is the capital gains and the treatment of recaptured depreciation. Low capital gains rates are important to unlocking investments and allowing capital to flow more freely and productively. Therefore, a further rate reduction would be welcome. However, to be meaningful to real estate, the depreciation recapture must be lowered as well. We support H.R. 2054, Mr. English's bill proposing to reduce the recapture rate to the capital gains rate, the same treatment that applied prior to the 1997 Tax Act. At a minimum, we believe the 25 percent depreciation recapture rate should be reduced proportionately with any reduction in the capital gains rate. Otherwise, real estate would be much further disadvantaged relative to other investment assets such as stock.

In the case of real estate, sales proceeds over the adjusted tax bases of the property in most cases is a result of appreciation in the property, not overly generous depreciation deductions. Several factors contribute to appreciation and the overall value of the property. These include inflation, land values, road and other transportation improvements, the economy, and local market conditions.

In conclusion, Mr. Chairman, we believe that these tax items: reforming depreciation for leasehold improvements, modernizing the REIT operating rules, and lowering both the capital gains and depreciation recapture rates together with the other items in our written statement will help sustain the economy, promote competitiveness, and create jobs. In particular, I want to point out one of the other items which we support is the provision in Mrs. Johnson's bill, H.R. 2020, allowing the deductibility of brownfield clean-up expenses. This would help community revitalization and in-fill development across the country.

Thank you for your time. I will be pleased to answer any questions you may have.

[The prepared statement follows:]

Statement of Arthur Greenburg, Counsel, Equity Group Investments, Chicago, Illinois; on behalf of National Realty Committee, National Association of Real Estate Investment Trusts, National Association of Realtors, National Association of Industrial and Office Properties, International Council of Shopping Centers, National Multihousing Council/National Apartment Association, and Building Owners and Managers Association International

Chairman Archer and Members of the Committee, the above mentioned real estate organizations [1] appreciate the opportunity to testify before the Committee on Ways and Means regarding tax relief to strengthen the family and sustain a strong economy. We applaud the Committee's effort to enact broad-based tax relief and look

[1] *National Realty Committee (NRC)* serves as Real Estate's Roundtable in Washington for national policy issues vital to commercial and income producing real estate. NRC Members are America's leading real estate owners, advisors, builders, investors, lenders and managers. NRC offices are located at 1420 New York Avenue, NW suite 1100, Washington DC 20005, 202–639–8400.Contact: Stephen M. Renna.

National Association of Real Estate Investment Trusts (NAREIT) is the national trade association of the REIT industry. NAREIT's members are public and private REITs, and professionals with an interest in the REIT and the real estate investment industries. NAREIT is located at 1875 Eye Street, NW Suite 600, Washington, D.C. 20006, 202–739–9400. Contact: Tony Edwards.

National Association of Realtors (NAR) is comprised of brokers, agents, property managers, counselors and others involved in all aspects of the real estate industry. About three-fourths of NAR's 730,000 members are involved in residential real estate. NAR is located at 700 11th Street, NW, Washington, DC 20001, 202–383–1000. Contact: Linda Goold.

National Association of Industrial and Office Properties (NAIOP) is provides developers and owners of industrial, office and related commercial properties with effective support to create, protect and enhance property values. Through chapters nationwide, NAIOP facilities communication, networking and provides a forum for continuing education and promotes effective grassroots public policy related to real estate development. NAIOP is headquartered at Woodland Park, 2201 Cooperative Way, Herndon, VA 20171, 703–904–7100. Contact: Mele Williams.

International Council of Shopping Centers (ICSC) is the trade association of the shopping center industry. Its 32,000 members in 60 countries represent owners, developers, retailers, lenders and all others having a professional interest in the shopping center industry. ICSC's Washington office is located at 1033 North Fairfax Street, Suite 404, Alexandria, VA 22314, 703–549–7404. Contact: Wayne Mehlman.

The National Multi Housing Council (NMHC) and National Apartment Association (NAA) represent the majority of the nation's firms participating in the multifamily rental housing industry. NMHC and NAA's combined memberships are engaged in all aspects of the development and operation of apartment communities, including ownership, construction, finance, and management. NMHC and NAA operate jointly a federal legislative program. NMHC is headquartered at 1850 M Street, NW, Suite 540, Washington, DC 20036, 202–659–3381. NAA is located at 201 North Union Street, Alexandria, VA 22314, 703–518–6141. Contact: James Arbury.

Building Owners and Managers Association International (BOMA) is a federation of 85 United States, 10 Canadian and 5 international associations representing over 6 billion square feet of North American office space. BOMA's purpose is to represent the interests of the commercial real estate industry on policy matters, and to collect, analyze and disseminate information. BOMA is headquartered at 1201 New York Avenue, NW, Suite 300, Washington, DC 20005, 202–408–2662. Contact: Gerald Lederer.

forward to working with you Mr. Chairman and with all the committee members on upcoming tax legislation.

Real estate taxation is comprehensive and complicated. There are many changes that should or could be made to this broad area of taxation. However, we have chosen to focus our testimony on the following limited number of initiatives that we believe have broad consensus throughout the industry and are important to sustaining a strong national economy:

- H.R. 844, legislation to provide a 10 year depreciation class life for leasehold improvements.
- H.R. 1616, the REIT Modernization Act.
- A reduction in the depreciation recapture tax rate that is at least proportionate to any reduction in the capital gains tax rate.
- Deductibility of brownfield cleanup expenses as provided in H.R. 2020.
- Modification to the closely held REIT rules only to the extent necessary to address clearly identified and substantiated tax avoidance transactions.
- Modification to the "at-risk" rules to allow publicly traded real estate debt to come under the "qualified nonrecourse financing" exception.

BACKGROUND

Real Estate and the U.S. Economy

Millions of Americans share in the ownership of the nation's real estate—those who own homes, those who own buildings in which they operate their businesses and those who invest directly or indirectly in real estate. Commercial and residential real estate assets constitute almost half of the nation's domestic investment. No tangible capital asset is more important to the U.S. economy than real estate.

Real estate represents about 20 percent of America's gross domestic product and accounts for nearly 9 million jobs. About $293 billion in federal state and local tax revenues is generated annually by real estate and almost 70 percent of all tax revenues raised by local governments come from real property taxes. Unquestionably, real estate is a direct, vital and major contributor to the nation's economy.

The impact of real estate on the nation's economic health and welfare is further complemented by the role it plays in providing the space in which Americans live, work, shop, recreate, learn, worship and heal. Real estate enhances our quality of life and is vital to the nation's productivity.

State of the Real Estate Industry

Today's real estate markets, as a whole, are in overall good health. Interest rates and inflation are low and availability of capital and credit is good. Furthermore, housing demand for multi-family and single homes is good and work and shopping space, in most regions, is at a high level of occupancy.

However, the current healthy status of real estate can be affected quickly and dramatically as demonstrated by the financial crisis that erupted last summer in Japan and Russia. The international credit crisis brought about by the faltering economies of these countries led to a near shut-down of the commercial mortgage-backed security (CMBS) market as anxious investors stood on the sidelines forcing yield spreads to widen to the point that no debt placements were being made. This occurred despite the underlying fundamentals of real estate investment remaining strong. Clearly, this was a financial crisis, not a real estate crisis, but real estate was nonetheless seriously affected. Fortunately, investor worries have eased and the credit markets are returning to normal. Nevertheless, some residual effects remain; particularly among public real estate investment trusts (REITs) whose stock prices plunged by double-digit amounts and have yet to fully recover.

Interest rates similarly can affect the course of the real estate industry. The anticipated increase in interest rates in response to inflation concerns will have a direct impact on all real estate from coast to coast as the cost of buying or owning a home, apartment building, office buildings, shopping center or warehouse will increase.

Real estate also is affected by its tax treatment. The turmoil in the industry created by the tax changes of the Tax Reform Act of 1986 is evidence of this. Real estate tax laws should bear a rational relationship to the economics of the real estate transaction. In cases where certain social results are clear, such as homeownership and affordable low-income housing, tax laws should help bring about such results. They also should not unduly restrict the ability of investment real estate owners to respond to changing economic and market conditions—an ability critical to the competitiveness of any investment asset.

SUMMARY OF PROPOSED REAL ESTATE TAX CHANGES

We urge the committee to include the following tax proposals in the broad-based tax relief legislation soon to be considered. We want to be clear that these are not all the real estate tax proposals supported by the above-mentioned real estate organizations. However, they do reflect those proposals of the highest priority and those that have the broad, collective support of the real estate industry.

Ten Year Depreciation for Leasehold Improvements (H.R. 844, S. 879)

As a function of doing business, most owners of office, retail and other commercial rental real estate must routinely reconfigure, change or somehow improve their rental space to suit the needs of new or existing tenants. H.R. 844, introduced by Representative Shaw with 91 bipartisan cosponsors including 32 Members of the Committee, would reduce the depreciable recovery period for leasehold improvements from the current 39 years to 10 years. This would more closely align the expenses incurred to construct these improvements with the income they generate during the lease term.

Enacting H.R. 844 would help make buildings more modern and efficient for business tenants and help businesses stay competitive. Small businesses particularly would benefit by H.R. 844 since their rapid growth rate often results in rapidly changing space needs. Further, an overwhelming percentage of building owners (80 percent) are small businesses. The bill also would help maintain the vitality of buildings and buildings are a main contributor to the overall vitality of neighborhoods and communities. By helping maintain and improve existing space, H.R. 844 would ease pressure to develop new buildings which is contributing to the "sprawl" problems in many communities across the country.

Current leasehold improvement depreciation rules clearly do not make economic sense. The owner receives taxable income produced by leasehold improvements over the life of the lease (i.e. 10 years) yet can only recover his costs for building those improvements over 39 years—nearly a rate four times slower. This mismatch of income and expenses causes the owner to incur an artificially high tax cost on these improvements.

For example, a building owner who makes a $100,000 leasehold improvement for a 10-year, $1 million lease would be able to recover his entire investment by the end of that lease at a rate of $10,000 a year. Under current law, this $100,000 improvement is recovered at a rate of $2,564 per year over 39 years. By reducing this cost recovery period, the expense of making these improvements would fall more into line with the economics of a commercial lease transaction, and more property owners would be able to adapt their buildings to fit the demanding needs of today's modern business tenant. Small business should find this bill particularly helpful. Small businesses turn over their rental space more frequently than larger businesses and over 80 percent of building owners who provide space to small businesses are small businesses themselves.

Also, the longer an existing building remains viable for tenants who need modern, efficient commercial space, the less pressure on property owners to develop greenfields in outlying suburban areas and the less growth impact on communities. This is particularly significant in light of the fact that Americans are increasingly concerned about preserving open space, natural resources and a sense of neighborhood. Current 39 year leasehold depreciation is an impediment to reinvesting in existing properties and communities and therefore contributes to the development of new properties and what is commonly known as "sprawl." This legislation would remove that tax impediment and help to level the tax playing field for new development and redevelopment.

Additionally, a recently issued Congressional Research Service (CRS) report entitled "Depreciation and the Taxation of Real Estate" by Jane G. Gravelle lends support to the merits of, and justification for, H.R. 844. The report concludes that depreciation of nonresidential structures is more restrictive today than at any time since 1953, while depreciation on residential structures is more restrictive than it has been since 1971. It also finds that the tax burden on structures is higher than that on equipment. In fact, in order to equalize the effective tax rates between equipment and office and apartment structures, a depreciation life of 20 years would be required. In the case of factory buildings, a life of 17 years would be required.

Finally, S. 879 is the companion bill to H.R. 844. Introduced by Senators Conrad, Mack Nickles, Robb and Baucus, it currently has 12 bipartisan cosponsors. We believe the broad, bipartisan cosponsorship and support for H.R. 844 and S. 879 justifies their inclusion in the respective tax bills drafted by this Committee and the Senate Finance Committee.

REIT MODERNIZATION ACT (H.R. 1616, S. 1057)

Based in part on the rationale for mutual funds, Congress created REITs in 1960 to allow people of all means to invest easily and effectively in income-producing real estate. A REIT is essentially a corporation or business trust combining the capital of many investors to own, operate, and/or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses. Like a mutual fund, a REIT may deduct all dividends paid to its shareholders provided that its assets are primarily composed of real estate held for the long term, its income is mainly derived from real estate, and it distributes most of its taxable income to shareholders. In addition to benefiting investors, the lower debt levels associated with REITs have had a positive effect on the economy.

Subsequent positive changes made by Congress over the almost 40 years since the enactment of the original REIT rules have helped to make the REIT industry a vibrant part of today's publicly traded real estate market. However, the real estate industry rapidly has been evolving into a customer-oriented service business. The current rules governing the REIT industry make it difficult for REITs to compete with others in the marketplace by limiting a REIT's ability to provide leading edge services to its tenants and to use its expertise to serve third parties.

Building on a similar proposal contained in the Administration's budget package, H.R. 1616, co-sponsored by over two-thirds of the members of the Ways and Means Committee, would modernize the REIT rules to allow REITs to remain competitive by satisfying customer demand. H.R. 1616 would permit a REIT to own up to 100% of a taxable REIT subsidiary ("TRS") that could provide "non-customary" services to its tenants and to provide services to third parties, thus enabling REITs to be in a better position to attract and retain top-quality tenants, maintain better quality control over the services rendered to their tenants, and produce greater customer loyalty. The TRS would be fully subject to a corporate-level tax as well as to a number of rules designed to prevent any inappropriate shifting of income between the parent REIT and the subsidiary company. H.R. 1616 also would modernize several other important rules applicable to REITs, such as reducing a REIT's distribution requirement to 90%.

Given the breadth of the support for REIT modernization and the legislation's importance to the continuing competitiveness of the publicly traded real estate industry, we encourage you to include H.R. 1616 in the Chairman's mark.

CAPITAL GAINS RATE REDUCTION AND DEPRECIATION RECAPTURE

In the context of the current tax debate, a number of policymakers in Congress have expressed interest in reducing capital gains taxes in order to sustain economic growth and generate additional revenues. Lowering the capital gains rates would further "unlock" assets and allow capital to flow more freely and productively. Historically, the real estate industry has favored low capital gains rates and would welcome further rate reduction. However, further capital gains rate reduction raises the important issue of depreciation recapture. If Congress chooses to enact a capital gains rate cut in 1999, we believe the appropriate action to take is to reduce the depreciation recapture rate to the same rate as the capital gains rate. At a minimum, the depreciation recapture rate should be reduced proportionately.

In 1997, Congress revamped the capital gains regime applicable to real estate that had been in place since 1963. From 1963 until the 1997 changes, when an income-producing property was sold, the aggregate of previously allowed depreciation deductions was taken back into income (or "recaptured"). If the owner had used the straight-line method of depreciation for recovering the costs of the property, then the recapture amount was taxed at capital gains rates. (During any periods between 1963 and 1986 when accelerated depreciation had been an allowable method, the accelerated method resulted in ordinary income treatment for depreciation recapture amount. Since 1986, however, accelerated depreciation has not been an allowable method for real estate.) Another way of describing this treatment was that the gain above adjusted basis was treated as a capital gain.

In 1997, Congress overturned this long-standing regime. Since 1997, the gain above the adjusted basis of real property has been broken into two elements. All previously allowed depreciation allowances (even straight-line) are taxed at 25% (representing neither ordinary income nor capital gains). Only the gain above the original purchase price (plus improvements) is taxed at capital gains rates of 20%. Thus, since 1997, the effective rate of tax on any sale of income-producing real estate has been higher than the 20% capital gains rate applicable to sales of most other capital assets.

Taxing recapture amounts at rates higher than capital gains rates implies that depreciation allowances have been taken in amounts in excess of economic depreciation, or that the depreciation allowance has been overstated. We disagree. The "gain" on the sale of real estate often is due to extrinsic factors—not excessive tax depreciation. The building itself does, in fact, depreciate over time like any other wasting asset. Real estate is very capital and maintenance intensive as the building shell and interior components constantly deteriorate and wear out requiring their upgrading or replacement.

Gains in real estate often are attributable to inflation, appreciation in the value of the land, road and other transportation improvements and the marketplace and economy in general. Applying a recapture rate to this appreciation higher than the capital gain rate is inappropriate because the appreciation is capital gain. Such treatment would discriminate against real estate relative to other assets and put real estate at an even greater competitive disadvantage for investment dollars

The recent CRS study on depreciation by Jane Gravelle cited above supports this position. The study shows that the cost recovery period for real estate is unduly long. It concludes that, in order to be treated on a par with investment in equipment, the cost recovery period for real estate should be reduced to 20 years. The 1997 depreciation recapture changes exacerbated the disparity in tax treatment between real estate and other assets. Another reduction in the capital gains rate without, at a minimum, the proportionate reduction in the recapture rate, would make this disparity even more pronounced.

We urge Congress, therefore, to be mindful of the recapture implications created by further capital gains rate reduction. We believe revisiting the capital gains issue presents an opportunity to redress the inappropriate recapture treatment imposed in 1997. At a minimum, Congress should act to ensure that that real estate is not further disadvantaged relative to other assets by making reductions in capital gains and depreciation recapture rates proportionate.

Deductibility of Brownfield Cleanup Expenses

Brownfield properties, once the source of jobs and tax revenue for hundreds of communities across the U.S., are often stigmatized by a legacy of environmental contamination and cleanup liability. Encouraging investors to purchase and remediate an estimated 400,000 mildly polluted yet potentially renewable industrial sites not only makes good economic and business sense, it makes for good neighborhoods. Yet, only a handful of these troubled properties have been restored. Why? One reason is the lack of clear federal guidelines to relieve innocent parties from the prospect of unlimited legal liability for cleaning up contamination that they had no role in creating. Another reason is a federal tax system that creates economic disincentives for businesses that might otherwise consider rehabilitating brownfields.

Unless a brownfields site is located in a federally targeted empowerment zone, the costs of cleaning up contaminants must be capitalized and added to the cost of the land rather than deducted in the year they are incurred. Capitalized costs can only be recovered when the property is sold. Long term holding of real estate results in minimal, if any, effective recovery of these costs. Depending on the extent and type of contamination, these costs can be substantial.

The 1997 Taxpayer Relief Act provided immediate expensing of brownfield cleanup costs in empowerment zones and other high poverty targeted areas. This tax treatment should be extended to non-targeted areas as well. Therefore, we support the urban revitalization provision in H.R. 2020, introduced by Representative Nancy Johnson (CT), which would allow the expensing of brownfield cleanup costs. Other Members of the Committee, such as Mr. Weller and Mr. Neal also have supported improved tax treatment of brownfield cleanup expenses. If full deductibility cannot be provided, then, at a minimum, a rapid amortization period such as 60 months should be provided. Requiring that these costs be capitalized to the basis of the land is a disincentive to acquisition and redevelopment. Removing this tax impediment would allow for more infill development and revitalization of existing properties. This would contribute to revitalization of existing communities and help ease the pressure to build new properties on greenfields.

Modifications to Closely-held REIT Rules

We understand that the Committee is reviewing a Clinton Administration proposal to modify the closely held REIT rules in light of recent high profile tax avoidance transactions that involved closely held REITs.

The capitalization of real estate through REITs that has occurred in the 1990s has been an important factor in the recovery of the real estate industry which itself is making a significant contribution to the strength of the overall economy. We are concerned with the impact the Administration's closely held proposal could have on capital flows to real estate and the potential resulting negative effect on asset values and jobs. We believe the Administration's proposed prohibition on all closely held REITs is overly broad and unnecessary to prevent improper tax avoidance.

The highly visible "step-down" preferred and liquidating REIT transactions do not represent all, or even most, uses of the closely held REIT. In fact, most of the uses of closely held REITs that we are aware of are quite legitimate and play an important role in the capitalization of real estate by domestic and foreign capital sources.

Legitimate uses of closely held REITs include, for example, REITs owning other REITs (which the Administration's proposal properly acknowledges) and incubator REITs. Incubator REITs are closely held REITs that serve as precursors to publicly held REITs. Incubator REITs that have developed into publicly held REITs have created jobs and resulted in additional revenue to Treasury through taxes paid on dividends.

Domestic and foreign partnerships, mutual funds, pension or profit-sharing trusts or other pass-through entities also should not be counted as one entity in determining whether any "person" owns 50 percent or more of the vote or value of a REIT. Partnerships, mutual funds and other pass-through entities are usually ignored for tax purposes and, therefore, the owners of these entities, be they partners, shareholders or beneficiaries, should be considered the "persons" owning a REIT.

Also, joint ventures between private and public REITs recently have taken on heightened importance. In present market conditions, depressed stock prices hamper the ability of many public REITs to go back to the stock market to raise equity capital. Many of these same REITs want to limit borrowings under their lines of credit to maintain, or improve, their investment grade ratings. They, therefore, are relying on privately structured joint ventures with closely held REITs to raise equity in order to complete new transactions and to grow.

In many cases, a third party investor owns a majority share of the closely held REIT. Although the Administration's proposal would allow a REIT to own another REIT, such ownership effectively would be limited to REITs that meet the ownership requirements of the proposal. This would have a material adverse impact on the ability of public REITs to tap into the much needed alternative source of capital provided by joint ventures with closely held private REITs.

Therefore, as you review the closely held REIT rules, we recommend that you refrain from enacting broad-based prohibitions such as that proposed by the Administration. We further recommend that, at a minimum, the legitimate uses of closely held REITs be allowed to continue under any modification of the closely held REIT rules.

Modify the "At-Risk" Rules to Treat Publicly Traded Debt as Qualified Nonrecourse Financing

The "at-risk" rules of Section 465 were extended to real estate in the 1986 Tax Reform Act in a broad effort to curb real estate tax shelters. Congress recognized at the time, however, that real estate traditionally used nonrecourse financing and, therefore, allowed "qualified nonrecourse financing" to receive at-risk treatment.

Qualified nonrecourse financing is nonrecourse financing provided by a person in the business of lending (i.e. banks, insurance companies, pension funds) that is secured by the real property. This exception was adequate for the type of real estate lending that existed in 1986—property specific financing from traditional lending institutions.

Since 1986, however, real estate financing has undergone significant changes. The most significant being the use of publicly traded debt to finance real estate. This is general obligation debt provided by the public through investment banks typically to real estate investment trusts. It is essentially the same as a corporate bond issued by any publicly traded corporation.

Currently, publicly traded debt does not meet the technical requirements of the qualified nonrecourse financing because the lender—in this case the public—is not in the business of lending. Furthermore, the debt is a general obligation of the company and is not secured by a specific property interest as is a typical mortgage loan.

The failure of the at-risk rules to be updated as real estate financing has evolved is creating unfair potential tax liabilities for many real estate owners and serious compliance headaches. The Internal Revenue Service has recognized this and issued private letter rulings that alleviate some of the concerns created by the outdated at-risk rules. However, these rulings are limited in their usefulness and only apply to the taxpayer applying for the ruling.

Logic dictates that a technical statutory modification is needed to update the at-risk rules so they are relevant to modern real estate financing transactions. We have been working on such a modification with Members of the Ways and Means Committee and staff of the Joint Committee on Taxation. Mr. Foley has submitted draft language to Chairman Archer and requested that this language be included in his mark. We urge you to adopt this narrowly targeted and appropriate modification to the at-risk rules.

CONCLUSION

Again, we thank you Mr. Archer and Members of the Committee for this opportunity to testify. We reiterate that real estate is a major contributor to our economy and the sustained and healthy growth rate experienced by it since the early 1990s. The aggregate value of the nation's real estate stock —land, buildings and other fixed improvements—is over $20 trillion. The importance of maintaining and growing this value cannot be understated. We believe the tax proposals outlined in this testimony are needed to for the health and welfare of the real estate industry and the economy. They are reasonable, carefully thought-through and necessary. We urge you to enact them today. Whatever revenue costs to the Treasury that may be associated with them, (and some, in fact, should raise revenues), will be offset by the economic and social benefits they would help bring about. We look forward to working with the Chairman and Members of the Committee on these issues as the broad-based tax relief effort progresses.

Chairman ARCHER. Thank you, Mr. Greenberg.
Mr. Leonard.

STATEMENT OF CHARLES H. LEONARD, SENIOR VICE PRESIDENT, CHIEF FINANCIAL OFFICER AND TREASURER, TEXAS EASTERN PRODUCTS PIPELINE COMPANY; ON BEHALF OF COALITION OF PUBLICLY TRADED PARTNERSHIPS

Mr. LEONARD. Good afternoon, Mr. Chairman and Members of the Committee. I am pleased and honored to have been invited to testify before you. My name is Charles H. Leonard, and I am the senior vice president and chief financial officer and treasurer of Texas Eastern Products Pipeline Co., the general partner of TEPPCO Partners, L.P., a publicly traded partnership based in Houston. TEPPCO is one of the largest pipeline common carriers of refined petroleum products and LPGs in the United States and is also engaged in the gathering, transportation, storage, and marketing of crude oil, and the transportation of natural gas liquids.

The Coalition of Publicly Traded Partnerships, on whose behalf I am speaking today, is a trade association representing publicly traded partnerships, or PTPs, and their general partners. The legislative issue on which I will testify is of critical importance not only to TEPPCO, but to all publicly traded partnerships.

I am here to ask your help in remedying a provision in the Tax Code which unfairly, unintentionally, and for no good policy purpose discriminates against PTPs with regard to investment by mutual funds. Legislation to address this situation, H.R. 607, has been introduced by Representative Bill Thomas and is cosponsored by 12 Committee Members.

As their name suggests, PTPs, also known as master limited partnerships or MLPs, are limited partnerships which are traded on public exchanges. The interests in a PTP are referred to as units, the investors are unitholders. Most PTPs are structured so that unitholders receive quarterly cash distributions which generally provide them with a very good yield on their investment.

On the financial markets, PTPs are seen as investments which provide steady income through the quarterly distributions and some measure of growth. This makes them an attractive investment option for retirees in particular or for anyone wishing to receive a steady income stream.

The Coalition currently knows of 56 PTP issues that are trading on the exchanges or over the counter. Of these, about half are in energy-related industries. The rest are in real estate investment and homebuilding, mortgage securities, timber, investment management, and various other industries. PTPs have operations in just about every State in the country and unit holders in every State.

Our problem is that the Tax Code prevents us from attracting mutual funds as investors. Under the Regulated Investment Co., or RIC, rules of the Code, mutual funds must receive 90 percent of their gross income from specified sources. Income from a partnership, even one that is publicly traded, does not qualify. Neither the quarterly distributions, nor the partnership income allocated to the mutual fund fall into one of the approved categories.

Thus, a mutual fund cannot invest in a PTP unless it is certain that the resulting income, together with all other nonqualifying sources, will not exceed 10 percent of its gross income. Faced with the burden of monitoring percentages, and loss of their special tax status if they exceed the 10-percent limit, most mutual funds choose not to take the risk.

Mutual funds are an increasingly important segment of the capital markets. Moreover, a growing number of individual investors, and most of our public unit holders are individuals, are investing through mutual funds rather than buying securities directly. This means that a company that is not bought by mutual funds is at a huge disadvantage. The disadvantage is compounded by the fact that if mutual funds aren't buying your securities, most analysts don't bother to follow them.

Analysts that do follow PTPs have found some excellent investments to recommend to their clients. For example, a recent analysis issued by an analyst at A.G. Edwards and Co. found several energy-related PTPs to be appropriate investments for both conservative and aggressive income investors. Unfortunately, such analysts are few and far between. We believe that if there were more activity in our units by mutual funds, it would increase interest among other investors.

We also believe that our units are seriously undervalued because of this problem and that resolving it could increase the value by anywhere from 5 to 10 percent. This could have a significant effect on capital formation and market value in those industries, particularly energy-related industries, where PTP use is concentrated.

The RIC rules were written before such a thing as a publicly traded partnership existed. As we understand it, the rules reflect two concerns. First, mutual funds should not be active participants in a company's business, as a partner in a smaller partnership might be. Second, because they were illiquid, sometimes risky, and often structured to generate tax losses, nontraded partnerships were considered inappropriate for mutual funds.

Neither of these concerns applies in the case of PTPs. PTPs are liquid by definition, are safe, and fully SEC regulated, and are structured to generate income. The mutual fund would be only one of tens of thousands of unitholders contributing capital, not a participant in managing the business.

In short, there is no reason to treat PTP units differently from any other publicly traded security, and it is highly unfair to place them at this disadvantage in attracting mutual fund investment.

H.R. 607 would resolve this issue by simply making income derived from a PTP a qualifying income source for mutual funds. This will allow the decision on mutual fund investment in PTPs to be made the same way it is made for other publicly traded securities: by a mutual fund manager who evaluates each PTP's current performance and outlook for the future.

This legislation will make it easier for PTPs to raise the capital they need to grow, expand their operations, and create new jobs. It will also increase the value of the units held by the PTP investors who live in your States. I urge you to make the Tax Code more fair and rational by including H.R. 607 in the tax bill that you will write in July.

[The prepared statement follows:]

Statement of Charles H. Leonard, Senior Vice President, Chief Financial Officer and Treasurer, Texas Eastern Products Pipeline Company; on behalf of Coalition of Publicly Traded Partnerships

I am pleased and honored to have been invited to testify before this Committee. My name is Charles H. Leonard, and I am the Senior Vice President, Chief Financial Officer and Treasurer of Texas Eastern Products Pipeline Company, the general partner of TEPPCO Partners, L.P., a publicly traded partnership based in Houston. TEPPCO is one of the largest pipeline common carriers of refined petroleum products and LPGs in the United States and is also engaged in the gathering, transportation, storage and marketing of crude oil, and the transportation of natural gas liquids.

The Coalition of Publicly Traded Partnerships, on whose behalf I am speaking today, is a trade association representing PTPs and their general partners. The legislative issue on which I will testify is of critical importance not only to TEPPCO, but to all publicly traded partnerships.

I am here to ask your help in remedying a provision in the tax code which unfairly, unintentionally, and for no good policy purpose that we can discern, discriminates against investment in publicly traded partnerships with regard to investment by mutual funds. For those of you who are not familiar with PTPs, I would like to briefly explain this business entity, and then discuss the problem.

PUBLICLY TRADED PARTNERSHIPS

As their name suggests, publicly traded partnerships (PTPs) are limited partnerships which are traded on public exchanges. They are also commonly known as "master limited partnerships" or MLPs. The interests in a PTP are called "units" and the investors are referred to as "unitholders."

Most PTPs are structured so that unitholders receive quarterly cash distributions, which generally provide them with a very good yield on their investment.

On the financial markets, PTPs are seen as investments which provide a steady income through the quarterly distributions and some measure of growth, although usually less than that of corporate investments. For this reason, they are often compared with bonds or utility stocks in market analyses. This makes them a very attractive investment option for retirees in particular, or for anyone wishing to receive a steady income stream.

Since the PTP rules of section 7704 of the Code were enacted in 1987, only those partnerships receiving 90 percent of their income from specific sources can be publicly traded and still be taxed as partnerships. These sources include interest, dividends, real estate rental income and gain from the sale of real estate, and income from a broad range of natural resource activities.

In addition, there are several PTPs not meeting the gross income test which were already in existence when the 1987 rules were passed. They received a 10-year grandfather period at that time, and now, under rules enacted in 1997, may continue to be taxed as partnerships if they elect to pay a 3.5% gross income tax.

The Coalition currently knows of 56 PTP issues that are trading on the New York and American Stock Exchanges, NASDAQ, or over-the-counter. Of these, 25 are in energy related industries—oil and gas exploration, processing, pipeline transportation of various petroleum products, propane distribution, and so on. Ten are in real estate investment or homebuilding, 7 invest in mortgage securities, 3 are timber companies, and one produces and markets agricultural chemicals. Three are "grandfathered" PTPs in the advisory business, and the rest are scattered among various industries. There may be other PTPs of which we are unaware because they are very thinly traded or are still in formation.

These PTPs collectively have operations in just about every state in the country and unitholders in every state. TEPPCO, for example, currently has operations in 24 states, including the following states represented by the Members of this Committee: Texas, our home state, Louisiana, New York, Illinois, Pennsylvania, Ohio, Colorado, Oklahoma, Missouri, and Kentucky. Other PTPs in the Coalition have a presence in many of these state—particularly Texas, which is the home of a number of the energy-related PTPs—as well as a strong presence in California and operations in Upper Midwest states like Minnesota, Wisconsin, Nebraska, Iowa and the Dakotas. A list of currently trading PTPs and the location of their headquarters is attached to this testimony.

A 1998 study by Pricewaterhouse Coopers estimated that as of 1996, PTPs collectively owned about $27 billion in net assets. Based on an examination of SEC filings, the Coalition believes that PTPs had roughly $20 billion in market capital at the end of 1997. While we are a small part of the overall market, we are not an insignificant one.

Regulated Investment Company Rules

The problem which we need your help in resolving is that the tax code prevents us from attracting mutual funds as investors. Under the Regulated Investment Company (RIC) rules in section 851 of the tax code, mutual funds must receive 90 percent of their gross income from specified sources. Income received from a partnership, even one that is publicly traded, does not qualify. The quarterly distributions, while resembling dividends, are not in fact dividends for tax purposes; and the partnership income allocated to the mutual fund only rarely will fall into one of the section 851 categories.

Thus, a mutual fund cannot invest in a PTP or other partnership unless it is certain that the income it receives from that partnership, together with all other nonqualifying income sources, will not exceed 10 percent of its gross income. Faced with the burden of monitoring percentages, and the dire consequences of exceeding the 10 percent limit—loss of their special tax status—most mutual funds choose not to take the risk.

Mutual funds, as we all know, are an increasingly important segment of the capital markets. Moreover, a growing number of individual investors—which is where most of our public unitholders come from—are investing through mutual funds rather than buying securities directly. This means that a company that is not being bought by mutual funds is at a huge disadvantage. The disadvantage is compounded by the fact that if mutual funds aren't buying your securities, most analysts don't bother to follow them.

Those few analysts who have chosen to follow the PTP market have found some excellent investments to recommend to their clients. For example a recent analysis issued by an analyst in A.G. Edwards & Company's St. Louis office found several energy related PTPs to be appropriate investments for both conservative and aggressive income investors. Unfortunately, such analysts are few and far between; there are not nearly enough to generate the type of "buzz" on Wall Street that helps sell securities. We believe that if there were more activity in our units by mutual funds, it would increase interest among other investors.

As a result of this situation, we believe our that our units are seriously undervalued, and that if this impediment to mutual fund investment were removed, their value would increase by anywhere from 5% to 10%. The 1998 Pricewaterhouse Coopers study agreed, and predicted that investors would realize substantially greater capital gains from their PTP units if this provision were enacted. It is our strong belief, therefore, that this measure could have a significant effect on capital formation and market value in those industries, particularly natural resource industries, where PTP use is concentrated.

Before changing the way the RIC rules work for PTPs, it makes sense to examine the policy behind these rules and whether that policy is applicable in the case of PTPs. It is our understanding that there are two essential policy reasons behind the current rules. First, because of the flow-through nature of a partnership, an investor in a partnership is technically considered to be engaging in the partnership's business. The writers of the RIC rules did not want RICs to be actively engaged in businesses, but only passive investors; hence they set the rules up so that a partnership investment would qualify only if it was generating income characteristic of a passive investment.

This makes sense in the case of smaller, nontraded partnerships, where the RIC might indeed be in a position to influence the partnership's business dealings. In a PTP, however, the RIC is in the same position it would be as a corporate shareholder, one of tens of thousands of investors who contribute capital to the enterprise but have no role to play in the company's management.

Also, at the time the RIC rules were written there were no traded partnerships. PTPs did not come into existence until the early 1980s, when computer technology made it possible to track complex partnership tax attributes for large numbers of investors. Before that, a partnership investment was highly illiquid, required a sizeable investment, and was often quite risky. As this Committee knows, many nontraded partnerships in earlier days were set up for the specific purpose of generating losses. For all these reasons, they were not a suitable investment for a mutual fund.

PTP units, however, are safe and potentially attractive investments for mutual funds. By definition, they are publicly traded and hence are liquid; and they can be obtained in small investment increments. Moreover, being fully regulated by the SEC, PTP units are no more risky than any other traded security. They have always been structured for the purpose of generating income, not loss, for their investors.

In short, there is no reason to treat PTP units differently from any other security that is traded on the public markets, and it is highly unfair to place them at this disadvantage in attracting mutual fund investment.

Legislative Solution

Representative Bill Thomas, with the cosponsorship of twelve members of this Committee, has introduced H.R. 607, which would resolve this issue by simply making income derived from a publicly traded partnership a qualifying income source for mutual funds. This will allow the decision on whether and how much a mutual fund invests in PTP units to be made in the same way it is made for other publicly traded securities: by a mutual fund manager who evaluates each PTP's current performance and outlook for the future.

PTPs are an important vehicle for capital formation, particularly in the energy and natural resources industries. This legislation will make it easier for PTPs which may currently operate in your states to raise the capital they need to grow, expand their operations, and create new jobs. And by eliminating an application of the Code which has no policy justification and which results in an undervaluation of PTP units, this provision will increase the value of the units held by the PTP investors who live in your states. I urge you to make the tax code more fair and rational by including the Thomas bill in the tax legislation that you will write in July.

COALITION OF PUBLICLY TRADED PARTNERSHIPS PUBLICLY TRADED PARTNERSHIPS

Partnerships trading as of June 22, 1999

	Exchange/Symbol	Principal Offices
REAL ESTATE—Income Properties and Homebuilders		
American Real Estate Partners	NYSE/ACP	Mt. Kisco, New York
Carey Diversified LLC	NYSE/CDC	New York, New York
Hallwood Realty Partners	AMEX/HRY	Dallas, Texas
Heartland Partners	AMEX/HTL	Chicago, Illinois
Interstate General Company, L.P.	AMEX/IGC	Chantilly, Virginia
National Realty L.P.	AMEX/NLP	Dallas, Texas
New England Realty Associates, L.P.	NASDAQ/NEWRZ	Boston, Massachusetts
Newhall Land and Farming Company	NYSE/NHL	Valencia, California
Royal Palm Beach Colony, L.P.	OTC/RPAMZ	Hollywood, Florida
Teeco Properties, L.P.	OTC/3TPLPZ	New York, New York
REAL ESTATE—Mortgage Loan		
America First Apartment Investors	NASDAQ/APROZ	Omaha, Nebraska
America First Tax Exempt Mortgage Fund.	NASDAQ/AFTXZ	Omaha, Nebraska
American Insured Mortgage Investors 85.	AMEX/AII	Rockville, MD

COALITION OF PUBLICLY TRADED PARTNERSHIPS PUBLICLY TRADED PARTNERSHIPS—Continued

Partnerships trading as of June 22, 1999

	Exchange/Symbol	Principal Offices
American Insured Mortgage Investors 86	AMEX/AIJ	Rockville, MD
American Insured Mortgage Investors 88.	AMEX/AIK	Rockville, MD
Municipal Mortgage & Equity, LLC	NYSE/MMA	Baltimore, MD
Oxford Tax-Exempt Fund II, L.P.	AMEX//OTF	Bethesda, MD
NATURAL RESOURCE—Oil and Gas, Energy Processing & Distribution		
Amerigas	NYSE/APU	King of Prussia, Pennsylvania
Buckeye Partners, L.P.	NYSE/BPL	Emmaus, Pennsylvania
Cornerstone Propane Partners, L.P.	NYSE/CNO	Watsonville, California
Dorchester Hugoton Ltd.	NASDAQ/DHULZ	Garland, Texas
Enterprise Products Partners, L.P.	NYSE/EPD	Houston, Texas
EOTT Energy Partners	NYSE/EOT	Houston, Texas
Ferrellgas Parters, L.P	NYSE/GEL	Houston, Texas
Hallwood Energy Partners	AMEX/HEP	Dallas, Texas
Hallwood Energy Partners, Class C	AMEX/HEPCWI	Dallas, Texas
Heritage Propane Partners, L.P.	NYSE/HPG	Tulsa, Oklahoma
Kaneb Pipe Line Partners—Sr. Preferred.	NYSE/KPP	Dallas, Texas
Kaneb Pipe Line Partners—Preferred	NYSE/KPU	Dallas, Texas
Kinder Morgan Energy Partners, L.P.	NYSE/ENP	Houston, Texas
Lakehead Pipe Line Partners	NYSE/LHP	Duluth, Minnesota
Leviathan Gas Pipeline Ptrs., L.P.	NYSE/LEV	Houston, Texas
National Propane Partners, L.P.	NYSE/NPL	Cedar Rapids, Iowa
Northern Border Partners, L.P.	NYSE/NBP	Omaha, Nebraska
Plains All American Pipeline, L.P.	NYSE/PAA	Dallas, Texas
Pride Companies, L.P.	NYSE/PRF	Abilene, Texas
Star Gas Partners, L.P.	NYSE/SGU	Stamford, Connecticut
Suburban Propane	NYSE/SPH	Whippany, New Jersey
Sun Energy Partners, L.P.	NYSE/SLP	Dallas, Texas
TEPPCO Partners, L.P.	NYSE/TPP	Houston, Texas
Unimar Company, L.P.	AMEX/UMR	Houston, Texas
NATURAL RESOURCE—Timber and Minerals		
Crown Pacific, L.P.	NYSE/CRO	Portland, Oregon
Pope Resources	NASDAQ/POPEZ; PSE/PRP	Poulsbo, Washington
Terra Nitrogen, L.P.	NYSE/TNH	Sioux City, Iowa
U.S. Timberlands Company, L.P.	NASDAQ/TIMBZ	Klamath Falls, Oregon
INVESTMENT ADVISORS		
Alliance Capital Management, L.P.	ANYSE/AC	New York, New York
NVest, L.P. (formerly New England Investment Companies)	NYSE/NEW	Boston, Massachusetts
PIMCO Advisors Holdings, L.P.	NYSE/PA	Newport Beach, California
MISCELLANEOUS		
Airlease, Ltd.	NYSE/FLY	San Francisco, California
Borden Chemicals & Plastics L.P.	NYSE/BCU	Geismar, Louisiana
Boston Celtics L.P.	NYSE/BOS	Boston, Massachusetts
Cedar Fair, L.P.	NYSE/FUN	Sandusky, Ohio
Equus Gaming Company	NASDAQ/EQUUS	Hato Rey, Puerto Rico
FFP Partners, L.P.	AMEX/FFP	Fort Worth, Texas
Mauna Loa Macadamia Partners, L.P.	NYSE/NUT	Honolulu, Hawaii

Mrs. JOHNSON of Connecticut [presiding]. I thank the panel for your testimony on a range of issues of importance across the country.

Mr. Capps, I wanted to have you address briefly, because I do have some other questions in my time, I did want to have you address why the AIRC is important, why extension of just the old R&D tax credit doesn't meet our needs? And then if you would also speak to the broader question of why the market—some people will say to me, "Well, the market rewards R&D. If you have better products out there, you win in the market," so why does government need to recognize R&D costs at all and then why do we need that addition that we, frankly, have worked so hard on?

Mr. CAPPS. Well, first addressing the AIRC or the alternative credit. It is extremely important to all members of the Coalition, including companies like EDS, who have historically used the traditional credit. Back in 1994, companies were coming from different directions as far as their approach to the credit. And Members of this Committee had suggested that the business community try to tie together and come up with a unified front and proposal for a structure for the credit. We deliberated and worked amongst ourselves for over a year and ultimately came up with a design, the traditional credit, which did in fact work well for most companies. But then also the incremental credit, which picked up other companies that were doing substantial amounts of research, were research-intensive but the historical base period that we used in the traditional credit wasn't a good measure or reasonable basis, a good basis to use to measure them on a go-forward basis.

So we came up with this compromise structure. We think it works well. As a business community, we are coming forward with a structure for the credit that includes both the traditional and the alternative credit. And the alternative credit is essentially the glue that helps hold our Coalition together. So it is very important to us.

As far as your question regarding the free market and why isn't it an adequate incentive for research and development in the private sector, much of the research that is done is compelled for competitive reasons by the free market. What the R&D credit is focusing on are those activities, those research projects that are on the margin, where a company is evaluating whether or not to go forward with a project, it will look at the benefits that it is going to realize from that research. Well, the benefits that flow to the economy and society at large can greatly exceed that benefit that the company is getting. So with the credit and the added capital that it provides the companies, they can pick up those marginal activities which end up providing a significant benefit to the economy as a whole.

Kind of driving home that point, I just saw something in The Washington Post this morning talking about my industry, the information technology industry, and it says that, "Information technology industries are having a huge impact on the economy, contributing more than one-third of U.S. economic growth between 1995 and 1998, even though they account for just 8 percent of the Gross Domestic Product." And that is reflecting this concept that the benefits that flow to the economy greatly exceed what the individual companies get. And that is out of a Commerce Department study that they just came out with.

Mrs. JOHNSON of Connecticut. I appreciate that because we actually in other areas invest a tremendous amount of public money, in health research, in much of our defense research flows over into the private sector and our national lab research capability goes over to the private sector only when it is economic for a company to be able to pick up the additional research necessary to translate the basic research into product. But you are right, if there is a one-to-one relationship between research and product, if it were always that easy, we wouldn't need to help. And many, many companies do that kind of research and don't take the credit because it is fairly inexpensive and it is very fast-moving and it is hard to document. So there is a lot of R&D that goes on that the government doesn't have any role in.

The kinds of R&D projects that go on that the government has a legitimate interest in are those that are higher risk, may not lead exactly to products, and do take a much longer term investment. And I know you made the point in your testimony that permanency is important because the bigger, more significant projects that are going to lead to generations of products in the future are the very kind of projects that need the credit and that are disadvantaged by these very short-term extensions that we have enjoyed or suffered in the past.

Mr. CAPPS. At EDS, we have undertaken research projects that have spanned 10, 12 years.

Mrs. JOHNSON of Connecticut. Thank you. I just want to ask Mr. Greenberg, if I may, Mr. Greenberg, thank you for your testimony and being specific about a number of bills that have been introduced by Committee Members and their impact on a number of markets that you are associated with, the number of industries that you are associated with. It is also true that 29 of the 39 Members of this Committee are cosponsors of my bill and Mr. Rangel's interest in raising the cap on the low-income housing tax credit to expand the availability of high-quality, well-managed, affordable units. The credits currently are in tremendous demand, the demand far exceeds the availability of the credits. And I just wondered what you thought about that bill since it isn't one of the ones you mentioned?

Mr. GREENBERG. Well, it isn't one of the ones we mentioned, but some of our members definitely have an interest in that. And we do support the fact that if low-income housing credits will increase the production and the construction of low-income housing for people, that it is a good thing and we would support that. It wasn't one of the main topics because it didn't encompass most of our members.

Mrs. JOHNSON of Connecticut. Well, your focus on broader things like build-out costs and brownfields and REIT modernization do take a slightly different approach to this. But certainly the low-income housing tax credit has proved its power in the affordable housing range.

Mr. GREENBERG. But we do support that because if it does create low-income housing, if it does help produce more construction of low-income housing, we do support that, yes.

Mrs. JOHNSON of Connecticut. Thank you.

Mr. Levin.

Mr. LEVIN. Thank you. Welcome. Mr. Baroody, in your testimony, you referred toward the end to section 127.

Mr. BAROODY. Yes, sir.

Mr. LEVIN. And might I kind of make a pitch? We have had an uphill battle on this, as you know, especially including graduate education. And I think there are a lot of misconceptions about what kind of graduate education was really being abetted by 127. It wasn't doctors and lawyers, it was primarily people who, for example, wanted to increase their engineering proficiencies. I don't know what the odds are for making progress this time around. We almost did so last time in this Committee. And I just want to express my hope that everybody who is interested in this will help to focus attention on it.

Mr. BAROODY. The pitch is taken, Mr. Levin. And our members are very serious about the continuing and the predictably growing need for higher level skills across the board of our membership. So we are very serious about this, and would look forward to working with you on it.

Mr. LEVIN. OK, because I think within manufacturing, there is really a revolution within the workplace and connected with it, this distinction between rust belt and high-tech and all that is really very, I think, misinformed, if I might say so.

Let me ask you, Mr. Capps, there was a question about the R&D tax credit, but I want to emphasize the issue of permanency because it is pretty clear there will be an extension. I would doubt that there won't be an extension. There always has been except there was one gap. So, briefly, if you would, make the strong case for its permanent extension.

Mr. CAPPS. With the on-and-off nature of the credit, it makes it difficult for companies, especially like EDS that have undertaken long-term research projects that can span a decade, to take the credit into account in the out years. Economically, I cannot tell my management at EDS and the people who are undertaking our research, that we are going to have a credit for sure next year. I gambled on the year when we had the lapse, and I said, "Oh, don't worry, they will extend it retroactively. They have been doing that consistently." And I got stung on that. All the economists that have studied it, we have got a number of reports we can cite to you, have found that the simple act of having it permanent as opposed to just these annual extensions effectively turbocharges it, and we get a huge incremental benefit going forward from the standpoint of jobs, from the standpoint of exports increasing, and imports decreasing. It is like turbocharging it effectively. And I know at EDS, we would avail ourselves of it even more in our economic analyses and modeling, just like we used to do with the investment tax credit. Every time before we purchased equipment or undertook a long-range capital investment plan, we modeled in the ITC, having a reasonable expectation that it was going to be around.

Mr. LEVIN. OK. Mr. Bloomfield, you mentioned some studies. Why don't you make sure we get them, if you would, just send them to us. I want to ask you a question though, if I might skip to the leaseholder improvement provision. When a lessee makes the improvements, not the lessor, but the lessee, what is the rule in terms of the amortization?

Mr. GREENBERG. They get to amortize it out over the period of their lease.

Mr. LEVIN. Over the period of their lease. So one of the arguments is that there is a major differential in treatment depending on who makes the leasehold improvements?

Mr. GREENBERG. That's true. In fact, there is a disincentive for the landlord to make an improvement, and more of an incentive for him to have the tenant make it.

Mr. LEVIN. OK, thank you. Thank you, Mr. Chairman.

Chairman ARCHER [presiding]. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. Mr. Greenberg, in your testimony you mentioned that REITs are at a competitive disadvantage in today's marketplace. Can you give us some examples on why REITs aren't competitive currently?

Mr. GREENBERG. Yes, the rules currently state that if a REIT renders services to its tenants that aren't customary and usual and for the convenience of the tenants, that it will taint all the rental income they get from that tenant and make it bad income. If a REIT has more than 5 percent of their gross income as bad income, they lose their REIT status. Now, the REITs have to wait while their competitors are offering these services to their tenants until enough of the competitors are doing it where it becomes customary and usual. And then the REIT has to wait on top of that until the IRS finally agrees that they then see that it is customary and usual.

To give you a couple of examples, I got the first ruling that said that cable TV was customary and usual for apartment buildings. It took us over 2 years to get the IRS to agree that it was customary and usual—that cable TV was customary and usual.

I just got a ruling on high-speed Internet for office buildings, that high-speed Internet was a form of communications for office tenants. It took over 16 months to get that. While the competitors of the REITs are out making deals and offering these services to their tenants, the REITs had to sit around and wait until they can get these private letter rulings.

Mr. ENGLISH. That's interesting. Mr. Greenberg, I want to thank you for mentioning in your testimony my legislation to reduce the depreciation recapture rate, which a number of my colleagues have signed on to. I noticed that there was a recent CRS report on real estate depreciation that concluded that real estate depreciation is less favorable today than at any time since 1953. It went on to conclude that the recovery period for commercial real estate would have to be reduced to 20 years to provide real estate the same effective tax rate as equipment. Would you agree that this supports your position, that "sale proceeds above the adjusted bases" are not "the result of overly generous depreciation, but are in fact a gain?"

Mr. GREENBERG. Yes, definitely I would. And to elaborate a little bit more on that, it was 20 years, the report said 20 years for office and residential and 17 years for industrial properties. So it was even lower to make them equivalent to the depreciation tax effect for equipment. Today we are using 39-year-life depreciation. So the depreciation recapture we are talking about, we are really taxing part of the appreciation, not the depreciation.

Mr. ENGLISH. Thank you, Mr. Greenberg. Mr. Bloomfield, I am curious about the details of your study on the impact of the reduction, the last reduction in 1997 of the capital gains tax. Can you elaborate on your findings and also how they might impact on the assumptions that underlay our revenue estimates about capital gains tax cuts?

Mr. BLOOMFIELD. Well, let me begin by indicating that DRI did an analysis of the 1997 capital gains tax cut. And, as you know, there are five revenue implications of reducing the capital gains tax cut. The first is the arithmetic one when you lower the rate. And David Wyss, the chief economist for DRI, looked at that, which is a revenue loss. The second is the unlocking that takes place, which is a revenue gain. The third, and perhaps the most important part of David Wyss' analysis, is that it had a significant impact on the value of the assets. So if the value of the asset went up, you obviously got more revenue when you sold that asset. The fourth is some small, minor revenue loss, reclassification of ordinary income into capital gains to take advantage of the lower rate. And the final one is the impact on the growth of the economy.

And the preliminary report, which is in our testimony, indicates that both in the short-term and in the long-run, if you take into account those five revenue implications, that the 1997 capital gains tax cut was a revenue gainer. It definitely was not a revenue loss. If you look at the impact of the 1997 capital gains tax cut in terms of its overall economic impact, whether it be on the impact of the cost of capital, whether it be impact on investment, whether it be impact on GNP, all of those are also positive. So a capital gains tax cut is one of those few tax cuts which really is a free lunch, particularly because of its impact on revenue.

Now, the next question I assume is, can we generate revenue with additional capital gains cuts? Senator Lott and others in the Senate have suggested reducing the capital gains tax cut to generate revenue. Obviously, a lot of it depends what revenue implications you take into account. And, as you know, both the Joint Committee and the CBO take into account some of those revenue effects. But as many people on this Committee, including the Chairman know, you can craft a capital gains tax cut which could raise revenue in the budget window that you are looking at if it is carefully crafted.

Mr. ENGLISH. Thank you, Mr. Bloomfield. That is testimony that really turns a lot of conventional notions on their head here and it is welcome for that reason.

Mr. Chairman, I thank you for the opportunity.

Chairman ARCHER. Mr. Hulshof.

Mr. HULSHOF. Mr. Chairman, may I begin by asking how many of you are appearing here personally for the first time to give testimony, just by a show of hands. So a few rookies and a few veterans. For those of you appearing for the first time, it is incumbent upon us at this moment to single out those provisions that we have authored or that we have cosponsored and to talk about them. And so since that is a requirement, let me take this moment then. Mr. Bloomfield, and especially thank you for your kind comments, I know you didn't mention them specifically, but Mr. Neal and I have the small savers provision, and I think it is seriously worth point-ing out that many of the other industrialized countries really do encourage savings and thrift. For instance, you talk about Germany providing some nearly $7,000 exclusion from taxable income, interest that is derived and married couples, and other countries, even more than that. And I know regarding the small savers provision that Mr. Neal and I have introduced, much more modest than that. And so I appreciate the fact that you have included that.

And now let me get to really a more serious policy question and maybe as a preface. In the days leading up to this Committee marking up the Taxpayer Relief Act of 1997, there was a witness sitting where you were, and I don't recall who asked him the question, but the question was posed if the witness had to choose whether he would embrace a capital gains cut or death tax relief, which one would he suggest the Committee accept and which one would he let go by the wayside. And I think the response was something like that, that that is like asking a pedestrian whether they would like to be hit by a bus or by a car. This question, if you could just put the policy, the theoretical, economics aside, there is some discussion among Members about addressing the corporate capital gains rate. And, as you have pointed out, there is no distinction between long-term gains or short-term gains, although you also note that in other countries that there is for instance a different rate perhaps for short-term gains as opposed to a different rate for a long-term gain. Is that a good idea? Why is it a good idea or not a good idea if we were to maybe create a two-tier approach of dealing with corporate capital gains or would you think that that is akin to being that dubious pedestrian that I mentioned?

Mr. BLOOMFIELD. You are talking about a sliding scale for corporate capital gains?

Mr. HULSHOF. I'm saying if we had, yes, a short-term gain or a long-term gain, similar as we do for individuals?

Mr. BLOOMFIELD. Well, let me first respond with two points. Number one, Mr. English, with regard to the impact of the 1997 capital gains tax cut, in my testimony, I have laid out the details of David Wyss's report.

Number two, with regard to Mr. Neal and Mr. Hulshof, it is true that there are incentives for small savers around the world, and what I would like to do is introduce into the record an analysis that Arthur Andersen did on that issue.

But getting back to the poor witness in my seat who had to choose among various tax cuts, I suggested a menu, which I said singularly and together could move the country forward because they would reduce the bias in the Tax Code against saving and investment. There are political and policy questions to address. There are economists like Stanford Professor John Shoven who have tried to rank the different tax cuts, but that is hard to do. I cannot be in a situation of saying that one tax cut, a capital gains cut versus elimination of the death tax would have a greater impact. It would depend on how the cut is structured.

For example, let's get to the issue you raised, that of capital gains cuts for corporations and individuals. We tax both individual and corporate capital gains much higher than the rest of the world. We have always had a differential between ordinary income and capital gains. We no longer have that on the corporate side. That causes all sorts of distortions. If you look internationally, corporate capital gains, both short- and long-term capital gains, are much lower in the rest of the world. Other countries do tax short-term corporate capital gains differently than long-term capital gains. In the United States, we tax both short- and long-term corporate capital gains at a 35-percent rate.

I would encourage you to strongly consider a corporate capital gains tax cut. There are ways to address it depending on holding periods, and so forth, to deal with the revenue effect.

Chairman ARCHER. Does any other Member wish to inquire?

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Mr. Bloomfield, is that Arthur Andersen report sympathetic to Mr. Hulshof's bill and my bill?

Mr. BLOOMFIELD. It most certainly is.

Mr. NEAL. All right, you can submit it for the record. [Laughter.]

Mr. BLOOMFIELD. Mr. Neal, I could read it here. It is several pages. You pick your country, and I will tell you what the——

[The information follows:]

American Council for Capital Formation

Center for Policy Research

Special Report

SMALL SAVER INCENTIVES: AN INTERNATIONAL COMPARISON OF THE TAXATION OF INTEREST, DIVIDENDS, AND CAPITAL GAINS

Many countries tax the interest, dividends, and capital gains income received by individuals more lightly than does the United States, according to a recent survey of twenty-four industrialized and developing countries that the ACCF Center for Policy Research commissioned from Arthur Andersen LLP. High tax rates on dividends and capital gains increase the bias against saving and investment, raise the cost of capital for new investment, and slow U.S. economic growth. The Center study also shows that many countries provide tax incentives for small savers by exempting some portion of the income from tax.

INTEREST INCOME

Interest received by individuals is taxed at a higher rate in the United States than in many other countries; the marginal tax rate is 39.6 percent in the United States compared to an average of 32.4 in the countries surveyed as a whole (see comparison table, p. 3, and accompanying notes, p. 5). Nearly 40 percent of the countries surveyed tax interest income at a lower rate than ordinary income; for example, Italy taxes ordinary income at a top rate of 46 percent while its top tax rate on interest income is only 27 percent.

In several countries surveyed, small savers receive special encouragement in the form of lower taxes or exemptions on a portion of the interest they received:

- Australia: The first $1,951 of interest is taxed at a rate of 33.5 percent (instead of the 48.5 percent rate on ordinary income).
- Belgium: The first $1,484 of interest on bank saving accounts is exempt from tax.
- Chile: The first $1,100 of interest income is exempt from tax.
- Germany: The first $6,786 of interest income for married couples filing a joint return ($3,393 for singles) is exempt from tax.
- Japan: Interest on saving up to $26,805 is exempt from tax for individuals older than 65.
- Netherlands: The first $987 of interest income for married couples ($494 for singles) is exempt from tax.
- Taiwan: The first $8,273 of interest received from local financial institutions is exempt from tax.
- United Kingdom: Interest income received by savers in the 23 percent income tax bracket is taxed at a rate of 20 percent.

DIVIDEND INCOME

Dividend income is also taxed more heavily in the United States than in the other countries surveyed; the U.S. tax rate is 60.4 percent (combined corporate and individual tax on dividend income) compared to an average of 51.1 percent in the surveyed countries as a whole (see comparison table, p. 3, and accompanying notes, pp. 5–6). Of the countries surveyed, 62.5 percent offset the double taxation of corporate income (the income is taxed at the corporate level and again when distributed in the form of dividends) by providing either a lower tax rate on dividend income received by a shareholder or by providing a corporation with a credit for taxes paid on dividends distributed to their shareholders.

In addition, small shareholders receive preferential treatment in about one-fourth of the countries surveyed:

- Australia: The first $1,951 of dividends is taxed at a rate of 33.5 percent (instead of the 48.5 percent rate on ordinary income).
- Chile: Taxpayers may exclude the first 50 percent of dividends received up to $33,000 annually; above this threshold, 20 percent of dividends received are excluded from tax.
- France: The first $2,661 of dividends on French shares received by a married couple is exempt from tax ($1,330 for singles).
- Japan: Dividends of less than $350 from each individual corporation are taxed at a top rate of 20 percent instead of 50 percent. In addition, shareholders with non-dividend income of less than $70,000 get a 10 percent tax credit on dividends received; those with non-dividend income greater than $70,000 get a tax credit on dividends ranging from 5 percent to 10 percent.
- Netherlands: The first $987 of dividend income for married couples ($494 for singles) is exempt from tax.
- Taiwan: The first $8,273 of dividends from local companies is exempt from tax.

CAPITAL GAINS TAX RATES

Both short- and long-term capital gains on equities are taxed at higher rates in the United States than in most of the other twenty-three countries surveyed. Short-term gains are taxed at ordinary income rates as high as 39.6 percent in the United States compared to an average of 19.4 percent for the sample as a whole (see comparison table, p. 4, and accompanying notes, p. 6). Long-term gains face a tax rate of 20 percent in the United States versus an average of 15.9 for all the countries surveyed. Thus, U.S. individual taxpayers face tax rates on long-term gains that are 26 percent higher than those paid by the average investor in other countries. In addition, the United States is one of only five countries surveyed with a holding period requirement in order for the investment to qualify as a capital asset.

Several countries provide incentives for small savers to invest in capital assets:

- Canada: Provides an exclusion for the sale of shares of Canadian-owned small businesses, subject to a lifetime limit.
- Chile: Provides an annual capital gains exclusion of $6,600.
- Denmark: Exempts capital gains from the sale of publicly listed shares valued at less than $16,000 if held three or more years.
- France: Exempts capital gains if gross proceeds are less than a threshold amount ($8,315 in 1998).
- United Kingdom: Excludes up to $11,225 per year of net gains.

CONCLUSIONS

The Center's study demonstrates that many countries tax the interest, dividends, and capital gains received by individual taxpayers at lower rates than does the United States. A substantial number of countries also provide special tax incentives to encourage small savers. Perhaps not coincidentally, almost all the countries surveyed have higher saving rates than the United States. More favorable tax treatment for U.S. savers, especially small savers, could encourage individuals to provide more for their own retirement as well as help to provide the funds necessary for investment and economic growth.

Country	Gross dom. saving as % GDP, 1996	INTEREST INCOME Interest income maximum rate	Other preferential rate for interest income of individuals?	DIVIDEND INCOME Taxation of Corp. Distributions Corp./Indiv. Integration?	Incl. Dividend Income Comb. Corp. & Indiv. Tax Rate
Argentina	18.0	33.0	Yes	Yes	33.0
Australia	21.0	48.5	Yes	Yes	48.5
Belgium	23.0	15.0*	Yes	No	74.1
Brazil	18.0	27.5	No	Yes	33.0
Canada	21.0	31.3	No	Yes	45.0
Chile	26.0	45.0	Yes	Yes	45.0
China	44.0	20.0*	Yes	No	63.1
Denmark	21.0	58.0*	No	No	74.7
France	21.0	58.1	Yes	Yes	66.8
Germany	23.0	55.9	Yes	Yes	55.9
Hong Kong	31.0	Exempt*	N/A	Yes	16.0
India	24.0	30.0	Yes	No	54.5
Indonesia	33.0	15.0*	No	No	51.0
Italy	22.0	27.0*	Yes	Yes	46.0
Japan	30.0	15.0	Yes	Yes	64.0
Korea	34.0	40.0	Yes	Yes	40.0
Mexico	23.0	1.7*	Yes	Yes	34.0
Netherlands	26.0	60.0	Yes	No	74.0
Poland	18.0	20.0*	Yes	No	61.6
Singapore	50.0	28.0	Yes	Yes	28.0
Sweden	22.0	30.0*	Yes	No	69.0
Taiwan	N/A	40.0	Yes	Yes	40.0
United Kingdom	15.0	40.0	Yes	Yes	48.3
United States	**16.0**	**39.6**	**Yes**	**No**	**60.4**
Average	25.2	32.4 *Rate is lower than that on ordinary income	79.2% answer "yes"	62.5% answer "yes"	51.1

Country	Individual Capital Gains Maximum tax rates on equities Short-term	Long-term	Individual holding period
Argentina	Exempt	Exempt	No
Australia	48.5	48.5; asset cost is indexed	No
Belgium	Exempt	Exempt	No
Brazil	15.0	15.0	No
Canada	23.5	23.5	No
Chile	45.0; annual exclusion of $6,600	45.0; annual exclusion of $6,600	No
China	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Denmark	40.0	40.0; shares valued at less than $16,000 exempt if held 3+ years	Yes, 3 years
France	26.0; annual exclusion of $8,315	26.0; annual exclusion of $8,315	No
Germany	55.9	Exempt	Yes, 6 months
Hong Kong	Exempt	Exempt	No
India	30.0	20.0	Yes, 1 year
Indonesia	0.1	0.1	No
Italy	12.5	12.5	No
Japan	1.25% of sales price or 20.0% of net gain	1.25% of sales price or 20.0% of net gain	No
Korea	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Mexico	Exempt	Exempt	No
Netherlands	Exempt	Exempt	No
Poland	Exempt	Exempt	No
Singapore	Exempt	Exempt	No
Sweden	30.0	30.0	No
Taiwan	Exempt (local company shares)	Exempt (local company shares)	No
United Kingdom	40.0; shares valued at less than $11,225 exempt	40.0; shares valued at less than $11,225 exempt	Yes, 1 to 10 years
United States	**39.6**	**20.0**	**Yes, 1 year**
Average	19.4	15.9	79.2% have no holding period

Notes

Interest Income

Argentina—Interest from certain saving accounts and certificates of deposit receives preferential treatment.

Australia—The first A$3,000 (US $1,951) of investment income from any source (including interest, dividends, and other business income of individuals) is subject to tax at 33.5 percent instead of 48.5 percent.

Belgium—Exemption up to BF 55,000 (US $1,484) for interest on bank saving accounts ("spaarboekje").

Chile—Interest income up to US $1,100 annually is exempt from tax.

China—Interest income earned on a deposit placed in China banks, or on a bond or debt issued by China, is exempt from tax.

France—A withholding tax of approximately 30 percent may be requested.

Germany—With respect to net interest income, single individuals can claim an allowance of DM 6,100 (US $3,393) per year, and married persons filing a joint income tax return can claim an allowance of DM 12,200 (US $6,786) per year.

India—Interest income from certain specified securities (typically government securities) could be exempt.

Italy—Interest income earned on bonds whose duration is longer than 18 months is taxed at 12.5 percent.

Japan—Interest on saving up to β3.5 million (US $26,805) is exempt from tax for individuals older than 65.

Korea—Various rate reductions are available for interest income.

Mexico—Mexican-source interest is withheld at 1.7 percent of the principal.

Netherlands—An exclusion of NLG 1,000 (US $494) (NLG 2,000 [US $987] if individual is married) is available for interest income. The exclusion will be reduced by tax-deductible interest paid on personal loans.

Poland—The interest income of individuals earned on loans and bonds is not aggregated with other sources of income and is subject to a flat 20 percent income tax. For individuals, interest income earned on State Treasury securities, local government bonds, and personal bank accounts is generally exempt.

Singapore—Interest income received from savings with the POS Bank in Singapore, or foreign source interest income that is not remitted to Singapore, is exempt.

Sweden—An individual may deduct certain interest expenses to offset interest income.

Taiwan—Individual residents may exclude interest income from deposits in local financial institutions and dividends from local companies from taxable income up to NT$270,000 (US $8,273) per year.

U. Kingdom—A U.K. individual whose marginal tax rate is 23 percent pays tax at a rate of 20 percent on savings income including interest.

United States—Interest earned on qualified municipal bonds is tax exempt.

Dividend Income

Argentina—Dividends are exempt from tax.

Australia—The corporation keeps account of the amount of tax it has paid. At the time a dividend is paid, the corporation "franks" the dividend by notionally attaching to it the amount of Australian tax the corporation has paid on the profits from which the dividend is paid. Dividends are deemed to have been paid from the taxed profits first. The shareholder is assessed on both the cash dividend and the imputed tax (i.e., the dividend is "grossed up"). The imputed tax is then allowed as a credit against the shareholder's tax. Any excess credit cannot be refunded.

Belgium—Dividends are subject to reduced rates of tax, 25 percent for dividends on bearer shares and 15 percent for dividends on nominative shares.

Brazil—Dividends are exempt from tax.

Canada—Individual shareholder is taxable on 125 percent of the dividend received, and claims a credit equal to 13.33 percent of the total taxable dividend amount.

Chile—The 15 percent tax paid at the company level may be credited against the tax on the shareholder's taxable dividend (i.e., cash dividend plus the tax credit). Under a special regime, individuals may exclude 50 percent of dividends received up to US $33,000 annually. Above this threshold, 20 percent of dividends received are excluded.

China—Dividends from A shares listed in Shenzhen and Shanghai Stock Exchanges are currently exempt from tax.

France—The shareholder credit equals 33.33 percent of the grossed-up dividend.

For dividends on French shares, a single individual may take a special deduction up to Fr 8,000 (US $1,330), and married persons may deduct up to Fr 16,000 (US $2,661).

Germany—A corporate income tax credit on dividends is granted to shareholders in the amount of 43 percent of the net dividend. In addition, the corporation receives a refund of income tax, reducing the corporate rate from 45 percent to 30 percent.

Hong Kong—Dividends from a corporation which is chargeable to tax are not included in the taxable income of any other person chargeable to tax.

India—The corporation paying the dividend pays an additional tax equal to 10 percent of the dividend distributed to the shareholders. The shareholders are not subject to any additional tax on the dividend received.

Italy—The credit is 58.73 percent of the dividends provided that the distributing company has paid an equal amount of taxes on the earnings distributed. The tax credit is offset against personal income tax computed on the dividend grossed up by the amount of the tax credit.

Dividends subject to a withholding tax as a definitive tax are excluded from the taxable income. Individuals are allowed to opt for the definitive withholding at 12.5 percent. In such cases no tax credit is granted and the total tax burden on corporate earnings is 49.5 percent.

Japan—Dividends of less than $350 from each individual corporation are taxed at a top rate of 20 percent instead of 50 percent. In addition, shareholders with non-dividend income of less than $70,000 get a 10 percent tax credit on dividends received; those with non-dividend income greater than $70,000 get a tax credit on dividends ranging from 5 percent to 10 percent.

Korea—The shareholder credit is 19 percent.

Mexico—Dividends are exempt from tax.

Netherlands—An individual may exclude NLG 1,000 (US $494) for dividends received from a Dutch resident company (NLG 2,000 [US $987] for married individuals).

Poland—Dividends distributed to individuals are subject to a definitive 20 percent withholding tax.

Singapore—The dividend is subject to normal individual income tax with a credit equal to the 26 percent corporate tax paid with respect to the earnings distributed.

Dividend income from shares held outside Singapore and not remitted to Singapore is exempt from tax.

Taiwan—The shareholder credit equals the amount of the dividend (net of corporate tax) multiplied by 33.33 percent.

An individual may exclude interest received from a financial institution and dividends from local companies up to NT$270,000 (US $8,273) per year.

U. Kingdom—At present, 25 percent of the cash dividend is available as a credit. From April 1999, 11.1 will be available. The taxable amount of the dividend is the cash dividend plus the credit.

After March 1999, the combined rate on corporate earnings will be 47.5 percent.

Capital Gains Income

Canada—Exclusion applies only to sale of shares of Canadian-owned small businesses, subject to a lifetime limit.

Chile—Original cost is adjusted by internal inflation. Annual limit for capital gains exclusion is approximately US $6,600.

Denmark—Gains on publicly listed shares held three or more years are tax exempt if taxpayer owns less than US $16,000 of the company's shares.

France—Capital gains realized by individuals are not taxed if gross proceeds are less than a threshold amount (for 1998, Fr 50,000 [US $8,315]).

U. Kingdom—Sliding scale of rates applies to one to ten years of ownership through an exclusion that rises gradually to 75 percent for assets held ten or more years. Thus, assets held ten or more years face a top marginal rate of 10 percent.

An individual may exclude up to λ6,800 (US $11,225) per year of net capital gains.

United States—Shares held 12 months or more are taxed at a rate lower than that on ordinary income under the IRS Restructuring and Reform Act of 1998.

Mr. NEAL. I was going to encourage you to save it if it wasn't supportive of our view.

Mr. Greenberg, I have a question on H.R. 844, the leasehold depreciation bill. I represent an old New England city and, as you know, old New England cities all look alike now. In your testimony, you make reference to how this bill would help small business and I would like you to speak to that after you speak to how the bill would help old cities in their revitalization processes. Our manufacturing base is fairly stable in this economy, but at one time the hand-tool industry was highly dominant and now it is but a fraction of what it once was.

Mr. GREENBERG. Well, the issue has to do with the disincentive for the landlord to make the improvements by virtue of the fact that he has to depreciate over 39 years and the rental stream is for a shorter period. As a result of that, the landlord is not willing to make the kind of improvements that someone else who is building a new building might already put in in the beginning, in the early period. And, therefore, you will find urban sprawl. You will find people moving out and going to more modern buildings, higher tech buildings, and so forth, rather than the landlord updating his. So that will create growth away from the inner city as opposed to trying to keep it in the inner city.

And regarding the small business person, the small business person is usually the person who is starting out and he doesn't have the capital to lay out to make his improvements, so you really want the landlord to make the improvements. And the small business person pays for the improvements by paying an increased rent over that period of time. And that is in effect having the landlord finance his improvements for him. The incentive would be if the landlord were able to write that off over the period he is receiving the income on it. In most other areas, we try to match income and expenses, but this one we don't.

And, as I said before, we have given an incentive for the tenant to make improvements because he can write it off over the period of his lease. The landlord must write it off over 39 years. So H.R. 844 would help small business because the landlord has as much of an incentive or he is not de-incentivized to make those tenant improvements for the small business. And, as you know, small businesses hope to grow and increase. Their size space needs change. The configuration of their office space changes, and they need all of these kinds of services.

Mr. NEAL. I think that given the debate that is about to be undertaken on the whole notion of suburban growth, urban sprawl, and a host of other issues that come together, I think there really is an extraordinary opportunity here for old cities as more and more suburbanites resist any sort of growth and put up signs essentially that say, "No more growth." And I think that how it is done, hopefully in a tasteful manner, can really bring many of these old cities back to life. And I think as perspective entrepreneurs look at old cities now, they look at them in a different light than they did just 10 years ago. So I think that the suggestion you made is right on target.

Mr. GREENBERG. Yes, I think there are two areas. I think both the tenant improvement one and the brownfields one should——

Mr. NEAL. Brownfields, yes.

Mr. GREENBERG. The two of them together should increase the ability to keep people back in the cities and to encourage construction within the cities.

Mr. NEAL. Thank you very much. Thank you, Mr. Chairman.

Chairman ARCHER.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. And I will direct my question to Mr. Greenberg, who represents the community who I have the privilege of representing and glad to see you here. You just, with my friend, Mr. Neal, you touched on an issue, of course, which is of great concern in the Chicago region and that is the issue of brownfields. And it is estimated that there is at least 2,000 brownfields in the Chicago metropolitan area. And 2 years ago, as part of the Balanced Budget Act, we had a limited provision which provided a tax incentive for the clean up of brownfields, encouraging private investors and I have seen that work in the 10th Ward in Chicago down in Hegwich with what is the largest brownfield in the State now is being rejuvenated as a result of that tax incentive.

But do you have a feel, since this tax incentive was targeted solely to Federal empowerment zones and to low-income census tracks and to neighboring census tracks, what percent of the brownfields in the Chicago metropolitan area benefit from that targeted brownfield incentive?

Mr. GREENBERG. I don't know. I believe it is a pretty small percentage. One of our members is someone who develops or redevelops industrial buildings. And he is extremely interested in this, especially in the Chicago area because there are a lot of areas that are not targeted empowerment zones.

And I don't look at it as a tax incentive, the ability to write off brownfields expenses. I look at it as correcting a disincentive because what is happening is if you were to repair or fix any kind of a problem, you get to write that off. You get to expense it as you fix the problem. The problem with brownfields is you bought a piece of property, you inherited a piece of property that has contamination. If you spend the money to fix it up, that gets capitalized into the cost of the land. You never recognize the benefit of what you paid for until you ultimately sell that project. Well, that is a disincentive. You are not giving the people incentive to correct the problem. And I think that cities like Chicago, would benefit tremendously by being able to have people not be disincentivized from repairing contamination.

Mr. WELLER. I know 2 years ago, I worked closely with Mayor Daley on this issue, and we had some success. And I am constantly reminded by a lot of other community leaders in Illinois, of course, that there are a lot of middle-class and rural communities in the suburbs as well as rural areas that are denied this tax incentive because of the way it was targeted. And I believe it is a fairness issue to these other communities because a brownfield could be that gas station on that strategic quarter in town that everyone wonders why nobody buys it and puts it to work or it could be an industrial park in a rural area that is just sitting there and it both has an environmental initiative to clean up the environment and preserve open space because it is estimated that greenfield industrial parks consume about three to four times as much land as the old traditional, old-fashioned brownfield industrial parks.

So my hope is as we work over the next few years that we can find a way to expand that brownfields, lack of a better word, tax incentive to encourage private investors to clean up these old brownfields, put them back to work, revitalize those old communities and also help clean up our environment.

Mr. GREENBERG. We hope so too.

Mr. WELLER. So thank you. I am glad you are here. I appreciate it.

Mr. GREENBERG. Thank you.

Chairman ARCHER. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. To the witnesses, thank you all for coming. And to my colleague from Missouri, thank you for delineating those who are newcomers to testify, as well as those who are grizzled but not cynical veterans of the entire process. My friend from the "Show Me State" really had more of a "tell me" approach when he talked about different legislation. And in that spirit, taking his cue, Mr. Baroody, thank you for your comments about the bill I am preparing to introduce today as a matter of fact with the cosponsorship of eight Members of this Committee.

You know, Mr. Chairman and colleagues, it is interesting that ofttimes we are awash in a sea of acronyms. In Washington, DC, in general, especially with reference to tax policies and just a casual observation, the letters I am about to use, you just invert a little bit and they become a major issue for America's bankers. We can get to that in a second. But in this case, I am not speaking of ATMs, but of the AMT, the alternative minimum tax. Mr. Baroody, why is the AMT referred to as an antimanufacturing tax?

Mr. BAROODY. Mr. Hayworth, because it operates with effect all too often among manufacturers generally, and our members specifically. Clearly, any company that has to make large investments in plant and equipment, and that is the manufacturing community, are especially affected by the AMT. And inherently the AMT is designed to have that effect when a company is doing relatively poorly in terms of profits. That is where the AMT inherently triggers in. So it has the effect of focusing specifically on capital intensive companies when they are in the worst situation financially.

Mr. BLOOMFIELD. Mr. Hayworth, can I also comment on that?

Mr. HAYWORTH. Indeed, please do.

Mr. BLOOMFIELD. First of all, let me not be dilatory and also not avoiding congratulating and thanking you for your leadership on the AMT. To put some numbers on that, if you could please look at table 1 of our testimony, there is a comparison of the taxation of equipment. Table 1 compares the present value of certain types of equipment in the United States under the 1985 lax law, MACRS, and the AMT with present values for the same equipment in several other countries. And whether you are looking at computer chips or telephone switching equipment, crankshafts, or pollution control equipment, you can see what the AMT does in reducing the value of that important investment.

I could say one other thing. I don't know what the rules of the Committee are in terms of studies appearing, but do CRS studies automatically become part of the Committee's record? Because there is one that is troublesome and that is Jane Gravelle's study of "Capital Gains Taxes, Innovation, and Growth" in January 28, 1999, that indicated that capital gains tax cuts do not have much of an impact on entrepreneurship and venture capital. And we have asked David Wyss of DRI to respond to that. And if I could at some point, I would like his analysis to be put in the record to rebuttal Ms. Gravelle's piece.

Mr. HAYWORTH. I thank you for that observation, Mr. Bloomfield. And we will check with the Chairman vis-a-vis the rules of the Committee and the House to see if that report can, in fact, be included.

I mentioned earlier the bankers. Mr. McCants, thank you for coming out from Goodland to this challenging land right here around the Nation's capital. And I just wanted to thank you as well for mentioning the legislation of Mr. McInnis and I am pleased to cosponsor that along with my friend from Louisiana.

Your testimony says that the IRS reasonable liquidity needs standards undermine a regulator's authority to examine and enforce safety and soundness laws. Could you please explain or elaborate what you mean by that statement?

Mr. MCCANTS. Well, from a regulatory standpoint, we need certain amounts of investments that are very liquid. And that liquidity comes from our bond portfolio, for the most part. And, consequently, such as in our particular case, we are just a small $250 million bank. But in December we may be borrowing $30 million or $40 million in funds from the Federal home loan bank in upstream correspondence. And then, in turn, in January, we may be selling $10 million or $20 million in funds because we are an agricultural bank and those farmers are not going to be paying taxes by selling grain in December when they sell it in January and defer those gains.

So, consequently, we see big shifts in liquidity and we have to be prepared for that. So we maintain large bond balances in our bank portfolio to help prepare for liquidity needs and seasonal runoffs of deposits. Well, by really overstating our balance sheet and our income from the bond portfolio, we are doing ourself a disservice and we could jeopardize our S corporation status by doing it.

And then, consequently, the other side of the coin is some of our municipalities are depositing huge government payments in January and we have to have bonds to pledge for our county as the funds are going to the school district and, consequently, we have got to pledge to both entities at the same time. So we have to have a very liquid bond portfolio to generate that kind of pledging ability.

So, in doing that, yes, we are overstating the income from our bond portfolio or the necessary. It is good business? No, probably isn't. Is it good for our municipalities? Yes, it is very good because they don't have to go outside our area.

Mr. HAYWORTH. Thank you, sir, very much. Thank you, Mr. Chairman.

Chairman ARCHER. The Chair will conclude the inquiry with this panel for about 5 minutes and then the Committee will stand in recess to vote. When we come back, we will hear from our last panel today.

Gentlemen, thank you for your input. You speak to a great degree on items in the Tax Code that will affect job creation and productivity which, in the Chair's opinion, is the essential ingredient to improve the lot of workers in the next century, all American workers. If we do not create better jobs and higher productivity, then we are not going to be able to see an improvement in the standard of living. Having said that, in the opinion of each of you, what is the single biggest thing that we can do in the Tax Code to bring that about: more job creation, higher productivity? Mr. Baroody.

Mr. BAROODY. You ask for a single——

Chairman ARCHER. One thing, now, only. [Laughter.]

Mr. BAROODY. Yes, sir. The discussion may have gone on when you were out about whether we want to be hit by a bus or a car. I won't try to hide behind that. As you heard—first, it is exactly what the Chairman intends, a very difficult question. What we have testified today and historically support are tax provisions which see to the continued growth of the economy. That was the thrust of my testimony.

That was why, last December, we called for across-the-board, evenly balanced, and fair approaches. I would be hard-pressed, Mr. Chairman, right now, to answer your question on its own terms. And I regret that.

Clearly the R&D tax credit, in terms of bang for the buck, if I could put it that way, is hugely important. But the operation of the AMT, right now, functions, as Mr. Hayworth's question suggests, as an antimanufacturing tax.

Chairman ARCHER. Well, that was three things.

Mr. BAROODY. Yes, sir.

Chairman ARCHER. You know, I have got to prioritize.

Mr. BAROODY. I understand.

Chairman ARCHER. I am asking each of you to prioritize. I am not saying that that is the only thing that you would want. But I would like to know what you feel is the number one priority. Mr. Capps.

Mr. CAPPS. Mr. Chairman, I think it all centers around technology. Federal Reserve Chairman Alan Greenspan——

Chairman ARCHER. OK. We have got a limited amount of time. What in the Tax Code would you change that would have the biggest impact on job creation and productivity?

Mr. CAPPS. I would make a permanent extension of the research tax credit. It is job-oriented, technology-oriented. It is going to give growth and productivity increases to the economy and keep driving it.

Chairman ARCHER. OK. All right. Mr. Bloomfield.

Mr. BLOOMFIELD. Replacing the income tax with a consumption tax. And if you won't do that——

Chairman ARCHER. That is the right answer. OK. [Laughter.]

Mr. BLOOMFIELD. Then I had better stop. If you won't do that, people smarter than me, like Professor John Shoven, said probably reducing the cost of capital for expensing for investment.

Chairman ARCHER. Reducing the cost of——

Mr. BLOOMFIELD [continuing]. The cost of capital by expensing investment.

Chairman ARCHER. OK. All right. Mr. McCants.

Mr. MCCANTS. I would have to agree with Mr. Bloomfield. I think whatever we can do to reduce the cost of capital is essential.

Chairman ARCHER. I agree with that, but what in the Tax Code would you change that would have the biggest impact on that?

Mr. MCCANTS. I think by being able to accelerate the expensing of items.

Chairman ARCHER. Accelerate expensing. All right. Mr. Greenberg.

Mr. GREENBERG. I agree because you need something to encourage the entrepreneurship in this country to create the jobs and I think that would be one of the ways to do that.

Chairman ARCHER. Mr. Leonard.

Mr. LEONARD. Encourage equity investment in American industry.

Chairman ARCHER. All right. But what change in the Tax Code would you make to do that?

Mr. LEONARD. Specifically in the case of my testimony is to allow publicly traded partnerships to be treated as investments by mutual funds. This would allow more equity to flow into such partnerships.

Chairman ARCHER. All right. In your opinion, that would do more for job creation and productivity than any other single change in the Tax Code?

Mr. LEONARD. I think in certain areas, yes.

Chairman ARCHER. OK. Several of you mentioned the R&E credit and there is good bipartisan support for extension of it. I have always been curious, though. How much of that credit goes to industries who would do the research any how without the credit? What percent of the credit, in your opinion or your knowledge by any data that you have, is going to industries that would otherwise, because of competitive pressures, do the very same thing?

Mr. CAPPS. I don't think it is a function of what industries is it going to; on the margin it makes a difference to all industries. In the United States now, we are all under competitive pressure and the market is driving us to do research. And much of our research is market-driven. But what is being incentivized is, across-the-board, those projects on the margin that wouldn't have gotten done otherwise. The credit is providing the capital and the incentive to go that extra step and pick up those projects. So it is not industry-specific. It is across-the-board, I think.

Chairman ARCHER. Well, that is my last question. I only have one brief statement to make before you are excused. As I listen to witnesses who come forward with different types of suggestions for improvements in the Income Tax Code, whether it be your panel or any other panel, it is generally on the basis of fairness and equity that the proposals are made. Every time that we adopt a proposal, we create within the Tax Code other areas of inequity and unfairness. When we do something to create more equity in one case, we have less equity in another case.

I am more and more convinced that Mr. Bloomfield is right. The only way to solve these problems is to have a true level playingfield by abolishing the income tax, completely and totally, and getting the IRS completely and totally out of running our lives one way or another. Go to a specific tax which has no grey areas, which is a consumption tax, a spending tax, a sales tax. Whatever you want to call it. Then you have specificity. You have no opportunity for the IRS to say, oh, but this is right. Or that is wrong. Or anything else.

So I simply say we will keep working to try to fix the income tax, but we will never get there. Thank you very much. We will stand in recess until the votes are over.

[Recess.]

Chairman ARCHER. The Committee will come to order. My apologies for keeping all of you people waiting. I know my former colleagues understand that when the votes are called over there, there is not much you can do about it. We are glad to have all of you before us. The rules, of course, are that we would like for you to try to keep your oral testimony within 5 minutes and your entire written statements, without objection, will be printed in the record. At least two of you are no strangers at all to this Committee room and we are delighted to see you back before us again. Henson Moore, would you like to lead off?

STATEMENT OF HON. W. HENSON MOORE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN FOREST AND PAPER ASSOCIATION; AND FORMER MEMBER OF CONGRESS

Mr. MOORE. Thank you, Mr. Chairman. My name is Henson Moore. I am the president of the American Forest and Paper Association, which is the national trade organization representing the forest products industry.

We are the biggest in the world. Nobody makes more lumber, building materials, or paper products than the United States, currently. In 1992, Fortune Magazine said that our industry was one of the two or three heavy industries the United States had left that was competitive worldwide. Unfortunately, since 1992—and it may have even begun before that—that competitiveness is slipping away.

We did a study last year, a study of all of the factors that are important to our industry and compared them with the countries with whom we compete in our industry. And, unfortunately, on every one of those factors, and taxes is one of them, we came out as being either the worst off or almost the worst off. And those factors are having a telling effect on us being able to compete.

In the field of taxes, we asked Pricewaterhouse to compare the effective tax rate of our industry, both as a manufacturer, which would affect industries besides just us, and on forestry operations, which is just us; to take a look at those and compare it with five sample countries with whom we compete that are major competitors of ours: Brazil, Canada, Finland, Indonesia, and Japan.

And as a result of that study by Pricewaterhouse, it came back a bit worse than we thought, that, overall, generally, the effective tax rate on our industry in the United States, as a corporation, is 55 percent. And the only country higher than that—and just slightly higher than that—is Canada. The rest of the countries with whom we compete had effective tax rates substantially lower.

In the case of manufacturing, we were at about something like 62 percent. Canada was at about 70 percent. And forestry operations, overall, we were at 55 percent and Canada was at about 60 percent. Some countries like Indonesia is minus 2 percent. They pay you to plant trees and take care of forests there. And just plain reforestation expenses, the cost of planting trees after you cut them and taking care of that until they get to a point you can harvest them, the United States has the distinction of having the highest tax rate of all of the countries studied at 63 percent.

Basically, Mr. Chairman, the biggest cost in our industry is fiber, the tree. The tree in the United States now costs more and is going up substantially. And then the tax bit on us providing or maintaining or reforesting and providing that source of fiber is too high for us to be competitive. We need to move on all of these factors we studied: costs of environmental compliance, transportation costs, international trade barriers and tariff barriers to our products. There are a number of factors we looked at, but taxes is one of the key ones.

And if we don't address that, our industry is not going to remain—in fact, it isn't today—as competitive as it was. And we don't think it is today as competitive as it should be. We may not even be competitive, period. And we saw changes last year for the first time, swings in reduction in our exports and increases in imports.

And so, basically, Mr. Chairman, we would like to call your attention to a bill that one of the Members of the Committee has sponsored, Representative Dunn, the Reforestation Tax Act, along with a number of cosponsors from the Committee and about 65 in the House. It has been introduced in the Senate, yesterday, by Senators Mikulski and Breaux with 13 senators cosponsoring it so far there.

It basically does two things. It cuts the capital gains tax rate for corporations and individuals in owning forest and it raises the cap that is on now for a tax credit for reforestation and shortens the amortization period on the balance. And those two things, according to Pricewaterhouse, if this Committee were to pass those two things on the forestation cost side of the tax study, it would put us about in the middle of the pack of the countries with whom we compete. We are now at the bottom of the pack or the top of the pack, however you look at it. Top of taxes, but it would move us to about the middle of the pack.

And so the bill would, in fact, have a dramatic effect on that part of our lack of competitiveness. The remaining part on taxes, just the tax rate and the tax bite on a manufacturing concern in the United States, that wouldn't really be affected by this and that is something that would have to wait for a later day when this Committee has a bill before it that affects all manufacturing in that regard. And so, Mr. Chairman, we would urge the Committee to seriously considering including in its bill, the Reforestation Tax Act.

[The prepared statement follows. Attachments are being retained in the Committee files.]

Statement of Hon. W. Henson Moore, President and Chief Executive Officer, American Forest & Paper Association; and Former Member of Congress

My name is Henson Moore. I am President & CEO of the American Forest & Paper Association. AF&PA represents more than 240 member companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from state-of-the-art paper mills to small, family-owned saw mills and some 9 million individual woodlot owners.

The U.S. forest products industry is vitally important to the nation's economy. We employ 1.5 million people, and rank among the top ten manufacturing employers in 46 states. Our industry has annual sales exceeding $230 billion, and accounts for about seven percent of U.S. manufacturing shipments.

The U.S. forest products industry has many important assets, including a productive work force, technological know-how, and an abundant renewable domestic fiber base. Yet we are facing severe global competitive challenges. In 1992, *Fortune* magazine listed this industry as one of the most competitive U.S. industries. That assessment increasingly no longer applies.

There is currently not a level playing field between us and our competitors around the world. Our taxes are higher than those of competing nations, and there are unfair trade barriers to the exporting of our products to other markets. The cost of compliance with our nation's environmental laws is higher, and transportation costs are greater than anywhere else around the globe. Additionally, increased restrictions on fiber are limiting access to the lifeblood of our industry. If we cannot successfully address these challenges, the public demand for forest products will increasingly be filled by other nations who do not adhere to our high standards. The cost to the global environment and to our economy will be significant.

As a result, our industry has done an intensive self-examination to determine what is causing that shift in our international competitiveness, and my written testimony includes AF&PA's white paper on that analysis. To summarize however, the US forest products industry critically looked at all of the key factors—forestry practices here and overseas, environmental practices here and abroad, access to fiber, tariff and non-tariff barriers to our exports, labor, taxes, and transportation costs—to determine where we could improve our international competitiveness. Some findings we expected—others we didn't. Basically, we are not as competitive as we need to be on any of these factors.

- Some key factors are beyond our industry's direct control, such as exchange rates and the build up of overseas capacity.
- Some factors are subject to the whims of international negotiations, such as the tariff reductions proposed in the APEC tariff initiative and now the ATL initiative, which we hope to see bear fruit in the WTO Ministerial in Seattle in November. Tariffs in the US on paper and wood products imports have been basically non-existent since the 1980's, while our major trading partners continue to hide behind tariff walls on these same products. We continue to fight for tariff elimination—through GATT, through APEC, and now maybe the WTO—but the window for meaningful change is becoming more narrow all the time.
- At home, other competitive factors can be improved by industry initiatives, such as the Sustainable Forestry Initiative. In the SFI, AF&PA members are voluntarily taking steps to show the rest of the world what can be accomplished through our industry's self initiated program to support sustainable forestry practices on lands AF&PA members manage and actively promote such practices on other forestlands.

However, today we would like to focus on one of the major domestic factors—that of taxes. As part of our industry analysis, we asked PriceWaterhouseCoopers to do a study that compared the effective tax burdens on investments in paper manufacturing and forestry and timber in the United States and our top 5 competitors: Brazil, Canada, Finland, Indonesia, and Japan.

And the results? The US has the second highest effective tax rate on all forestry operations among its major competitors—55%—while reforestation costs in the US were subject to the highest effective tax rate of all countries studied—63%.

These results probably were not intended and were the result of years of tax policy changes without an analysis of the accumulated effect on competitiveness. But the problems we now face can and must be addressed through positive Congressional action. Congress can act now to remove certain tax disincentives in current law that would go a long way to insure the future competitiveness of this industry.

The changes the forest products industry recommends are embodied in the Reforestation Tax Act, HR 1083, introduced by Rep. Jennifer Dunn, a member of this committee, and supported by 64 additional co-sponsors in the House, including 14 members of this committee. An identical bill, S.1240, has also been introduced in the Senate by Senators Murkowski and Breaux with 15 co-sponsors.

HR 1083 would essentially do two things:

1. MITIGATE THE COMPETITIVE DISADVANTAGE OF INVESTING IN THE FOREST PRODUCTS INDUSTRY.

The Reforestation Tax Act recognizes the unique nature of timber and the overwhelming risks that accompany investment in this essential natural asset, and attempts to place the industry on a more competitive footing with our competitors. In short, it would reduce the capital gains paid on timber for both individuals and corporations and expand the current reforestation credit. Because it often takes decades for a tree to grow to a marketable size, it is important that we look carefully at the long-term return on investment and the treatment of the costs associated with owning and planting of timber.

The bill would provide a sliding scale reduction in the amount of taxable gain based on the number of years the asset is held (3% per year). The maximum reduction allowed would be 50 percent. Thus, if the taxpayer held the timber for 17 years, the effective tax rate for corporate holdings would be 17.5% and the rate for most individuals would be 10%.

AND

2. ENCOURAGE REPLANTING BY LIFTING THE EXISTING CAP ON THE REFORESTATION TAX CREDIT AND AMORTIZATION PROVISIONS OF THE TAX CODE.

Currently, the first $10,000 of reforestation expenses are eligible for a 10 percent tax credit and can be amortized over 7 years. No additional expenses are eligible for either the credit or the deduction, meaning that most reforestation expenses are not recoverable until the timber is harvested. The legislation removes the $10,000 cap and allows *all* reforestation expenses to qualify for the tax credit and to be amortized over a 5-year period. This change in the law will provide a strong incentive for increased reforestation by eliminating the arbitrary cap on such expenses.

These tax changes will provide a strong incentive for landowners of all sizes to not only plant and grow trees, but also to reforest their land after harvest. This is key to maintaining a long-term sustainable supply of fiber and to keeping land in a forested state. The Dunn bill does not affect the manufacturing tax competitive inequities—that will have to wait for another day. But it does address the reforestation element and goes a long way to solving that part of the problem. We believe it moves us from the most taxed to about the middle of the pack. That will start us down the path back towards being competitive.

HR 1083, the Reforestation Tax Act, has united this industry and is endorsed by all elements of the forest products industry—small growers, organized labor, large and medium sized forest and paper companies, and regional forestry associations across the country. I would like to submit for the record letters of support for the Dunn bill which express the backing of 98 industry CEOs, the Carpenters Union, and 28 regional and state forestry associations. I might add these include a resolution of support for HR 1083 from the Texas Forestry Association. The Reforestation Tax Act recognizes the unique nature of timber and the overwhelming risks that accompany investment in this essential natural asset, and attempts to place the industry on a more even footing with our competitors.

HR 1083 would reduce capital gains taxes paid on timber for both individuals and corporations and expand the current reforestation credit. Because it often takes decades for a timber grower to recoup his or her investment, it is important that we look carefully at the long-term return on investment and the treatment of the costs associated with owning and planting of timber.

It is our strong belief that this bill represents not only fair tax policy, but also promotes good trade and environmental policy, and will help keep the industry competitive as we enter the next century.

As you begin the process of putting together a tax bill next month, we urge you to include HR 1083 in the Chairman's mark. It is a bipartisan bill which is in the best interest of the environment, the economy, and both corporate and private landowners who are some of the best environmental stewards in this country.

Thank you, Mr. Chairman, for this opportunity to testify, and I would be happy to answer any questions.

Chairman ARCHER. Thank you, Mr. Moore.

Mr. Andrews.

STATEMENT OF HON. MICHAEL A. ANDREWS, TRUSTEE, NATIONAL TRUST FOR HISTORIC PRESERVATION; A FORMER MEMBER OF CONGRESS

Mr. ANDREWS. Thank you very much.

Chairman ARCHER. Welcome. We would be pleased to receive your testimony.

Mr. ANDREWS. I am delighted to have a chance to be here. I am Michael Andrews, and I am here on behalf of the National Trust for Historic Preservation. I serve on the board of trustees and I am here because president Richard Moe could not be here this afternoon. But I am delighted to have an opportunity to talk with you about H.R. 1172, the "Historic Home Ownership Assistance Act."

It is a bill that the National Trust believes can be a powerful tool to encourage revitalization of our inner-city communities and save precious historic structures. Let me say at the onset that there are 19 Members of this Committee that are cosponsors of the bill and some 130 bipartisan members of the House. Congressman Clay Shaw and John Lewis are the two leading cosponsors of this really, truly important legislation.

Briefly, let me tell you a little bit about the National Trust. There are over 275,000 members in the Trust. It was chartered in 1949 by the Congress to preserve our Nation's historic structures and heritage. There is nothing more important than recognizing what needs to be done in our country's inner cities and historic neighborhoods to maintain the sense of community and save those structures. This bill really augments and complements the Federal rehabilitation tax credit that has been so successful for commercial uses.

For instance, the Federal rehabilitation tax credit, just in the last year, has leveraged some $2 billion in private investment in restoring commercial structures for business use; structures, in many cases, that would have been razed or not used at all have been put back into active use and most of them—most, not all, but most of them—find themselves in inner-city areas. And in the last 20 years, since Federal rehabilitation tax credit was initiated, $20 billion in private investment has gone into saving those kinds of structures.

In our city of Houston, for instance, the famed Rice Hotel would likely not have been restored without the use of that important tax credit. And what this legislation (H.R. 1172/S. 664) does is focus on families and home ownership. It is very tightly drawn to say that a young family or a couple that wants to live in a historic neighborhood, to live in a historic structure, can receive a 20 percent tax credit to help them restore that structure. There is a maximum allowable credit of $40,000 on any given structure. The developers themselves could rehabilitate the properties, but they have to pass on the tax credit to the homeowners. Homeowners have to live in the property itself for 5 years to qualify for the tax credit.

We think these historic areas, much like the way the commercial tax credit works in empowerment zones, should have added incentives for poor families to encourage them to restore structures. In Houston, for instance, again, the fourth ward, Freedmanstown, where 15 years ago there were well over 400 structures on the National Register for historic sites is a good example. And today there are less than 200. They are being destroyed almost daily. Those are primarily homes for single families. They are not businesses; they are not tall buildings, as you know, Mr. Chairman. They are homes.

And the way this tax credit is structured is that a young family or family that wants to restore a historic house and use that credit, can get a tax credit against the interest rate that they pay. They can turn it into their mortgage company, if they don't have enough revenue to itemize their taxes. So it is tightly drawn not to simply reward a wealthy family in particular in a wealthy neighborhood, but to try to focus the credit where it is needed the most, in our country's inner cities and older suburbs.

This is an important bill. It is modest, relatively modest in its cost. The revenue estimate is about $678 million over 5 years. It is something that I hope the Chairman will consider in the context of the tax bill as a very important way to encourage home ownership in our country's inner cities.

[The prepared statement follows:]

Statement of Hon. Michael A. Andrews, Trustee, National Trust for Historic Preservation; a Former Member of Congress

H.R. 1172, THE HISTORIC HOMEOWNERSHIP ASSISTANCE ACT

I am pleased to have this opportunity to present to the U.S. House of Representatives Committee on Ways and Means the views of the National Trust for Historic Preservation on H.R. 1172, the Historic Homeownership Assistance Act, which would provide a 20 percent income tax credit based on expenditures related to the certified rehabilitation of an owner-occupied home in a historic district. The National Trust strongly supports passage of this legislation, and asks the Committee to include the provisions of this bill in any tax package it advances. The National Trust for Historic Preservation, chartered by Congress in 1949, is a nonprofit organization with more than 275,000 members. As the leader of the national historic preservation movement, the Trust is committed to saving America's diverse historic environments and to preserving and revitalizing the livability of communities nationally.

I want to begin my testimony by commending Congressmen E. Clay Shaw and John Lewis for championing the Historic Homeownership Assistance Act, which is critical to preserving historic districts and stabilizing older neighborhoods around the country. The legislation has 130 cosponsors in the House from both sides of the aisle, including 19 members of the Ways and Means Committee. The Historic Homeownership Assistance Act accomplishes the goals of historic preservation, homeownership and community revitalization.

I. *The Need for a Historic Homeowner Tax Credit*

America's historic resources are at risk. In the decades since World War II, in tragic counterpoint to the growth of the sprawling new suburbs, we have witnessed the progressive erosion and loss of older neighborhoods and communities all across the country. As new development pushes relentlessly into the countryside, it erodes the prospects for preserving (or restoring) the economic vitality of our older cities, towns, and suburbs.

Protecting the Irreplaceable: Historic buildings cannot be saved unless they have users. They will not have users unless the areas in which they are located have an economic pulse.

I believe that all Americans are committed at heart to the preservation of our heritage. As preservationists, we have developed tools to save the individual treasured building from the wrecker's ball. We do not always succeed, but we are not without the means to show the way and make the case for preservation.

What we lack are the tools to address the problems of blight and abandonment that threaten entire older neighborhoods and communities. In the decade from 1980 to 1990, Chicago lost 41,000 housing units to abandonment, Philadelphia 10,000 and

St. Louis 7,000. Smaller communities suffered the same fate, and the trend continues. Some of these houses were architectural gems; many were ordinary houses. But taken together they constituted the physical fabric of a way of life which is now gone.

The historic homeowners tax credit would complement the existing historic rehabilitation tax credit for commercial historic properties. The commercial tax credit has generated approximately $20 billion in private reinvestment in historic commercial properties across the country over the past 20 years. This tax credit leveraged more than $2 billion in private investment last year alone. Unlike the commercial credit however, only existing and prospective homeowners would benefit from the new tax credit.

H.R. 1172 is designed to work in a broad range of contexts; each community is likely to find its own applications. From small towns in New England and the midwest to large and small cities on the east and west coasts, as well as older neighborhoods everywhere, homeowners will be attracted by the appearance of a different era, but the convenience of living in older, established neighborhoods.

Clearly, this is no time for massive government programs which might or might not be successful in helping to preserve these resources. What is needed is a carefully targeted incentive to revitalize these communities which will involve a minimum of government involvement and a maximum of individual initiative, one that is modest in cost and limited in scope but that can spark broad private activity. We believe H.R. 1172 is a fair, feasible and cost-effective answer for revitalizing older communities, encouraging homeownership, and protecting historic homes.

II. *Eligible Structures*

The universe of buildings eligible for the tax credit is a limited one. Only buildings that are listed in the National Register of Historic Places, are contributing buildings in National Register Historic Districts or in nationally-certified state or local districts, or are individually listed on a nationally-certified state or local register would qualify. The National Park Service has estimated that slightly in excess of one million buildings nationwide presently fall in those categories.

To insure that their historic character is preserved, buildings receiving the credit would have to be rehabilitated in accordance with the Secretary of the Interior's Standards for Rehabilitation. However, the bill provides that certification of compliance may be performed by states or even localities under cooperative agreements entered into with the Secretary of the Interior. In addition, the bill authorizes the states to charge processing fees, the proceeds of which would be used to fund the costs of processing the applications for certification.

III. *Costs and Benefits*

Because of the constraints on eligibility that I have described, the revenue implications of H.R. 1172 would be modest. Nevertheless I believe it can make a real difference in communities all across the county—from decaying small towns to threatened big-city neighborhoods. By providing an incentive for Americans at all income levels to invest in the rehabilitation of deteriorated buildings and become home owners in older neighborhoods and communities, it can provide the following benefits:

- saving invaluable historic resources, which would otherwise be lost through decay, abandonment and demolition.
- stabilizing and rescuing endangered communities through the infusion of new home owners, who will make a commitment to the enhancement of community life through their purchase of a home.
- providing cities and towns with the chance to strengthen their tax bases by attracting middle-income and more affluent residents.
- creating jobs and stimulating economic activity in areas where economic opportunities are scant.

IV. *Major Provisions of H.R. 1172*

Rate of Credit:

The credit, which would equal 20% of qualified rehabilitation expenditures, would be available to homeowners in condominiums and cooperatives as well as single-family homes. It could be used by the do-it-yourself rehabber, or someone who purchases a home rehabilitated by a developer. In the latter case, the credit would accrue not to the developer, but to the purchaser of the home.

Maximum Credit, Minimum Expenditures

The maximum credit allowable would be $40,000 for each principal residence, subject to Alternative Minimum Tax provisions. As with the current credit, rehabilitation must be substantial—the greater of $5,000 or the adjusted basis of an eligible building, with an exception for buildings in census tracts targeted as distressed for Mortgage Revenue Bond purposes under I.R.C. Section 143(j)(1) and Enterprise and Empowerment Zones, where the minimum would be $5,000. At least five percent of the qualified rehabilitation expenditures would have to be spent on the exterior of the building.

V. *Homeownership and Historic Preservation*

Central to the American dream is the desire to own one's own home. But home ownership is more than just a personal goal; by giving residents a true stake in their community, it promotes the qualities of neighborliness needed to heal and revive threatened and decaying residential areas.

The existing Federal tax credit for historic rehabilitation is not available to homeowners, but applies only to commercial property or other property held for the production of income. H.R. 1172 fills that gap. Moreover, because the tax credit that H.R. 1172 would create is limited to persons who occupy the building for which the tax credit is claimed as their personal residence, there are no tax shelters, no "passive losses" and no syndications. This provision is in contrast the to the existing rehabilitation tax credit for commercial historic properties. The historic homeowners tax credit only acts is an incentive purely for homeowners and homebuyers.

VI. *Opportunities for Low and Moderate Income Home Buyers*

There is a widespread misperception that historic districts are places where only upper-income families live. While it is true that some of the better known districts on the National Register have been rehabilitated by or for affluent people, it is equally true that the older housing stock in the United States tends far more to be occupied by families with more modest incomes. Indeed, according to an analysis of 1990 census data, 29% of the 8,700 National Register historic districts lie within or contain tracts with poverty rates greater than 20%.

This legislation has been drafted to provide homeownership opportunities in rehabilitated historic buildings to Americans with a broad spectrum of income levels. For those who do not have sufficient income to be able to use a tax credit, the bill creates a Historic Rehabilitation Mortgage Credit Certificate that can be used to reduce the interest rate on their mortgage loan.

Rehabilitation would have to be substantial. As I stated earlier, the bill would follow existing law by requiring a minimum investment in qualified rehabilitation expenditures equal to the greater of $5,000 or the adjusted tax basis of the building. However, an exception would be made for economically distressed census tracts where the minimum investment required would be $5,000. Taxpayers at all income levels would be permitted to use the credit, but the amount of credit available to a homeowner would be limited to $40,000.

Consider, as an example, a hypothetical home rehabilitated by a developer which qualifies for the credit. Assume that the home has a selling price of $150,000 and contains $100,000 in qualified rehabilitation expenditures. The credit on this home is $20,000 (20% of $100,000). This would more than cover a down payment of 10% on the home. In this case the credit would have the effect of reimbursing the home purchaser for the down payment. Although this example involves a developer, the credit could also be used by an individual homeowner to help defray the cost of rehabilitating his current or newly-purchased residence.

VII. *Illustrations*

As I stated earlier, the Historic Homeownership Assistance Act benefits families with a broad spectrum of incomes. Allow me to provide two examples:

Barrington Historic District in Barrington, Illinois, is a historic commuter suburb of Chicago consisting of Victorian country homes. Barrington is a much-desired place to live. While Barrington's popularity has encouraged investment in the historic district, it has also invited problems. Some homes have been destroyed or converted drastically through speculation, while others have been boarded up while owners hold out for property values to increase. The Historic Homeownership Assistance Act would spur further revitalization, and help prevent Barrington's popularity from ruining the very qualities that make the town so special—and strengthen the sense of community of Barrington.

Mount Morris Park Historic District in Harlem consists of 19th Century townhouses, originally bought by prosperous white middle-class households. Today, Mount Morris is a growing neighborhood, with an economically diverse African-American population. One district homeowner, Josephine Jones, has spent the last decade reconverting her 1880s townhouse from a boarding house to a single-family home. Because she is a retiree, she has limited tax liability. Ms. Jones wants to complete her rehabilitation at a cost of $200,000. With the Historic Homeownership Assistance Act, Ms. Jones could receive a Mortgage Credit Certificate for $40,000 (20 percent of qualified rehabilitation expenditures). She could transfer the certificate to the mortgage lender in exchange for a reduced interest rate on her home mortgage loan. A local bank, more likely to grant her a loan with the backing of the certificate, could reduce its own federal income tax by $40,000.

VIII. *Conclusion*

When preservation begins in a community, good things follow. H.R. 1172 is not a cure-all for ailing communities. Change for the better, if it is to come, will be incremental. It will result from decisions made by individual Americans, one family at a time. But H.R. 1172 can be a spark that ignites those private decisions to the benefit of our families, our communities, and our heritage as Americans. On behalf of the 275,000 members of the National Trust for Historic Preservation, I strongly urge the prompt enactment of this legislation.

Chairman ARCHER. Thank you, Mr. Andrews.

Our next witness is Mr. Wolyn. Welcome. You may proceed.

STATEMENT OF MICHAEL A. WOLYN, EXECUTIVE DIRECTOR, NATIONAL ALLIANCE OF SALES REPRESENTATIVES ASSOCIATIONS, ATLANTA, GEORGIA

Mr. WOLYN. Mr. Chairman, Members of the Ways and Means Committee, my name is Michael Wolyn. I am executive director of the National Alliance of Sales Representatives Associations or NASRA. And, on behalf of the 10,000 members of NASRA, I want to thank you for the opportunity to speak to you today and discuss a tax relief issue of great concern to that membership.

The issue that we would like to address impacts every sales representative and other independent businessowner who must travel to sell for a living. The issue I would like to address is the tax limiting the tax deduction for meals. Current tax law allows the deduction of a business meal at half its value, not 100 percent, as a legitimate business deduction, but 50 percent. Many of our member groups have asked legitimate questions. If the meal is a true business meal or a true business-related expense, why isn't it fully deductible?

Most of our members do not have formal offices. Most work out of home offices. When a rep is working his or her territory, they are technically on the road. Many are out 150 to 170 nights a year. One of the methods of dealing with their customers, the small and large retailers they service, is to get them out of their store, out of their stock room or to get them into an area where a relationship can be developed. And, more often than not, that relationship is developed in a local coffee shop or a bagel shop.

I have got an example for you. One of the gentlemen you may well know, Bob Lantour out of Houston, Texas, who, unfortunately, can't be here because his roof blew off last week in a storm, indicates to me by letter that he was out 137 nights last year and had 411 meals. Now I posed the question: 411 meals? And he says, yes, I sometimes eat five times a day.

Well, before I became executive director of this body, I was a traveling sales representative. I traveled the 13 western States based out of San Francisco, California. And I was out more than 200 nights a year and, quite literally, had more than 5 meals a day. I would build my business around meals. I would have coffee in the morning. Breakfast, if you will. Coffee and danish. I would have a mid-morning break where I would take a retailer out of a store.

My best story, I think, that I can relate when I was drafting the testimony, speaking to some of the folks up here. I used to be a manufacturer out of Hong Kong and this one particular story, I flew in from Hong Kong to New York in advance of a market week, had to go, got in at 5 in the morning, went to the New York Athletic Club from there to Chock Full O'Nuts, if you have ever been to Chock Full O'Nuts on Broadway. Didn't go to have coffee, went to have a business meeting. On that particular day, according to my record, I had seven meals. None of which, by the way, for sustenance. All of which were for relationship building.

And my point, simply, is this. That this is a, for people that do not have a marketing budget or promotional budget, this is, in fact, their marketing and promotion budget. I know this conduct, business may seem strange—five meals a day—but the average ticket is not enormous. We are looking at meals—the National Restaurant Association suggest that the average meal is about $11.00 a meal. Dinner is about $22.00.

To date, two bills have been introduced on this issue that meet the stated goal of helping small business. H.R. 1195, which was introduced by Congressman McCrery—we appreciate that and thank you very much—has been cosponsored by Representatives Tanner, Foley, Farr, Ramstad, Dunn, Weller, Jefferson, and Shaw. In the Senate, the companion language has been introduced by Senator Breaux. Identical language is also included in H.R. 2087, a bill that has been introduced by Congressman Talent, Chairman of the Committee on Small Business.

Both bills target the increased meal deduction to small business with less than $5 million in gross sales. The proposed legislation would increase the meal deduction limitation to 80 percent by 5 percent increments over the next 6 years and we would appreciate your consideration for this bill.

[The prepared statement follows:]

Statement of Michael A. Wolyn, Executive Director, National Alliance of Sales Representatives Associations, Atlanta, Georgia

Mr. Chairman, members of the Ways and Means Committee, my name is Michael A. Wolyn, Executive Director of the National Alliance of Sales Representatives Associations, or NASRA. On behalf of the 10,000 members of NASRA I want to thank you for the opportunity to speak before you today to discuss a Tax Relief issue of great concern to NASRA members.

NASRA is a coalition of sales representative organizations founded by the Bureau of Wholesales Sales Representatives and the International Home Furnishings Representatives Association. NASRA represents the interests of more than 10,000 independent wholesale sales representatives in the apparel, home furnishings, gift, western, ski/outdoor, and footwear industries. A full list of NASRA member groups is included in this statement.

NASRA is comprised solely of national sales representative associations. These associations are generally made up of local chapters, which conduct regional trade shows in their respective industries. These trade shows bring together hundreds of representatives and thousands of retailers, making them a significant contributor to the local economies.

NASRA's sole objective is the advocacy of the legislative interests of its member organizations. On the federal level, NASRA promotes economic and tax policies that level the playing field on which sales representatives compete. At the state level

NASRA has achieved a remarkable record of successfully advocating state laws protecting sales representatives right to collect earned commissions.

The typical NASRA member is a self-employed business owner. NASRA members represent the lines of multiple manufacturers and participate in regional trade shows in cities throughout the US, often comprising a territory of up to seven states.

Usually paid exclusively by commission, these sales representatives pay all business expenses out-of-pocket and are not reimbursed by their principals. They typically drive 30,000 business miles per year and spend approximately 150 nights per year in hotels. While compensation levels vary, the average member grosses between $80,000 and $100,000 per year, and expends approximately $30,000 per year in business-related expenses.

At the outset I would like to compliment the members of this Committee. In recent years the Ways and Means Committee has proposed changes in several areas of the tax law that are of great benefit to the sales representative community. Legislation clarifying the home office deduction rules and making permanent and increasing the health insurance deduction for self-employed business owners are of substantial benefit to sales representatives, and they are grateful to you for these tax rule changes.

Today, I wanted to address a provision that impacts every sales representative and other independent business owners who must travel to sell for a living. The issue I would like to address is the tax rule limiting the tax deduction for meals. It is an issue that several members of this committee have become concerned over and it is one that we hope Congress can redress this year.

BACKGROUND

As a part of the Tax Reform Act of 1986 Congress determined that the meal deduction should be reduced from 100 percent to 80 percent. The General Explanation of the Tax Reform Act of 1986 prepared by the Joint Committee on Taxation, stated the following rationale for limiting the meal deduction.

"The Congress believes that prior law, by not focusing sufficiently on the personal-consumption element of deductible meal and entertainment expenses, unfairly permitted taxpayers who could arrange business settings for personal consumption to receive, in effect, a Federal tax subsidy for such consumption that was not available to other taxpayers.

The taxpayers who benefit from deductibility tend to have relatively high incomes, and in some cases the consumption may bear only a loose relationship to business necessity."

In 1993 Congress further limited the deduction by reducing it from 80 percent to 50 percent. The rationale by congress for further reducing the meal deduction limits presumed a bias that the person using the meal deduction was a wealthy corporate executive and that the meal was incidental to the business purpose at best.

The substantiation rules, while slightly revised, provided no increased reliability to Congress that the meal deduction incurred was a valid tax deductible business expense. For purposes of comparison, large companies weren't asked to relinquish any portion of their advertising budgets nor a portion of their office rents that applied to lavish conference rooms for client meetings.

HOW SALES REPRESENTATIVES USE MEALS IN THEIR BUSINESS

An independent sales representative like any other salesperson must go out and meet the person they are selling to. To do that they must go to the customer's location in small towns and on country roads. On average sales representatives travel 30,000 miles per year and spend an average of 150 days and nights on the road.

Having taken the time to go to the customer's business, they seek to find an opportunity to build a relationship with the buyer. They must then find a way to meet one on one with the buyer, away from distractions like CNN, other calls, employee questions, etc.

This is normally done in a moderately priced local restaurant where both individuals can have a quiet focused discussion on products and prices. On the road this restaurant is the sales rep's conference room. On the road this is the rep's advertising budget. On the road this is the way business is done.

ADVERTISING & CONFERENCE ROOMS

Most sales representatives work out of their homes. Therefore they lack a formal conference room for client meetings. Yet they are expected to have a place to meet with a prospective client. In addition sales representatives do not have large advertising budgets with which to create goodwill and name recognition. Advertising of this nature is not cost effective and misses most of the real target market.

The conference room for the rep on the road is the local restaurant, the advertising budget is the time that a rep can get a buyer to spend one on one time with him or her to view the products that they represent.

CURRENT RESEARCH ON WHO USES MEAL DEDUCTIONS

In 1998 a study on the use of the business meal deduction confirmed several facts widely understood by sales representatives who are major users of the meal deduction as a way of doing business.

The research done for the National Restaurant Association revealed that:

One fifth of business meal users are self-employed.

Over two thirds of the business meal spenders have incomes of less than $60,000 and 37 percent have incomes below $40,000.

Low to moderately priced table service restaurants are the most popular types for business meals, with the average check equaling less than $20, and occur throughout the US, with 50 percent occurring in small towns and rural areas.

The average check size was $11.60 for lunch and $22.52 for dinner. These facts illustrate that the primary user of the business meal who is putting out the cost of the meal from his or her own pocket, are not tax abusers but business people expending business capital for a business purpose.

Clearly, the rationale that limiting the meal deduction would only harm large companies for whom a meal as entertainment was merely incidental to any business purpose, is inaccurate. In reality, the limitation inadvertently harms many small businesses, and especially the independent sales representative.

Restricting the meal deduction is also discriminatory against those small business owners for whom the meal is both advertising and conference room facility. It is especially interesting to note that an employer can reimburse an employee for a meal permitting the employee to entertain, yet a self-employed business owner is limited to a 50 percent deduction for entertainment. This creates an imbalance between the independent sales representative and the employed sales representative.

It does seem that the rules are stacked in favor of the large company to keep small business owners at a competitive disadvantage.

LEGISLATIVE PROPOSALS

To date two bills have been introduced on this issue that meet their stated goal of helping small business. HR 1195, was introduced by Congressman McCrery, and has been cosponsored by Representatives Tanner, Foley, Farr, Ramstad, Dunn, Weller, Jefferson, Johnson, and Shaw of the Ways and Means Committee. In the Senate, companion language has been introduced by Senator Breaux.

Identical language is also included in HR 2087, a bill that has been introduced by Congressman Talent, Chairman of the Committee on Small Business. Both bills target the increased meal deduction to small businesses with less than $5 million in gross sales. The proposed legislation would increase the meal deduction limitation to 80 percent by 5 percent increments over the next six years.

Similar legislation has been enacted on behalf of employees are limited to the number of hours they may work by federal rules such as truckers and airline pilots. This proposal mirrors the same concept.

ECONOMIC IMPACT

This hearing is focused on tax relief to sustain a strong economy, and information that supports a positive economic effect from a tax benefit is important. The National Restaurant Association has estimated the economic benefit of moving the 50 percent meal deduction to 80 percent. Based on data produced by the Bureau of Economic Analysis, they estimate that this change would produce between $4.2 and $5.2 billion in economic impact across the country.

We do know that for a sales representative the meal deduction is a cost of doing business, not a tax dodge. It is as much a cost of doing business as buying a computer or a car for travel to meet with customers.

CONCLUSION

Once again, I appreciate the opportunity to appear before you today. We strongly believe that enacting the proposal HR 1195, would be positive tax relief that would benefit many independent sales representatives, and many other small business owners.

We believe that restoring this provision would address a competitive disadvantage that they have had to deal with since 1986. We encourage the members of this committee to include such language in any tax relief legislation enacted this year.

APPENDIX

NASRA MEMBERSHIP

Bureau of Wholesale Sales Representatives
International Home Furnishings Representatives Association
National Golf Sales Agents
Ski & Outdoor Sales Representatives Association
Western Winter Sports Sales Representatives Associations
New England Ski Sales Representatives Association
Eastern Ski Sales Representatives Association
Mid West Ski Sales Representatives Association
Southeast Winter Sports Association
Western Shoe Association
Boot & Shoe Travelers of New York
National Association of Selling Agents
Professional Representatives Organization
Independent Sales Association

Chairman ARCHER. Mr. Wolyn, thank you. As I listen to the kind of life that you have led and the amount of sustenance that you have taken in every day, I wonder why you are not 300 pounds. [Laughter.]

Mr. WOLYN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Nemtzow.

STATEMENT OF DAVID NEMTZOW, PRESIDENT, ALLIANCE TO SAVE ENERGY; ON BEHALF OF COALITION FOR ENERGY-EFFICIENT HOMES

Mr. NEMTZOW. Thank you, Mr. Chairman. I am David Nemtzow, and I am president of the Alliance to Save Energy. Thank you very much for the opportunity to testify today.

I am testifying today on behalf of the Coalition for Energy-Efficient Homes. This is an ad hoc coalition that we have created for one single purpose: to support Congressman Thomas on H.R. 1358, the Energy Affordable Home Act. If it pleases the Chairman, I would like to include for the record the more than 50 companies that are members of our coalition, many of whom are represented here today. And if the Chairman would indulge me, my colleagues are right behind me, representing the National Association of Home Builders; representing the Nation's leading insulation manufacturers; Owens Corning Window Manufacturers; and the Alliance to Save Energy. And it is a very broad coalition designed to help this one bill.

[The information follows:]

ALLIANCE ASSOCIATES, 1998

3M
AlliedSignal
American Gas Association
American Gas Cooling Center
Andersen Corporation
Anonymous
Armstrong International
AT&T

Battelle/PNNL
Bear Stearns and Company
Brookhaven National Laboratory
California Energy Commission
Cardinal IG
CertainTeed Corporation
City of Austin/Austin Energy
Dewey Ballantine
Dow Chemical
Edison Electric Institute
E–Mon
Energy Performance Services
Enron Corporation
Fannie Mae Foundation
Florida Solar Energy Center
Gas Research Institute
Geothermal Heat Pump Consortium
Hagler Bailly, Inc.
Honeywell
IBM
Intercontinental Energy Corporation
Iowa Energy Center
Johns Manville
Johnson Controls
Lawrence Berkeley National Laboratory
Libbey-Owens-Ford
Lithonia Lighting
Los Angeles Department of Water & Power
MagneTek
National Insulation Association
National Renewable Energy Laboratory
New England Electric System
New York State Energy Research & Development Authority
Nexus Energy Software
North American Insulation
Manufacturers Association
Northern States Power Company
Oak Ridge National Laboratory/
Lockheed Martin Corporation
Ontario Power Generation
OSRAM SYLVANIA
Owens Corning
Polyisocyanurate Insulation
Manufacturers Association
Public Service Company of New Mexico
Sempra Energy
Sensor Switch
Society of the Plastics Industry
Polyurethane Division
Solar Energy Industries Association
Southern California Edison
Spirax Sarco
Swagelok
Tennessee Valley Authority
Texas A&M University
Energy Systems Laboratory
Thermo Electron
Washington Gas
Watt Stopper
Whirlpool Corporation
Xenergy

Mr. NEMTZOW. Let me just say that the Alliance to Save Energy was founded in 1977 on a bipartisan basis by Senator Chuck Percy and Senator Hubert Humphrey. And they invited their colleagues in the Congress and in business to work together to promote energy efficiency. And today we are chaired by Senator Jeff Bingaman and Jim Jeffords on the Senate side and by your colleagues John Porter and Ed Markey and continue our tradition of bipartisan support for energy efficiency.

We are here today to testify in the strongest support for Congressman Thomas' bill, the Energy Efficient Affordable Home Act, H.R. 1358. It is also cosponsored by several Members of this Committee and I want to thank Mr. Herger and Mr. English for their cosponsorship. Mr. Rangel also is a cosponsor as well as several other Members. And I would also like to acknowledge Mr. Matsui who, on behalf of the administration, is introducing a similar bill, somewhat different from ours, but with similar goals. And what these Members of Congress have in common is a commitment to work to provide energy efficient homes for America's families.

I know you have heard a lot of witnesses today and I know you are tired and I very much appreciate your attention. So I will try to sweeten the deal for you by saying, of all the witnesses you hear today, I may be the only one who will promise you and can deliver to you—are you ready—affordable housing for American families, cleaner air quality, lower risk from foreign oil, and an opportunity to cut bills nationwide and stimulate the economy. So I know you have heard a lot of witnesses. Let me tell me how we are going to do that and why you can be confident in that.

H.R. 1358 would provide a tax credit for new and existing homes that significantly upgrade their energy efficiency. For new homes that met these tight standards—and these standards, Mr. Chairman, are 30 percent beyond what is known in my business as the IECC, the International Energy Conservation Code. And the IECC code is already quite stringent. So 30 percent beyond that is really a tough standard. Only about 1 percent to 2 percent of the homes in the country this year even come close today. And it would provide a $2,000 credit for homes that can meet that new tough standard. It would be around for 5 years and then sunset after 5 years. And we have built in provisions to make sure that this credit is verifiable and that this Committee can be confident that you are getting your money's worth.

Why are we doing this? The reason is quite simple. By making homes more energy efficient, we are doing several things. One is we are making housing more affordable for American families. Energy is the second largest cost of housing in this country. After the rent or the mortgage, energy is number two. It is ahead of security. It is ahead of insurance. It is ahead of landscaping. And so by lowering energy bills and by lowering utility bills through more insulation or better windows or a better furnace, we are lowering Americans' utility bills and making their homes more affordable for them for years to come.

Number two, we are improving the air quality. Why do I say that? Because homes pollute. We don't notice it the way we notice it with cars, but when homes use energy and they burn that energy, whether it is at a power plant or in the basement in the fuel oil tank, there is pollution that is created. In fact, the average home in America produces twice the pollution of the average car. If we cut that, we will be able to lower the pollution, whether it is climate pollution or local urban pollution.

I don't have to tell you, Mr. Chairman, about our dangerous dependence on foreign oil. Do you know a lot of our oil imports are for home heating oil? We can cut that.

And, finally, the reason this bill is so important and why we thank Congressman Thomas and his colleagues for their leadership, is that homebuilders are trying to do the right job for America. They are trying to build good homes at a good price. But the reality is that homebuilders don't pay the utility bills. They build the house. They want it to be a good quality house. But they don't pay the bills. It is the home buyer who pays the bills. So by providing this modest tax credit that is verifiable, you are bridging the split incentive. You are letting the homebuilders focus on what they are good at, building a good quality home that is affordable, because of the credit. And you are helping American families, especially those middle income families make their homes more affordable for years to come.

I think you will find it is a winner for American families. It is a winner for this Committee. Thank you again for the opportunity to testify on behalf of the coalition.

[The prepared statement follows:]

Statement of David Nemtzow, President, Alliance to Save Energy; on behalf of Coalition for Energy-Efficient Homes

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify before you today on behalf of the 50 member organizations of the Coalition for Energy-Efficient Homes regarding H.R. 1358, sponsored by Rep. Bill Thomas, the Energy Efficient Home Act of 1999.

My name is David Nemtzow. I am President of the Alliance to Save Energy, a bi-partisan, non-profit coalition of business, government, environmental, and consumer leaders dedicated to improving the efficiency with which our economy uses energy. Senators Charles Percy and Hubert Humphrey founded the Alliance in 1977; it is currently chaired by Senators Jeff Bingaman and James Jeffords, as well as your colleagues, Representatives John Porter and Ed Markey.

Seventy companies and organizations currently belong to the Alliance to Save Energy. If it pleases the Chairman I would like to include for the record a complete list of the Alliance's Board of Directors and Associate members, which includes the nation's leading energy efficiency firms, electric and gas utilities, and other companies providing cost savings and pollution reduction to the marketplace.

I am pleased to be testifying today on behalf of the Coalition for Energy-Efficient Homes, a group of companies, trade associations, and non-profit groups united in the goal of seeking incentives for the construction of homes that are better for the environment, more affordable, and more comfortable. This broad collection of members is composed of energy-efficiency advocates, home builders, electric utilities, and building products manufacturers. Prominent members of the Coalition include the National Association of Home Builders, the North American Insulation Manufacturers Association, the Andersen Windows Corporation, Cardinal IG, the Polyisocyanurate Insulation Manufacturers Association, and the Edison Electric Institute. I would also like to include for the record a list of the current members of this group.

The Alliance to Save Energy has a long history of researching and evaluating federal energy efficiency efforts. We also have a long history of supporting and participating in efforts to promote energy efficiency that rely not on mandatory federal regulations, but on partnerships between government and business and between the federal and State governments.

I. INTRODUCTION

Today's Testimony

Mr. Chairman, I am here today to address the need for promoting energy-efficiency in residential construction and existing homes. The Coalition for Energy Efficient Homes strongly supports H.R. 1358, the Energy-Efficient Affordable Home Act of 1999, sponsored by your colleague, Rep. Bill Thomas. We believe that this legislation will provide a sound plan for substantially increasing the energy-efficiency and affordability of American homes by providing tax credits to home builders for constructing highly-efficient homes, and to home owners for upgrading the efficiency of their existing houses.

In addition, I will elaborate on the continuing need for increasing energy-efficiency in the U.S. and, Mr. Chairman, the forceful role that energy-efficiency has already played in bolstering our economy and protecting our environment.

Tax Credits: A Mechanism for Change

For as long as the current tax system has been in place in the U.S., policy-makers have used tax credits to promote activities deemed desirable for the public good. Whether investment tax credits or the earned income credit, Congress has extensively used this mechanism to provide financial incentives for public goals. We support the extension of this practice to fortify the energy-efficiency of our nation by enlisting home builders and homeowners in active participation.

II. THE ENERGY-EFFICIENT AFFORDABLE HOME ACT OF 1999

Mr. Chairman, we have nothing but strong praise today for Rep. Thomas, and his foresight and concern in offering H.R. 1358. We have taken up the banner for his legislation and are building strong support for it. The Energy Efficient Affordable Home Act currently has 24 cosponsors, including several members of the Committee, such as Congressmen Rangel, Ramstad, Herger, English, Cardin, and Weller.

However, Mr. Chairman, Mr. Thomas' bill is not the only proposal circulating which would provide tax credits for highly efficient homes. Last year, Rep. Matsui worked with President Clinton to offer a credit for efficient new homes and we understand that an updated version is soon to be introduced. As we will explain later, we differ with the qualification level in last year's Matsui bill. However, the Coalition for Energy Efficient Homes still strongly commends both Congressman Matsui and President Clinton for their fine efforts to address and raise attention for this issue.

Why Do We Need Tax Credits for Energy Efficient Homes?

Mr. Chairman, tax credits for energy-efficient homes will address several key areas of concern for Americans. Frankly, Mr. Chairman, increasing the energy-efficiency of the economy is an ongoing process for the nation, desirable for its significant benefits to the economy, the environment, national security and our competitiveness internationally. Increased energy-efficiency has already resulted in a windfall for the U.S. economy, which I will discuss in more detail later. As well as providing a macro-economic boon, energy efficiency is a decentralized way for average Americans to gain better financial control of their lives.

H.R. 1358 Improves Home Affordability—This tax credit would make houses more affordable for average American families. In many homes, energy is the second largest component of the total cost of housing, so cutting energy and utility bills can make homes dramatically more affordable for Americans, especially for moderate and low-income households. While some mortgage lenders and underwriters have programs that make loans based on the lower energy costs of efficient homes, the reality is that home buyers and home builders alike need a break up front to lower the first cost of efficient housing. Home-ownership for all who desire it has long been a public policy goal in the U.S. and this legislation would further that goal.

H.R. 1358 Improves Environmental Quality—Mr. Chairman, investments in energy-efficiency provide a no-regrets strategy for reducing emissions which carries huge ancillary benefits to Americans, regardless of what one thinks of climate change. Frankly, energy-efficiency has been noted in a number of studies as a potentially key solution to the problem. Although the Alliance to Save Energy does not endorse any specific targets or timetables for emissions reductions, we believe that if reducing carbon emissions is a national goal, investment in energy-efficiency provides a non-regulatory, decentralized, cost-effective way to do that. In addition, the Alliance believes if a scientific and political consensus for action should develop down the road, early investment in energy-efficiency provides a cost-effective insurance policy that can help make sure that we are still in a position to affect the problem when we decide to act.

H.R. 1358 Increases National Security—Mr. Chairman, we went to war in large part over oil in 1991 and we bombed Iraq again last year. Aside from transportation, our largest household use of oil is for home heating. Increasing the energy-efficiency of new and existing homes may be the best way to reduce our more than 50 percent dependence on foreign oil supplies, next to raising automobile fuel economy standards—a politically difficult alternative. This legislation, by lowering our per capita national consumption of home heating oil will help in the battle to maintain our lifestyle while reducing our vulnerability to oil supply fluctuation.

H.R. 1358 Increases Consumer Awareness—Focus groups conducted by the Alliance to Save Energy revealed that a large number of Americans are unaware of either the scope or the effect of energy use in the home. In fact, many of the people we spoke with were shocked to learn that their home generates twice as much air pollution as their car on a yearly basis. Yet our studies and other research shows that the vast majority of Americans consider themselves environmentalists and want to do the right thing. H.R. 1358 will provide needed incentives for homeowners to become better educated about their energy situation and enable them to act in the most economically wise and environmentally sound manner. Currently the options for buying energy-efficient homes are limited, as I will now discuss.

Tax Credits for Energy-Efficiency: A Checkered Past?

As you know, we are not the first group to advocate tax credits for improving energy-efficiency in homes. Credits for energy-efficient equipment spawned by the energy crises of the 1970s gave a broad credit for items that might loosely be construed to reduce energy-use in homes. Those credits have been regarded by many observers as having cost the Treasury far too much for the actual energy-efficiency gains achieved. In fact, Mr. Chairman, you could basically enclose your hardware store bills with your tax return and that credit for nearly any home improvement that could broadly be construed as improving efficiency.

H.R. 1358 represents a generation of progress from those initial attempts at providing incentives for home energy-efficiency. This bill offers a credit for very specific measures of achievement. It draws from the work of scores of experts over the past

20 years who have painstakingly determined what constitutes an energy-efficient home. Back in 1980, there was no such consensus. We have the ability to act decisively today to make our homes more affordable, less polluting, and more comfortable—and document it in a precise and reliable fashion.

Mr. Chairman, even the greatest ideas often take time to be reconsidered, debated and improved. The plan for providing tax credits for energy-efficient homes is no exception. As we speak, we are wrapping up several months of hard work to try and improve the mechanisms in H.R. 1358, and working with Rep. Thomas to incorporate those changes. The input of environmentalists, home builders, home energy raters, state officials and others has been critical to what we believe will reduce revenue-impact, reduce the possibility of free riders and fraud, and ultimately broaden the support for this bill. Where applicable, the changes we will be recommending to Rep. Thomas will be noted.

Major Provisions of H.R. 1358:

New Homes Tax Credit—Mr. Chairman, 1.5 million homes are built each year. The Alliance to Save Energy estimates that less than 2 percent of those are built to a what we would call a high level of energy-efficiency, achievable with technology available at your local Home Depot. We now measure energy-efficiency levels against the International Energy Conservation Code (IECC) of 1998. The IECC is a model, consensus code developed by the private sector to employ existing, off-the-shelf technology to produce a reasonably energy-efficient home. The IECC corrects for climatic differences throughout the country.

H.R. 1358 provides that between the years 2000 and 2004, a tax credit of $2000 may be claimed by a home builder for construction of an energy-efficient home that exceeds the 1998 IECC by 30 percent or more. Mr. Chairman, moving 30 percent beyond that code constitutes a highly efficient house. In addition, Mr. Chairman, the Alliance estimates that the average increased cost of reaching this level of efficiency in a home costs $3000, so that a 5-year federal incentive would leverage significant additional resources. The Alliance estimates that these measures will save the owner of an average new home approximately $250 per year.

Builder Credit Vs. Buyer Credit: The Chicken Versus the Egg

While my political instincts see merit in providing a tax credit to home buyers, I am strongly supportive of a builder credit. Unless highly-efficient houses are built in greater numbers than they are today, a tax credit for these homes will be highly underutilized. Without offering an incentive for construction, rather than sale of the house, there simply won't be enough houses available for people to buy, to have any effect on our housing stock.

It brings me back to my earlier question of why highly energy-efficient homes aren't being built. Frankly, many if not all home builders are attentive to at least two things: keeping homes affordable and responding to customer demand. As an energy-efficiency advocate, it pains me to say this, but most consumers do not yet pay as much attention as they should to the energy-efficiency of a new home. While these concerns are essential for how comfortable their house will be and how much it will cost to live in on a year-to-year basis, a buyer's eye is often more swayed by the jacuzzi tub or Corian countertops than by the insulation level in the walls.

Giving the builder a tax credit gets their attention, gives them a chance to upgrade their building practices, and to use advanced energy-efficiency as a sales tool, addressing three of the biggest obstacles to improving the energy-efficiency of our nation's housing stock in a significant way. While a credit for the buyer might be more attractive politically, it simply won't do the job as well. With the builder credit, the typical tract builder putting up a development of 100 townhouses will be motivated to build higher efficiency into them up front—meaning more homebuyers, and more moderate-income families—will get the real benefit of the credit, which is lower energy bills.

How is a House Certified as Energy Efficient?

This is one area almost certain to be markedly affected by changes to the bill. Those changes will provide two paths to the builder for certifying his homes for qualification for the credit.

First, we recommend that there be a prescriptive path that sets out very specific values for a number of areas of the home, such as windows, wall insulation, foundation insulation, and other areas of the building envelope. The second suggested path is a performance option that would allow an accredited home energy rater to come in and certify the house for annual energy performance 30 percent beyond the IECC. Bringing in a professional to assess the home allows a builder to exploit particularly effective efficiency measures without having to follow a prescriptive path in every area of the house. We believe that a combination of the two options gives the builder the maximum flexibility while assuring that qualifying homes will reach the required efficiency level.

Why Not 50 percent Above IECC ... or More?

Last year's proposal by Rep. Matsui contained a very similar credit as H.R. 1358 does, only it required that qualifying homes be 50 percent beyond the model code. We have three major differences with a 50 percent approach. First, we believe that a 50 percent improvement is not achievable by the average builder. Second, requiring houses to be 50 percent beyond the IECC will severely limit the number of builders that become interested in qualifying, because the cost of that extra 20 percent will further outstrip the size of the credit. Third, the awarding of the credit to the home buyer will fail to provide the incentive to builders needed to result in the construction of a significant number of energy-efficient homes.

I believe that part of the reason the Administration program went with a 50 percent standard is that they were restricted by the revenue allocations for the various parts of their Climate Change Technology Initiative. If we were to devise a package with a cap of $3.5 billion over 5 years—as the Administration package has done—energy-efficient homes would play a larger role in it than the $450 million allocated to it in that program.

What Does it Cost?

The short answer to this one, Mr. Chairman, is we don't yet know. Rep. Thomas made a request for scoring by the Joint Committee on Taxation, but has not yet returned its estimates. In addition, information has been submitted to JCT reflecting amendments we hope to see in H.R. 1358.

Existing Homes Tax Credit

While making new homes more energy-efficient is essential for the future, the lion's share of energy use and energy waste in the residential sector remains in existing homes. The 1.5 million homes built each year pale in comparison to the 100 million that already stand—many millions of which were built before energy-efficiency became a major consideration in housing construction.

The current bill allows a homeowner to claim a tax credit for 20 percent of the cost of improving the energy-efficiency of their home by 30 percent from a baseline level, up to a $2000 limit over the 5 years. We have been working with Coalition members, other stakeholders, and Rep. Thomas to better-define the details of the existing home provision to limit revenue-impact, free ridership and the potential for fraud.

III. ENERGY-EFFICIENCY: A CONTINUING NATIONAL PRIORITY

In order to fully make the argument for H.R. 1358, Mr. Chairman, the Alliance would like to comment on how energy-efficiency has delivered over the past 25 years for the American public. That background, illustrates why improving the energy-efficiency of our economy is a more urgent priority than ever before.

A Bipartisan Political Tradition

From the days of our first national nightmare of gas lines and soaring fuel prices, energy-efficiency has had champions in Congress from both sides of the aisle. Sen. Charles Percy, who founded the Alliance to Save Energy in 1977, recognized the need to promote energy-efficiency to address a glaring hole in our nation's economic security. He recruited Sen. Hubert Humphrey for this endeavor in the final days of his life to demonstrate that the need to pursue greater energy-efficiency in the economy obliterated party lines. In addition, he knew that a partnership between business, government, environmentalists, and consumer advocates would not only result in benefits for each sector, it would help avoid the need for coercive regulation when our problems reach crisis level.

That maxim is no less true today, even though oil supplies and prices have eased. Our fossil fuel economy is now believed by many to have put new stresses on our environment. Energy-efficiency has been repeatedly cited as a key solution to slow the loading of carbon and other greenhouse gases into the atmosphere. Fortunately, we now have a quarter-century track record of showing how energy-efficiency reduces emissions of criteria air pollutants as well as carbon.

Support of action by the federal government to promote energy-efficiency has also been historically bipartisan. Though the establishment of the Department of Energy and energy-efficiency programs is most often associated with the Carter Administration, key advancements in federal efforts were made under the Reagan and Bush

Administrations. While funding was cut severely from Carter-era levels, President Ronald Reagan signed the National Appliance Efficiency and Conservation Act (NAECA) the law requiring DOE to set energy-efficiency standards for appliances and other equipment. That program has led to tens of billions of dollars in savings for the American people and significant carbon emissions reductions. The Bush Administration, in the context of its support for the Rio Treaty, began to significantly expand funding for DOE energy-efficiency and renewable energy efforts and created the Green Lights and Energy Star programs at EPA. In addition, President Bush signed the Energy Policy Act of 1992, which expanded the scope and magnitude of energy-efficiency efforts.

The House and Senate caucuses devoted to promoting renewable energy and energy-efficiency continue that tradition of bipartisanship. Currently, the House Renewable Energy Caucus features 65 Republicans and 84 Democrats, while the newer Senate version counts 10 Republicans and 14 Democrats. Such support from all parts of the political spectrum is what has made clean energy a driving force in the American economy.

Mr. Chairman, of the current cosponsors of this legislation, 11 are Republicans and 13 are Democrats. Rep. Thomas's plan to bolster our nation's energy-efficiency through housing follows this long bipartisan tradition of support for doing more with less.

An Economic Workhorse for the U.S.

Energy efficiency makes money and puts people to work. The economic gains from energy efficiency come in two forms. The greatest benefit comes from displaced costs—money that households and businesses can spend elsewhere because they no longer have to spend it on energy. That spending includes additional investment and hiring additional workers. Direct economic benefits come from growth in industries that generate energy-efficient products and services. Companies that sell insulation or efficient windows domestically and/or for export employ Americans in high-skill service and manufacturing jobs. Secondary economic benefits come from businesses and consumers re-spending these newfound energy savings in sectors of the economy which are more labor-intensive than energy supply.

Energy-Efficiency Must Be Measured as an Energy Source

The U.S. economy has become significantly more energy-efficient over the past quarter-century. But we often fail to realize the actual contribution of energy efficiency to our GDP and national well being.

Mr. Chairman, it isn't easy to compare the contribution of energy-efficiency to the environment and the economy with more traditional energy sources such as oil and coal. It requires the observer to regard saved or unused energy as created energy in the same way that oil comes out of the well and coal comes out of the mine. In addition, I think that any economist would tell you that energy-efficiency measures have increased the supply of energy and thus helped to lower the price. Energy not used is just as salable and usable when conserved as when produced. Upgrades in energy-efficiency made to home appliances, industrial equipment, building systems, or car and truck fleets serve as an energy source that increases our overall supply of electricity, coal, oil, and natural gas.

Energy-Efficiency, our Number 2 Energy Source

Alliance research shows that, for 1997, the most recent year for which we have complete data, energy-efficiency was the second leading source of energy for U.S. consumption, and if we consider only domestic energy sources, it's number one. Mr. Chairman, it would have been number one if we declined to count oil imports, now more than half of this nation's oil consumption. Our analysis of 1997 energy consumption shows that energy efficiency provided the nation with 29.5 quadrillion Btus (quads), approximately 25 percent of U.S. energy consumption. While energy-efficiency trails our mammoth oil consumption (36.3 quads), it significantly outstrips the contribution of natural gas (22.5 quads), coal (21.0 quads), nuclear (6.7 quads) and hydro (3.8 quads). (See attached chart.)

Mr. Chairman, the contribution of energy-efficiency to our nation's overall supply is now so great that we cannot regard it as an esoteric externality anymore. It is a commodity just like oil and gas, and deserves a the same consideration. We must promote and support it in the same way we do the coal belt and the oil patch, which enjoy a variety of tax breaks and subsidies based on their use of fuel.

These figures show energy-efficiency for what it is—an unparalleled driver of environmentally sound economic growth.

Mr. Chairman these economic snapshots of efficiency show an energy industry that spans the economy and the populace. But it is not an energy industry that looks like what we have known in the past. However, all the functions of traditional energy industries are represented. But with energy-efficiency, the miners are businesses trying to cut their costs. The roughnecks are homeowners trying to keep their families warmer in the winter. The geologists are mechanical engineers working to get more out of less. Energy-efficiency is highly dispersed throughout the economy. And because of its diffuse nature, energy-efficiency doesn't carry the political clout of the coal-mining regions, or of the oil and gas-producing regions. There is no "energy-efficiency patch."

By the same token there is not a defined energy-efficiency industry. Whirlpool makes highly efficient appliances but they sell washing machines and refrigerators, not energy efficiency. Honeywell sells controls that regulate building systems that can save a company millions of dollars a year, not energy efficiency. Johns-Manville and Owens-Corning sell fiberglass insulation which can make a house warmer, more comfortable, and more economical to live in, but they sell insulation, not energy-efficiency. Likewise, Andersen Corporation sells highly-efficient windows, but their first concern is marketing those products, not the energy-efficiency they carry with them.

So when we have to make tough choices about what we do with federal dollars, we must think about energy-efficiency as what it is—an energy source that is essential for the economic health of our nation—and one that is paying off like a gusher for the American people. And yes, Mr. Chairman, that energy is produced cleanly, displacing both conventional air pollutants as well as ones believed by many to be causing a warming of the Earth's climate. It enhances our national security, as I have spoken of earlier. Energy-efficiency cuts costs for businesses and consumers, and it increases our international competitiveness—all the things we have traditionally talked about.

The tough choices on our environment and economy—such as whether to establish tax credits for efficient homes—must be made with a clear eye on the contribution to the environment, the economy, national security, and international competitiveness delivered in the past and promised for the future by energy-efficiency.

III. CONCLUSION

Mr. Chairman, H.R. 1358 and the improvements to it that I have discussed here set out a prudent, accountable path to significantly upgrade the energy-efficiency of our nation's housing stock. It does this not just by subsidizing efficient construction, but by teaching more home builders to construct more efficient houses, and more consumers about the value of owning them. Once a builder is acquainted with energy-efficient building practices he or she will more likely realize that they are not difficult, that significant strides that can be made with off-the-shelf technology, and that energy-efficiency is helpful as a marketing tool. Homeowners will realize a difference in dollar savings attainable by making relatively inexpensive improvements to their home.

A Time For Action

Mr. Chairman, as I have shown, energy-efficiency has provided a massive source of clean, affordable energy to our economy, and has significantly reduced air pollution in this country. One guarantee for the future is that as our population rises, our housing stock will grow with it. Providing incentives to improve the energy-efficiency of the our homes will have help save American families millions of dollars on heating and cooling bills and reduce air pollution significantly, while allowing more families to own homes.

We believe these are highly laudable goals, Mr. Chairman, and on behalf of the Coalition for Energy Efficient Homes, I urge that you include H.R. 1358 in any tax bill reported by the Ways and Means Committee this summer.

Thank you for your consideration and the opportunity to speak before you. I would be happy to take any questions that you or other Committee members might have at this time.

Chairman ARCHER. Thank you.

Mr. Wallace, welcome. You may proceed.

STATEMENT OF ERIC P. WALLACE, CERTIFIED PUBLIC ACCOUNTANT, PITTSBURGH, PENNSYLVANIA; ON BEHALF OF ASSOCIATED BUILDERS AND CONTRACTORS, INC., ROSSLYN, VIRGINIA

Mr. WALLACE. Thank you, Mr. Chairman. Good afternoon, Mr. Chairman and Members of the Committee. My name is Eric Wallace. I am a CPA and I speak today on behalf of the Association of Builders and Contractors.

ABC is a national trade association representing more than 20,000 contractors, subcontractors, material suppliers, and related firms from across the country, including all specialties, in the construction industry. We would like to thank Chairman Archer and the Committee Members for conducting this hearing on providing the tax relief to strengthen the family and sustain a strong economy.

I am a practicing CPA with over 20 years of experience serving contractors and service providers from across the country in the fields of taxation, accounting, auditing, and consulting. I recently researched and authored an article titled "The IRS and the Cash Basis Contractor" that appeared in several publications. My extensive experience dealing with this issue enables me to provide you specific expertise and insight concerning the need for legislation to clarify that small business taxpayers are allowed to use the cash method of accounting without limitation.

The IRS is currently targeting nearly all contractors and service providers who report their taxable income on the cash method of accounting. One of the most onerous changes that a contractor or service provider can face is an IRS initiated change in its tax accounting method from the cash to the accrual method. Such IRS proposed audit changes typically subject the taxpayer to over $100,000 due with a significant portion of this consisting of mandatory assessed interest and penalties.

The difference between the cash method and the accrual method of accounting is not that the cash method necessarily results in a greater income. The only difference is one of timing of the reporting of income and expenses. For example, if a cash basis contractor collects their money early and doesn't pay their vendors, they could actually be reporting their income earlier. It is a matter of timing, not of collection based upon revenue.

But now more than ever, the IRS is pushing the cash audit position on a national level. The IRS spelled out its position on the cash basis when, in 1987, it released its Construction Audit Technique Guide as part of its market segment specialization program. In their Audit Technique Guide, it stated that IRS examiners should generally conclude that a contractor or service provider should be changed from the cash method of accounting when their material costs as a percentage of their gross receipts is 15 percent or more. There are not that many contractors that would be able to fulfill that criterion. And, depending on the facts and circumstances, the method when it is less than 15 percent. This position is not based upon any specific Tax Code, but is the result of several court cases that are successfully litigated by the Service.

This push is based upon a certain logic flow. The Service logic flow is generally summarized as follows: materials are merchandise. If the cost of merchandise is over 15 percent of gross revenues, it is a significant income-producing factor. If it is a significant income-producing factor, they have to use inventories. And if they have to use inventories, they are required to use an accrual method of accounting. The result of this push would leave few if any contractors able to stay on the cash accounting method.

One of the IRS authors of the Audit Technique Guide stated to me that the only type of cash contractor that the IRS is permitting to stay on the cash method is an asphalt contractor who does not maintain their own asphalt plant. All other contractors are fair game. The Service denies that there is a national coordinated effort to focus on the construction contractors and service providers. And they believe that they are merely enforcing the laws as they interpret them.

I, however, do believe there is a national effort, based upon the calls that I have received from across the country and advising other CPAs and advising construction contractors. For example, the IRS audited a carpet installer from Michigan doing slightly more than $1 million in revenue with materials and supply costing equal to 12 percent of the revenue. The only IRS audit adjustment was to change him from cash to the accrual, resulting in penalties of almost over $100,000.

The Service believes that, based upon a selective series of court decisions and their interpretation of regulations and congressional intent, their position to change all contractors and service providers from cash to accrual is justified. But that is in conflict with congressional intent on the cash method, referring back to the 1986 congressional documentations: Quote, “The Committee recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continued use by certain taxpayers for certain types of activities. Small businesses should continue to use the cash method of accounting in order to avoid the higher cost of compliance, which would result if they are forced to switch from the cash method.”

The IRS specialist who wrote the Audit Technique Guide stated to me that the only hope for cash basis contractors is a congressional solution. ABC applauds H.R. 2273, introduced by Mr. English along with the Small Business Committee Chairman Jim Talent, which would provide a much needed congressional solution. The English-Talent legislation would stop the IRS’ universal push against cash basis contractors and service providers and enable those small businesses to utilize the simple cash method without fear of IRS reprisal. ABC, along with a broad-based coalition of other construction groups and other organizations, endorses this legislation. We strongly urge the Committee to include this common-sense legislation as it draft its legislation this year.

In addition, the ABC would just like to comment on several other issues, such as Mr. English’s introduction of a bill to repeal the look-back method, H.R. 2347; the indexing of thresholds for construction contractors including the section 460 threshold requiring recognization of the percentage of completion method; AMT relief, as we have discussed; and, certainly, estate tax relief. Again, I would like to thank Chairman Archer and the Committee Members for allowing ABC to present their concerns regarding these important issues and I do welcome the questions you may have.

[The prepared statement follows:]

Statement of Eric P. Wallace, Certified Public Accountant, Pittsburgh, Pennsylvania; on behalf of Associated Builders and Contractors, Inc., Rosslyn, Virginia

Good afternoon, Mr. Chairman and members of the Committee. My name is Eric P. Wallace, CPA, and I speak today on behalf of Associated Builders and Contractors, Inc. ABC is a national trade association representing more than 20,000 contractors, subcontractors, material suppliers and related firms from across the country including all specialties in the construction industry. We would like to thank Chairman Archer and the Committee members for conducting this hearing on "Providing Tax Relief to Strengthen the Family and Sustain a Strong Economy."

I am a practicing CPA with over 20 years of experience serving contractors and service providers from across the country in the fields of taxation, accounting, auditing, and consulting. I recently researched and authored an article titled "The IRS and Cash Basis Contractors" that appeared in publications of the Construction Financial Management Association as well as ABC. My extensive experience dealing with this issue enables me to provide to you specific expertise and insight concerning the need for legislation to clarify that small business taxpayers are allowed to use the cash method of accounting without limitation.

Later in this statement, ABC would like to weigh in on some additional key issues affecting its members, the construction industry and the economy as a whole. The complexity and cost of these tax burdens are taking a devastating toll on contractors—particularly small contractors—and their employees. Lifting the weight of these outdated and burdensome requirements will allow contractors to devote their time, money and resources towards productivity, growth and providing new jobs.

CASH BASIS METHOD OF ACCOUNTING

The IRS is targeting just about all contractors and service providers who report their taxable income on the cash basis of accounting. One of the most onerous audit adjustments a contractor or service provider can face is an IRS initiated change in its tax accounting method from the cash to the accrual method. Such IRS proposed audit changes typically subject the taxpayer to over $100,000 due to the IRS with a significant portion of this consisting of mandatory assessed interest and penalties.

The difference between the cash method and the accrual method is not that the accrual method necessarily results in a greater taxable income. The only difference is one of timing of the reporting of income and expense. As an example, if a cash basis contractor or service provider collects its billings in advance and delays the payment of its payables, it will report income sooner under the cash method than it would under the accrual method.

Now, more than ever, the IRS is pushing their cash audit change position on a national level. The IRS spelled out its position on the cash basis when, in late 1997, it released its "Construction Audit Technique Guide" (ATG) as part of its Market Segment Specialization Program. In this ATG, it stated that IRS examiners should generally conclude that a contractor or service provider should be changed from the cash basis of accounting when their material cost, as a percentage of their gross receipts, is 15% or more, and depending on the facts and circumstances, can be changed when the ratio is less than 15%. This position is not based on any specific code section but is the result of several court cases successfully litigated by the Service.

This push is based upon a certain logic flow. The Service foundation logic is generally summarized as follows: materials are merchandise; if the cost of merchandise is over 15% of gross receipts, it is a significant income producing factor; if material is a significant income producing factor, the contractor or service provider must use inventories; if the taxpayer is required to use inventories, it is required to use an accrual method of accounting.

The result of this national push by the Service would leave few, if any, contractors or service providers remaining on the cash basis of accounting. One of the IRS authors of the ATG stated to me that the only type of cash basis contractor that the Service is permitting to stay on the cash basis is an asphalt contractor who does not produce their own asphalt in a plant. (This is based upon the Galedridge Construction, Inc. v. Commissioner, T.C. Memo 1997–240 court case, though the IRS has still not agreed to the Galedridge decision.) All other contractors or service providers are "fair game."

The Service denies that there is a national coordinated effort to focus on construction contractors and service providers and that they are merely enforcing the law as they interpret it. I, however, do believe that there is a national effort based upon the calls that I have received from contractors, service providers, and other practicing CPAs from across the country. For example, the IRS audited a carpet installer from Michigan doing $1.2 million in revenue with material and supplies equaling 12% of his revenue. The only audit issue was to change him from the cash method to the accrual method. The cost to him of such a change was almost $100,000. The IRS auditor had used as support the newly released IRS ATG. I advised an underground utility pipeline contractor from Pennsylvania to voluntarily change from the cash method to the accrual method because, if audited by the IRS, it would face over $100,000 in interest and penalties. A window installer from Texas, with about 20% of revenues for materials as a cost of revenue, would be forced out of business if the IRS proposed a change from the cash method and assessed the mandatory interest and penalties.

The Service believes, based upon a selective series of court decisions and their interpretation of regulations and congressional intent, that their position to change all contractors and service providers from the cash method of accounting to the accrual method is justified. This is in conflict with congressional intent on the use of the cash method. “The committee recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continue use by certain types of taxpayers and for certain types of activities. Small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher cost of compliance which will result if they are forced to switch from the cash method.” [House Report 99–426, at 605–606 (1985), 1986–3 C.B. (Vol.2) 1, 605–606.]

A head IRS Construction Industry Specialist stated to me that, based upon the current IRS approach and court cases, cash basis contractors and most service providers will not be able to maintain their cash reporting position or have it supported in court. Their only hope is a congressional solution.

ABC applauds legislation introduced by Ways and Means member Phil English along with Small Business Committee Chairman Jim Talent, which would provide this much-needed congressional solution. Mr. Talent included an identical provision in the Small Employer Tax Relief Act (H.R. 2087). The current ATG states that “Reg 1.446–1 (a)(4)(i) and 1.471–1 provide that the use of an inventory accounting method is required in every case in which the sale of merchandise is an income producing factor. The fact that the use of an inventory accounting method may result in inventory balances that are zero or minimal is irrelevant.” It is clear that the Service position is inappropriate. The English-Talent legislation would stop the Service’s universal push against cash basis contractors and service providers and enable these small businesses to utilize the simpler cash method without fear of severe IRS reprisal. ABC, along with a broad-based coalition of construction and other organizations from across the small business spectrum, endorses this legislation. We strongly urge the Committee to include this common sense legislation as it drafts its tax legislation this year.

LOOK-BACK METHOD

The construction industry has fallen under a provision in the Tax Reform Act of 1986 aimed to target major defense and aerospace contractors. The law requires “percentage of completion” and look-back accounting methods for contracts lasting more than one tax year. Contractors must estimate their costs and revenues and, upon completion of the contract, “look back” and substitute the actual costs and revenues for those estimated at the conclusion of the prior tax years. Construction contractors face look-back calculations can number in the thousands and can take between 15 to 30 hours to complete for each project. Construction contractors pay thousands of dollars each year just to comply with look-back requirements without any justification or need to do so.

Because the majority of construction contracts are completed within one or two years and success in the industry is dependent on financial accuracy, look-back has no effect on “catching” underreported revenues or gains. Instead, approximately 75% of the industry’s look-back calculations result in zero dollars being remitted to the IRS, and 25% are owed money by the IRS. Look-back accounting is an unnecessary requirement and an onerous burden on construction contractors (as well as the IRS) with virtually no gain to the Treasury. The current de minimis rules, including those recently implemented as part of 1997 Taxpayer Relief Act, are not sufficient relief. ABC strongly supports repeal of look-back for commercial construction contractors.

INDEXING OF THRESHOLDS

Several key thresholds in the tax code affect contractors' tax liability. These include the $10 million threshold under section 460(e) and the $5 million threshold under section 448. Since 1986 these amounts have not been adjusted for inflation. This has had the effect of forcing contractors to use more complex accounting methods.

ABC believes that these thresholds should be indexed for inflation in the same manner as other items are treated in the tax code. An example would be how the amount of the personal exemption increases each year or the mileage rate increments annually.

ALTERNATIVE MINIMUM TAX (AMT)

The corporate AMT was enacted in 1986 to end a perceived abuse that corporations were reporting earnings to shareholders, yet not paying any federal income tax in that year by taking legitimate deductions and credits. The actual operation of the AMT has imposed a severe penalty on companies whose businesses require large capital investments to modernize and remain competitive. The AMT penalizes investment, particularly by imposing a considerably slower depreciation rate. It doubles compliance costs, forcing corporations to keep two separate deduction records and engage in complex calculations. The AMT also adds complexity for small contractors by requiring use of the percentage of completion method for long term contracts.

AMT proponents see it as a significant revenue source and argue that it ensures all corporations reporting income pay at a base tax. However, the AMT treats corporations with generally the same long-term economic incomes very differently. The AMT penalizes capital intensive firms with relatively low profit margins for their products. These firms are being denied the benefit of accelerated depreciation which is afforded to their non-AMT competitors.

ABC supports repeal or a significant reduction in the adverse effects of the AMT. ABC advocates allowing S-corporations similar treatment to C-corporations regarding small company exemptions. Additionally, ABC favors allowing the AMT credit to be carried back, as contractors can be unfairly penalized due to depreciation and other unique timing preferences;

ESTATE TAX RELIEF

Federal estate [death] tax rates have increased significantly since their implementation in the early 1900s. They are so high now that families must often sell their businesses in order to pay the taxes. This in turn creates disruption for the employees, customers, and suppliers and the community. Death taxes not only jeopardize the survival of family-owned construction companies, they also divert critical funds that could be invested in the business to grow and provide more jobs.

Construction companies are frequently family owned and do not have the liquid assets to withstand an assault from the IRS upon the unfortunate death of the owner. Therefore, the construction industry is particularly hard hit by the estate tax burden. ABC is supportive of legislation that will relieve the estate tax burden on businesses. Specific measures ABC supports include rate relief, increasing and simplifying the exemption for closely held businesses, and indexing the unified credit and closely held business exclusion for inflation. Ultimately, ABC members would like to see death taxes eliminated. ABC strongly supports H.R. 8, the Estate and Gift Tax Rate Reduction Act.

CAPITAL GAINS CUTS AND SIMPLIFICATION

The 1986 Tax Reform Act constituted the largest capital gains tax hike in more than 50 years. Real Estate and Construction were devastated, and have only in the last few years recovered. Increasing the exclusion for capital gains would unlock hundreds of billions of dollars of unrealized capital gains, thus promoting more efficient allocation of capital and increasing capital formation, economic growth and job creation. Opponents claim a capital gains relief will be a tax cut for the rich. In fact, a cut in the capital gains tax would actually increase taxes paid by the wealthy and benefit poor and working-class Americans most. It would expand economic opportunities for the working-class by encouraging capital formation, new business creation, and investment in capital-starved inner cities. It would lead to the creation of more than half a million new jobs and increased wages by the year 2000.

ABC supports reducing or eliminating the capital gains tax burden on businesses and individuals.

INDEPENDENT CONTRACTOR SIMPLIFICATION

Currently, the Internal Revenue Service relies on a 20-factor test to be classified as an independent contractor. It is often criticized as too subjective, arbitrary, inconsistent, and burdensome. Considering the fact that back-tax assessments imposed on businesses with reclassified employees are often large and potentially bankrupting, ABC believes that the test for classification should be clear and simple.

The construction industry faces unique problems due to its fluctuating work demand and seasonal forces which affect employment levels. Many in the industry can not afford nor have the need to maintain specialized trade craftsmen as full-time, long-term employees, which may be needed several times throughout the year but not enough to warrant full-time or even part-time employment. Independent contractors are often the perfect answer to a pressing demand for the special skills and know-how often required for short term projects.

Independent contractors are an important sector of the economy—there is no better way to become established as a small business than to begin as an independent contractor. Many ABC members started their own businesses by working as independent contractors. Independent contractor relationships can be advantageous for all involved. The arrangement allows the independent contractor to have the freedom to choose his or her work schedule, a business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced, quality product. ABC believes that companies should be able to make sound economic decisions about the classification of individuals as employees or independent contractors, without fear of misclassification or penalty from the IRS. ABC opposes H.R. 1525.

SCHOOL CONSTRUCTION TAX CREDITS

ABC would like to express its strong opposition to tax proposals before the Committee that would limit flexibility and competition for small contractors by expanding Davis-Bacon requirements to school construction tax credits. Representatives Charles Rangel (H.R. 1660) and Nancy Johnson (H.R. 1760) have introduced bills which would allow states and localities to issue special bonds for school improvements and construction. The federal government would effectively pay the interest via a tax credit to the bond holder.

H.R. 1660 and H.R. 1760 include an unprecedented *expansion* of the Davis-Bacon Act into the area of school construction tax credits for purchasers of qualified school modernization bonds, by amending the General Education Provisions Act. As a result, this is a wholly new application of the federal Davis-Bacon Act to tax credits, without any justification for such an expansion into these state and local efforts. Davis-Bacon has been shown to increases public construction costs by anywhere from 5 to 38 percent above what the project would have cost in the private sector. The unnecessary costs will be directly passed on to the customers—the American taxpayers in these school districts—who have to pay for the inefficiencies and waste in federal programs. Furthermore, the application of Davis-Bacon makes no sense because the burdensome requirements of the Act operate as a disincentive to contractors and corporations to get involved in school construction, undercutting the very purpose of the bill which is supposed to be to create tax incentives to attract capital.

In contrast, Chairman Archer's school construction proposal would make it easier for state and local governments issuing public school construction bonds to comply with the arbitrage rebate rules, by extending the time for issuers to spend bond proceeds from two to four years. It would preserve local control of education funds and help scarce tax dollars go farther.

Congress and the Administration should not be hampering efforts to leverage capital into school construction by imposing outdated and wasteful Davis-Bacon Act requirements that act as an unfunded mandate on local school districts. Adding federal Davis-Bacon requirements to local school construction tax credits would hurt those who fund, provide, and receive public education by forcing school districts to pay more for providing less. The inflated construction costs from Davis-Bacon will further limit already scarce dollars which could be better spent on real efforts to help education, such as additional schools, more repairs and facility improvements, schoolbooks, computers, and other educational services that actually improve classroom learning and benefit school children.

CONCLUSION

As stated earlier, these onerous tax provisions are having a dramatic negative effect on contractors, their employees and the economy as a whole. Much needed legislative changes to these outdated and burdensome requirements will allow small companies to devote their time, money and resources towards productivity, growth and providing new jobs. We would like to thank Chairman Archer and the Committee members for allowing ABC to present its concerns regarding these important issues, and I welcome any questions the Committee may have.

Chairman ARCHER. Thank you, Mr. Wallace.

Our remaining witnesses come in tandem. Ms. McMullin, I believe you share your time and testimony with Mr. Henderson. We are happy to have you before the Committee. Welcome. You may proceed.

STATEMENT OF RUTH R. MCMULLIN, CHAIRPERSON, EAGLE-PICHER PERSONAL INJURY SETTLEMENT TRUST, CINCINNATI, OHIO

Ms. MCMULLIN. Mr. Chairman, thank you very much. My name is Ruth McMullin and I am here as a trustee, as chairperson of the Eagle-Picher Personal Injury Settlement Trust to testify on behalf and in support of H.R. 580, which has been introduced by Congressman Crane and is cosponsored by Congressman Rangel and several other Members of this Committee.

The Eagle-Picher Trust is a settlement fund under section 468(b). Like other settlement trusts, it was established to pay claims of persons who were deemed by a court to have been injured. Typically, these trusts are substantially underfunded. They can pay claims at nowhere near their full value. The trust that I chair is responsible for making payments to people with asbestos-related illnesses, past, present, and well into the next century.

Now section 468(b) governs how settlement funds are taxed. Currently, settlement funds pay taxes on both capital gains and ordinary income tax at the very highest ordinary income tax rate. Now in 1986, when the tax rules for settlement funds were established, there was no difference in the rate of taxation between ordinary income and capital gains and so there was no need to specify different rates on those two types of income for settlement funds. But now, however, things have changed and settlement funds still pay ordinary income tax rates on their capital gains. As a result, our beneficiaries are subjected to higher taxes on capital gains than any other beneficiaries of any other taxable trust or, for that matter, any other individual taxpayer.

H.R. 580 remedies this inequity. It is a very simple bill, one that provides capital gains earned by settlement funds to be taxed at capital gain rates like all other taxable trusts. Simple or not, this bill is extremely important to the beneficiaries of long-term settlement funds such as the Eagle-Picher Trust.

As trustees, we are obligated to pay claimants several decades into the future. Today, asbestos trusts make payments to approximately 500,000 people and our actuaries estimate that approximately another 500,000 people will become ill and make claims that we will have to meet over the next few decades.

Now, without capital gains relief, trustees of these funds cannot prudently invest in equities. trustees of these funds need to be able to avail themselves of the long-term growth potential which investment in equities would permit. If H.R. 580 is passed, it will, first, allow us the higher rates of return available from equities. And, second, equally importantly, it will allow us to invest in ways such as to reduce investment risk through critically important diversification, particularly important because our trusts will last for so many years. Now, even with this bill, our assets will fall far short of the amount needed to permit payment in full of the claims of our beneficiaries. Nonetheless, it will make a huge difference in the lives of our beneficiaries and their families, the vast majority of whom are working people, sick and who have very limited financial resources.

Mr. Chairman and Members of the Committee, I want to thank you again for the opportunity to testify on behalf of the beneficiaries of my trust and other settlement funds. With your permission, I am pleased now to introduce Mr. Roosevelt Henderson, who is one of those beneficiaries. He can tell you, firsthand, exactly how important this bill is to him, to his family, to others like him, and to their families. Thank you very much.

[The prepared statement follows:]

Joint Statement of Ruth R. McMullin, Chairperson, Eagle-Picher, Personal Injury Settlement Trust, Cincinnati, Ohio; and Roosevelt Henderson, Texas City, Texas; on behalf of Eagle-Picher Personal Injury Settlement Trust

Mr. Chairman and members of the Committee, my name is Ruth McMullin, and I am Chairperson of the Eagle-Picher Personal Injury Settlement Trust.

Thank you very much for the opportunity to testify in support of H.R. 580, which has been introduced by Congressman Crane and is cosponsored by Congressman Rangel and several other members of this Committee. H.R. 580 is a very simple bill. Due to a technical flaw in current law, capital gains earned by settlement funds are presently taxed at the highest ordinary income tax rate rather than at the rates normally applicable to capital gains. That flaw, which appears to be a drafting oversight, unfairly penalizes the hundreds of thousands of families who depend on settlement funds to help pay their medical and living expenses. H.R. 580 would correct that flaw by providing that capital gains earned by settlement funds would be taxed at a capital gains rate, as is the case with all other taxable trusts.

By way of background, settlement funds are trusts which are used in connection with the settlement of certain tort claims. The settlement fund which I chair, and others like it, have been established in accordance with section 468B of the Internal Revenue Code. Section 468B, which was enacted as part of the Tax Reform Act of 1986, controls the tax treatment of qualified payments to funds used in the extinguishment of tort liabilities as well as the taxation of income earned by those funds. Section 468B(d)(2) defines a designated settlement fund as any fund (1) which is established pursuant to a court order, (2) which extinguishes completely the taxpayer's tort liability with respect to a class of claimants, as determined by the court, (3) which is managed and controlled by persons unrelated to the to the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, and (5) to which no amount may be transferred other than "qualified payments."

Because section 468B does not cross-reference to the capital gains rates of section 1(h) of the Internal Revenue Code, settlement funds are taxed at the highest ordinary income tax rate of 39.6% on both ordinary and capital gains income earned before such earnings are distributed to claimants. The capital gains earned by all other taxable trusts are taxed at capital gains rates, typically 20%. Despite an exhaustive search of the legislative history, we have not found any explanation of this anomaly. In fact, we have not found any evidence that Congress even was aware that section 468B created this problem. In view of the fact that there was no difference between capital gains and ordinary income rates at the time section 468B was enacted, the failure to cross-reference to the capital gains rates of section 1(h) in section 468B appears to be a drafting oversight. Indeed, Congress traditionally has allowed capital gains earned by a trust to be taxed at capital gains rates where a differential between the rates exists. For example, in "The Small Business Job Protection Act of 1996," Congress specifically provided that capital gains earned by "electing small business trusts" be taxed at capital gains rates.

H.R. 580 simply would amend section 468B by adding a cross-reference to section 1(h), thus ensuring that capital gains earned by settlement trusts would be taxed at capital gains rates. Doing so is consistent with sound tax policy and simple fairness. The burden of taxing a settlement fund's capital gains at the highest ordinary income rate falls upon the claimants of the fund, thus reducing the amounts that they would otherwise be able to recover. Moreover, capital gains income should be taxed at the same rate, whether generated by a settlement fund, an electing small business trust, or an individual.

Passage of H.R. 580 is particularly important to the beneficiaries of settlement funds such as the Eagle-Picher Personal Injury Settlement Trust, which will be obligated to pay claims several decades into the future. Certain settlement funds, such as those established to pay, for example, securities fraud claims, distribute all their assets to a clearly defined group of claimants over a relatively short period of time, typically a matter of months. Those settlement funds almost never invest in equities, and thus do not realize capital gains. Other settlement funds, most notably those established to pay individuals afflicted by asbestos-related illnesses, must manage their assets to maximize payments to a very large, undefined group of claimants over the course of many years. Asbestos settlement funds currently make payments to approximately 500,000 persons, and actuaries estimate that approximately 500,000 additional claimants will be identified in the coming years. Furthermore, those payments will need to continue until about the year 2030.

Unfortunately, the asbestos settlement funds have enough funds to pay only a small fraction of the amount of the claims against them. Therefore, it is imperative that we be able to invest the assets of the trusts in a way to maximize the return for our beneficiaries. In general, the best long term returns are achieved by investing in equities. Yet investment advisers have stated that settlement funds cannot responsibly invest more than a very modest part of our portfolios in equities given the current taxation of capital gains, and as fiduciaries, trustees of the settlement funds must be attentive to their advice. Changing the capital gains rate on settlement funds would change the investment advisers' asset allocation models to permit greater investments in equities. As a consequence, passage of H.R. 580 would permit settlement trusts to earn a higher return on their investments. In fact, we project that that greatest benefit to settlement fund claimants would result not from tax savings, but from the reallocation of a portion of the portfolios from relatively low-yielding assets, such as tax-free municipal bonds, into higher-yielding equities. Unfortunately, those investment gains still would fall far short of the amounts needed to permit full payment of the claims of our beneficiaries. Nonetheless, the additional investment income would make a very real difference in the lives of our beneficiaries and their families, the vast majority of whom are working people with very limited financial resources.

Mr. Chairman and members of the Committee, thank you again for the opportunity to testify. I am now pleased to have you hear from Mr. Roosevelt Henderson, who can explain this issue to you further.

Chairman ARCHER. Mr. Henderson, we are happy to have you before the Committee. I am particularly happy to have another Texan sitting out there. We welcome you and we will be glad to hear your testimony.

STATEMENT OF ROOSEVELT HENDERSON, TEXAS CITY, TEXAS; ON BEHALF OF EAGLE-PICHER PERSONAL INJURY SETTLEMENT TRUST, CINCINNATI, OHIO

Mr. HENDERSON. Mr. Chairman and the rest of the Members of the Committee, I am Roosevelt Henderson from Texas City. I would like to thank the Members of the Committee for allowing me this opportunity to come before you and talk about H.R. 580.

This H.R. 580 would allow us to have more money to pay our bills, for medical expenses, which these settlements are coming from. And we would like to take this opportunity to ask the Chairman and the Committee to rely on passing this bill, H.R. 580. And we want to thank you again, Mr. Chairman. Thank you for the job you have done in Texas and we want to continue to thank you.

We just want to be put on the playingfield with everybody else. Everybody else is paying 20 percent taxes and we are paying 39.6 percent. And we would just like to be put on the same playingfield with everybody else. And thank you.

[The prepared statement follows:]

Statement of Roosevelt Henderson, Texas City, Texas; on behalf of Eagle-Picher Personal Injury Settlement Trust, Cincinnati, Ohio

Mr. Chairman and members of the Committee, my name is Roosevelt Henderson and I live in Texas City, Texas. I am here to testify on behalf of approximately one million families of disabled persons who are, or will be, dependent on settlement funds to meet their medical and living expenses. On behalf of those families, I strongly urge the Committee to support H.R. 580.

For many years, I put installation in industrial plants, businesses, and homes in the Texas City area. Because of my exposure to asbestos, I developed severe breathing problems and was forced to retire. I am a former president of the Texas City chapter of the NAACP and I try to remain active in civic affairs to the extent my health permits. However, most of my time and energies are spent at home, where I care for my wife, who is in poor health.

Mr. Chairman, I am grateful that you have called this hearing to discuss tax relief for America's families. I can tell you first hand, we need it. I am also grateful for your leadership in seeking capital gains tax cuts. You are right when you say that capital gains tax relief is important to all Americans, no matter what their income levels. My wife and I do not have much, but we would certainly benefit if settlement funds paid the same lower taxes on capital gains as everyone else. Right now, settlement funds set up to pay asbestos-related claims do not have enough money to pay the full value of the claims due to people like me. Ending the unfair tax treatment of capital gains earned by settlement funds would make a very real difference for my wife and me.

Finally, I personally want to thank Mr. Crane and Mr. Rangel for sponsoring H.R. 580 and for arranging for me to speak here today. They are both fine public servants, and I know I speak on behalf of all the families that would be helped by H.R. 580 in expressing our deep gratitude.

Mr. Chairman, thank you for the chance to speak with you today.

Chairman ARCHER. Thank you, Mr. Henderson. The Chairman would like to put everybody on the same playingfield with a zero tax on income, but we will get into that at another time.

We are very fortunate today, Mr. Henderson. We have got another Texan at the other end of the table down there appearing with you, Mr. Andrews. I am pleased to hear the testimony of every one of you. I thank you for coming.

I now will find out if any Members wish to inquire.

Yes, Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. Mr. Moore, we heard testimony at the beginning of this day from Representative Turner and comments from Representative Dunn, who have both offered different approaches to a reforestation credit. I wondered if I could get your comments, given that Representative Turner's credit seems to be narrower. Representative Dunn's seems to apply to a much broader range of taxpayers. My understanding is that your preference would be that there be no limit on this credit and that it form the basis of a very strong tax policy aimed at encouraging reforestation. Could you give us your thoughts on the relative benefits of those two approaches?

Mr. MOORE. Yes, Congressman, I would be happy to try. They are similar in the extent that both bills deal with the reforestation tax credit. Jennifer Dunn's bill also deals with corporate capital gains rates on forest products—on trees, rather, which Congressman Turner's bill does not. Congressman Turner's bill also stops—I think it raises the cap from $10,000 where it presently is to $25,000. Ms. Dunn's bill takes it off entirely.

What the effect of that is simply you are targeting the tax effect to some very small landowners in the Turner bill concept, and that's all well and good. The problem exists across the entire panoply of growing trees in the United States, and so you are missing the much bigger target. In terms of moving the needle of the industry being competitive, his bill moves it a notch; Ms. Dunn's bill moves it halfway.

And, so, for example, in the United States today, corporate landowners own probably about 17 percent of the forest land of the country, but they produce 45 percent of the wood. That is intensive silvaculture going on, which brings on expenses. Congressman Turner's bill would completely miss that and would go at small landowners who basically aren't producing that much wood but own half the forest land in the country and who are very important to the process. Congresswoman Dunn's bill affects both. It doesn't just affect just the small; it covers both. It lowers the capital gains rate on everybody. It raises the cap or takes the cap on reforestation expenses for everybody.

And, so you have correctly characterized it. Her bill is much broader, affects the entire industry, does a great deal more. Our initial indication is, as I said, would put us at about the middle of the pack of the country's with whom we compete in taxation on forestry operations.

Mr. ENGLISH. Thank you, sir.

Mr. Wallace, I am delighted to see another western Pennsylvanian here, and I wondered if I could pursue a line of questioning on your testimony?

First of all—because I think most people really still have trouble getting their arms around the real differences between cash and accrual. In your view, what does the average contractor spend as a percentage of revenue on material or merchandise costs?

Mr. WALLACE. I would say, at a minimum, 30 to 50 percent; some contractors more, but I would say in order to achieve the IRS numbers of 15 percent or less, there are very few, if any, contractors are going to meet that number.

Mr. ENGLISH. So, in other words, this mandate would be applied to almost all contractors.

Mr. WALLACE. That is exactly right, almost all contractors.

Mr. ENGLISH. If the IRS continues this push to change all contractors with material costs in excess of 15 percent from the cash method, what effect would this have on the construction industry?

Mr. WALLACE. It is going to have a tremendous negative effect on the construction industry. It is going to reduce production, the creation of jobs, it is going to require a lot of compliance and paperwork, and it is going to require them to report their taxes earlier than collecting the funds.

Mr. ENGLISH. And if Congress legislates the use of the cash method for small contractors of service providers, are you at all concerned about the transition end or implementation of such a law?

Mr. WALLACE. I am concerned, and I would like to see a congressional comment or intent to say to the IRS, "Let us just not enforce this for 1999 and beyond, but don't pick on those contractors for the prior years that they are still currently auditing, and so forth."

Mr. ENGLISH. And, Mr. Wallace, finally, if the IRS requires a contractor's service provider to report their income on the accrual method, would this mean that they would pay tax on retainages that have not been collected, and doesn't the retainage amount typically equal 10 percent of the contract and in the majority of times exceed the contractors profit on the Federal contract?

Mr. WALLACE. The answer is yes to both of your questions. It will require them to report their income earlier, and it is going to require them to pay taxes in a greater amount than their final profit on the job.

Mr. ENGLISH. Thank you, Mr. Wallace, for your testimony. It is most helpful in making the case for Congress intervening in this issue. Thank you for your time.

Mr. WALLACE. Thank you for your help and the Chairman's help.

Chairman ARCHER.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

First, just a comment for Mr. Wolyn. I appreciate your coming before the Committee today and underscoring the fact that business meals are in fact a legitimate business expense, particularly for small business people who have to use that as a means to market their products.

But my questions are for Mr. Moore, a fellow Louisianan; not because he is a fellow Louisianan, but——

Chairman ARCHER. If the gentleman will yield, I intended to say that he was an almost Texan. [Laughter.]

Mr. MCCRERY. That is right—but because I share Mr. Moore's concern about our domestic timber industry, forest products industry. Louisiana, of course, has a very large stake in that industry. Mr. Moore, would you say that our domestic forest products industry is distressed right now?

Mr. MOORE. Yes, Congressman, it is. I will give you some examples. We are, by every economist agreement, the second most capital intensive industry in the United States, yet we have earned the cost of capital once in the last decade—1995. We were ranked last year by Fortune magazine—the same magazine that said in 1992 we were competitive—ranked the 26 industries in the United States in terms of profitability. We were 25th, the very bottom. Our imports have gone down dramatically—our exports, rather, and imports to the United States in our area are going up dramatically. The last factor—there are no new mills being built in our industry in the United States; they are being built in developing countries. And, so, basically, we can try to provide some additional data, but I think those indicators pretty well indicate this is an industry that is losing its competitive edge and is starting to downsize. We lost

10,000 jobs last year. We used to employ 1.5 million; last year, we lost 10,000, and we see that trend continuing.

Mr. MCCRERY. And you pointed out in your testimony several reasons why you think our domestic industry is at a competitive disadvantage in the tax treatment, and I agree with that. When you look at just the growing trees, for example, why should we treat an investment in trees any different from any other investment? Is it more risky? Are you less likely—is it easier to put your money into some safer investment? Can you expand on that?

Mr. MOORE. I think the ultimate optimist is somebody who puts money in the ground in trees. Farmers are thought to be real optimists, but their crops are generally annual. In this business, you put your money in the ground, and you are lucky if you can start harvesting or getting anything back. Depending on the species and the part of the country you are in, the soonest is about 15 to 17 years, and you really get your investment back in about 40 years. Meanwhile, you have the risk of forest fires, the risk of storms, the risk of insect infestation, and there is even theft, and all of this makes this a very risky proposition, one that our companies are beginning to measure whether it is worth putting the money into it or would they do better putting the money someplace else? And individuals who are not in our business but just might own 100 acres of land or 50 acres of land are important to us, because they do provide about half of the fiber that our industry consumes. They are sitting there 50-years-old thinking, "I am going to put $200 an acre into reforesting an acre in land and wait 40 years to recover it?" And, so, yes, it is a pretty risky business, and it is one that Congress has recognized. Even the 1986 Tax Act recognized this industry's investment was very different from that of others.

Mr. MCCRERY. And it is a problem not only for individuals but also for corporations. You said that even some corporations are beginning to question whether they should put their stockholders' money into some other investment, because the return is not enough to justify the risk. Is that right?

Mr. MOORE. Exactly. We have seen some companies develop housing developments and golf courses out of the forest lands. I think if you want to see the country stay forested, there needs to be incentives, at least on par with other competing countries, to put the trees in the ground. Otherwise, I think we are going to see a decline in that.

Mr. MCCRERY. Well, besides the obvious advantage of a vibrant forest products industry—1.5 million jobs in this country—is there an environmental advantage to keeping a healthy forest, healthy trees, in this country?

Mr. MOORE. Well, judging by the folks who get upset when we cut them even when we plant them, I would say that, yes, there must be some advantage to keeping trees in the ground. Certainly, it is important for wildlife; it is important to the aesthetics—all of us like the thought of there being forest there that we might someday take a walk in or hunt or fish in. And, so, yes, we think there very definitely is that. If there is something to global warming, then, obviously, carbon sequestration is very important, and so these things addressed in the Dunn bill will promote, hopefully, and begin to take some of the incentives out of reforestation; take some of the disincentives out of reforestation.

Mr. MCCRERY. Thank you, Mr. Moore. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. I would like to follow up just a little bit on the previous line of questioning with regard to Henson and the planting of the trees. Also, there is not only just the environmental considerations that you have talked about, there is also the question of erosion. As a matter of fact, there are erosion programs whereby the Federal Government actually pays people to plant trees to stop the erosion, so it is good for clean water, as well.

And I would like to add to the answer that you gave with regard to why would you distinguish this from, perhaps, other investments? And another reason is what we are doing is if you are farmer and buy fertilizer and whatever you buy, you get to write that off; you don't have to wait until that crop comes in, and this is just recognizing the tree farmer as a farmer, and that is exactly what they are. They just have to wait longer for their investment to come back, but I think just from the standpoint of just not only competitiveness and the environment, I think it is just a question of basic fairness, not requiring the capitalization.

Do we have any figures or do we have any estimates as to what it would be to go back to the old law like it used to be, just simply saying when you cut your timber and replant it, you get to write it off? Do we have any figures on that?

Mr. MOORE. Congressman, we don't. We can try to get those for you. I think you could probably get them quicker from the Joint Committee than we can. We do have figures, obviously, that we have seen on the Dunn bill, but, no, I don't know what the revenue loss would be for that.

Mr. SHAW. I think maybe the Committee ought to take a look at that to see what would be the effect rather than going through the—writing it off over a period of several years and then getting a tax credit. I mean, it is just a quick writeoff. Just go back to existing law what it was a number of years ago. In fact, since I have been in this Congress, I think that has been changed.

Historic preservation, and it is nice to see you back here before this Committee, Mr. Andrews and I know you have been very active in this area. This is a piece of legislation that really gives you a two-for. You get not only historic preservation, but you also get housing, and I can tell you having renovated two townhouses on Capitol Hill, it is a little costly, and I think that there is certainly a national interest in preserving many of these older homes around the country, and I think the statistics that you gave us as to how they are disappearing is really quite startling, and I would hope that that would be included in the bill that finally comes out of this Committee and maybe even the Chairman's part.

Mr. MCCRERY. Will the gentleman yield?

Mr. SHAW. Yes, I would be glad to yield.

Mr. MCCRERY. If I am not mistaken—Mr. Andrews, correct me if I am wrong—but you are here totally on a voluntary basis, is that right? [Laughter.]

Mr. ANDREWS. Yes, I am. Yes, this is something that I feel very strongly about. You know, there are a lot of things that need to be done for our country's cities and our neighborhoods—fighting crime, better schools, better infrastructure. This is one important step, though, that can make a significant difference in encouraging families to rehabilitate historic structures and preserve our culture and our heritage. If you look at every successful city, those cities have done a good job of preserving their history and their culture and their heritage. They have not allowed their neighborhoods to be decimated and razed, and this is a very modest cost bill, but it will have far-reaching impacts on historic neighborhoods.

Mr. MCCRERY. Mr. Chairman, let me clarify, I didn't mean to imply that any of the others were here—were compelled to be here; I mean that Mr. Andrews is not being paid by the association he is representing; he is here just as a volunteer on behalf of that cause. So, thanks.

Chairman ARCHER. The gentleman might want to quit while he is ahead. [Laughter.]

Mr. SHAW. Thank you. I yield back, Mr. Chairman.

Chairman ARCHER. Mr. Moore, one of the things I have noted over the years is a misunderstanding about forestry and proper management of trees. Is it not true that with proper forest management and selective cutting, in contrast to clear cutting, there are environment benefits? You reduce the amount of greenhouse gases that come from the decaying of older trees that are not cut prior to the time that they go into decline.

Mr. MOORE. Yes, Mr. Chairman. Also, you would help prevent insect infestation. Anything old tends to get weaker; it tends to get sicker; it tends to do less for the environment, and it consumes less carbon.

Chairman ARCHER. Furthermore, don't you open up the forest for the growth of younger trees so that they can produce their beneficial effect on the environment?

Mr. MOORE. Yes, that is a raging debate now in the Kyoto Protocol discussions of these very points you are making. The science of silvaculture and the foresters would say, "Absolutely, you are correct on these points." That is disputed by some who are not trained in forestry.

Chairman ARCHER. Thank you. Any other inquiry?

The Chair thanks all of you for your presentations today, we appreciate all of your input, and you are excused.

There being no further testimony before the Committee, the Committee will stand adjourned.

[Whereupon, at 3:43 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of America's Community Bankers

Mr. Chairman and Members of the Committee:

America's Community Bankers appreciates this opportunity to submit testimony for the record of the hearing on ways to strengthen the family and sustain a strong economy. America's Community Bankers (ACB) is the national trade association for progressive community bankers across the nation. ACB members have diverse business strategies based on consumer financial services, housing finance, small business lending, and community development, and operate under several charter types and holding company structures.

INTRODUCTION

Our testimony will focus on a single legislative proposal that is uniquely suited to both strengthening the family and helping to sustain a strong economy. This is a proposal to increase the per capita limit on the low-income housing tax credit (LIHTC) from $1.25 to $1.75. It was introduced in the House this year by Representatives Nancy Johnson and Charles Rangel as H.R. 175 and introduced in the Senate this year by Senators Connie Mack and Bob Graham as S. 1017, as well as advocated in the Administration's fiscal year 2000 budget proposal. As an important part of the thrift industry's commitment to housing, ACB's member institutions have been participants, as direct lenders and, through subsidiaries and affiliates, as investors, in many low-income housing projects that were viable only because of the LIHTC. The per capita ceiling on the annual allocation of the LIHTC has not been increased since the credit was created by the Tax Reform Act of 1986. Many member institutions have communicated to ACB that there are shortages of affordable rental housing in their communities and that, if the supply of LIHTCs were increased, such housing could be more efficiently produced to address this shortage.

Experts in the field have commented on the unique ability of the LIHTC to strengthen the family and create private sector jobs that strengthen the economy. For example, Joseph Lynch, the Commissioner of the New York State Division of Housing and Community Renewal testified on May 27, 1999, at the IRS public hearing on proposed regulations intended to enhance the compliance monitoring of LIHTC projects (REG 114664–97) that:

> "It is important to note that the housing credit not only develops and preserves decent housing, it also stimulates business activity, creating private sector jobs and generating tax revenues. Based on information provided by the National Association of Home Builders, my staff estimates that the housing credit assisted development of those 30,840 units that I talked about has created more than 31, 765 jobs and generated more than a billion dollars in wages and more than half a billion dollars in combined federal, state, and local tax revenues and fees, the bottom line is that the housing credit is a very wise investment, a wise investment for the federal government, for the states, for private investors, and for low-income families and other citizens who live in decent, safe, and affordable housing made possible by the credit."

BACKGROUND

The LIHTC was created in 1986, and made permanent in 1993, to replace a variety of housing subsidies, the efficiency of which had been called into question. Under Section 42 of the Internal Revenue Code, a comprehensive regime of allocation and oversight was created, requiring the involvement of both the IRS and state and local housing authorities, to assure that the LIHTC is targeted to increase the available rental units for low-income citizens. This statutory scheme has been revised in several subsequent tax acts to eliminate potential abuses.

Nevertheless, the Code does impose the judgment of federal bureaucrats over that of state housing agencies in making credit allocations. Section 42 requires the housing credit allocation agencies to develop qualified allocation plans to target their tax credits to proposed housing projects that meet their "housing priorities" and that include selection criteria that are "appropriate to local conditions." In addition the Code requires the agencies to "give preference" to projects "serving the lowest-income tenants" and projects "obligated to serve qualified tenants for the longest periods." Because the Code does not define these terms or set forth the procedures for implementing the program's requirements, it gives the allocating agencies the flexibility to respond to their particular needs.

Every year since 1987, each state has been allocated a total amount of LIHTCs equal to $1.25 per resident. The annual per capita limit may be increased by a reallocation of the unused credits previously allocated to other states, as well as the state's unused LIHTC allocations from prior years. The annual allocation must be awarded within two years or returned for reallocation to other states. State and local housing authorities are authorized by state law or decree to award the state's allocation of LIHTCs to developers who apply by submitting proposals to develop qualified low-income housing projects.

A "qualified low-income project" under Section 42(g) of the Code is one that satisfies the following conditions. (1) It must reserve at least 20 percent of its available units for households earning no more than 50 percent of the area's median gross income, adjusted for family size, or at least 40 percent of the units must be reserved for households earning no more than 60 percent of the area's median gross income, adjusted for family size. (2) The rents (including utility charges) must be restricted for tenants in the low-income units to 30 percent of an imputed rental income limitation based on the number of bedrooms in the unit. (3) During a compliance period, the project must meet habitability standards and operate under the above rent and income restrictions. The compliance period is 15 years for all projects placed in service before 1990. Amendments in 1989 extended the period for which credit project are required to serve low-income households to 30 years, but included an exception that, in some instances, could permit a sale that would result in the project's conversion to market rental rates after 15 years.

Putting together a qualifying proposal is, however, only the first step for a developer seeking an LIHTC award. The state or local housing agency is required to select from among all of the qualifying projects by means of a LIHTC allocation plan satisfying the requirements of Section 42(m). The allocation plan must set forth housing priorities appropriate to local conditions and preference must be given to projects that will serve the lowest-income tenants and will serve qualified tenants for the longest time.

Section 42 effectively requires state and local housing agencies to create a bidding process among developers to ensure that the LIHTCs are allocated to meet housing needs efficiently. To this end the Code imposes a general limitation on the maximum LIHTC award that can be made to any one project. Under Section 42(b) the maximum award to any one project is limited to nine percent of the "qualified basis" (in general, development costs, excluding the cost of land, syndication, marketing, obtaining permanent financing, and rent reserves) of a newly constructed building. Qualified basis may be adjusted by up to 30 percent for projects in a qualified census tract or "difficult development area." For federally subsidized projects and substantial rehabilitations of existing buildings, the maximum annual credit is reduced to four percent. The nine and four percent annual credits are payable over 10 years. In 1987, the first year of the LIHTC, the 10-year stream of these credits was equivalent to a present value of 70 percent and 30 percent, respectively, of qualified basis. Since 1987, the Treasury has applied a statutory discount rate to the nominal annual credit percentages to maintain the 70 and 30 percent rates.

The LIHTC has to be taken over 10 years, but the period that the project must be in compliance with the habitability and rent and income restrictions is 15 years. This creates an additional complication. The portion of the LIHTC that should theoretically be taken in years 11 through 15 is actually taken pro rata during the first 10 years. Where there is noncompliance with the project's low-income units during years 11 through 15, the related portion of the LIHTC that was, in effect, paid in advance will be recaptured.

Where federally subsidized loans are used to finance new construction or substantial rehabilitation, the developer may elect to qualify for the 70 percent present value of the credit by reducing the qualified basis of the property. Where federal subsidies are subsequently obtained during the 15-year compliance period, the qualified basis must then be adjusted. On the other hand, certain federal subsidies do not affect the LIHTC amount, such as the Affordable Housing Program of the Federal Home Loan Banks, Community Development Block Grants, and HOME Investment Partnership Act funds.

The LIHTCs awarded to developers are, typically, offered to syndicators of limited partnerships. Because of the required rent restrictions on the project, the syndications attract investors who are more interested in the LIHTCs and other deductions the project will generate than the unlikely prospect of rental profit. The partners, who may be individuals or corporations, in essence, provide the equity for the project, while the developer's financial stake may be limited to providing the debt financing.

The LIHTC is limited, however, in its tax shelter potential for the individual investor. Individuals are limited by the passive loss rules to offsetting no more than $25,000 of active income (wages and business profits) with credits and losses from rental real estate activities. For an individual in the 28% bracket, for example, the benefit from the LIHTC would be limited to $7,000. It should also be borne in mind that such credits are unavailable against the alternative minimum tax liability of individuals and corporations.

NO ABUSES FOUND BY GAO

Three years ago the Chairs of the Ways and Means Committee and its Subcommittee on Oversight requested the GAO to study the LIHTC program and, specifically, to evaluate: whether the LIHTC was being used to meet state priority housing needs; whether the costs were reasonable; and whether adequate oversight was being performed. The resulting GAO report, which took more than a year to compile, amounted to, in the measured terms of such reports, a validation of the program. (The report was careful "o emphasize that GAO has never taken a position on whether the tax credit should be retained or repealed." See *Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program* (GAO/GGD/RCED–97–55, March 28, 1997, p. 52).

Among the GAO findings were the following:

1. Although renters in credit properties are permitted by the Code to earn up to 60% of the local area's median income, the actual renters earn on average 37% of the local median and more than three-fourths meet HUD's definition of "very low income"—i.e., their incomes were below 50% of the local median income. (To verify tenant income, GAO selected a random sample of at least one tenant in each of the randomly sampled projects and reviewed IRS tax return data on those tenants.

2. The average monthly rent of about $453 per apartment in a credit property is below market—as much as 23% below the maximum rent set by the Code and 25% below HUD's national Fair Market Rent.

3. About 26% of the properties were intended to serve primarily the elderly and about 5% were intended to serve people with special needs. About 53% of the properties were in rural areas, 36% were in urban areas, and the remainder were in suburban areas.

4. States are giving preference in awarding credit to projects dedicated to providing low-income housing for more than the 30-year compliance period required for properties placed in service after 1989. Two-thirds of the projects studied by the GAO had extended use commitments to low-income tenants longer than 30 years or had waived the option to convert to market rate after the fifteenth year.

5. Development costs for credit properties are reasonable. The average cost of developing credit properties was about $60,000 per unit and about two-thirds of these units cost less than or the same as the average noncredit unit.

6. Section 42 requires the states to consider the "reasonableness" of project development costs, but does not specify a national standard of reasonableness. The states have adopted a number of practices to directly control costs and to manage competition in ways that will promote cost control. The National Council of State Housing Agencies has provided "best practice" guidance on cost control. Of the 54 allocating agencies surveyed by the GAO, 48 have established guidelines for controlling overall project construction costs. The remaining agencies reported that they rely on competition in the application process or on their staff's expertise to control development costs.

PROPOSED IRS COMPLIANCE REGULATIONS

While the GAO could find no actual abuses or fraud in the LIHTC program, it did determine that the procedures that some states use to review and implement project proposals needed to be improved. The report recommended changes in the appropriate IRS regulations with respect to existing state agency compliance procedures used to ensure the eligibility of projects for the credit. The GAO also recommended that the IRS regulations be amended to establish clear requirements to ensure independent verification of the developer's information on sources and uses of funds submitted to a state agency. The assurance of reliable and complete cost and financing information will enable state agencies to avoid providing more (or fewer) credits than are actually authorized.

In response to the GAO recommendation the IRS issued proposed regulations under section 42(m)(1)(B)(iii) of the Code that substantially toughened the compliance monitoring currently required of the state agencies administering the LIHTC. Under the proposed regulations state agencies will be required to conduct an on-site inspection of every one of their LIHTC projects at least once every three years, including a review of the compliance records of 20% of the project's tenants. The agencies will be required to conduct an on-site inspection of each new project by the end of the year following the year it is placed in service, including a review of the compliance documents for 100% of the tenants. In addition, the proposed regulations would shift to the state agencies the responsibility for conducting all health, safety, and building code inspections of LIHTC projects and would require such inspections at least once every three years.

The proposed regulations also require that, under section 42(m)(2)(A) of the Code, the developer must obtain a CPA's audit opinion on the accuracy of the financial statements and certifications provided by the developer to the state agency, including the costs that may qualify for inclusion in eligible basis under section 42(d) and the amount of the LIHTC. At the hearing on the proposed regulations held on May 27, 1999, The three, out of the four, speakers who represented state agencies and developers stated that these new requirements were too burdensome.

The Necessity for Expanding the LIHTC

The GAO, after a detailed examination, found no evidence that fraud or abuse is occurring in the LIHTC program and did find substantial evidence that the program is working as Congress intended to provide the genuinely needy with decent affordable housing. The IRS, at the recommendation of the GAO, has issued stringent proposed regulations that are intended to assure compliance with the congressional purpose expressed in the LIHTC statute. Whether or not these proposed regulations would impose compliance burdens on state agencies and developers that are too onerous, Congress should at least be assured that the IRS is diligently working to eliminate any potential for fraud of abuse in the LIHTC.

The only problem with the LIHTC is its insufficiency to meet the urgent need that currently exists for affordable housing. The only increase in the total amount of LIHTCs since 1987 has been through population growth, which has been only five percent nationwide over the 10-year period (floor statement of Senator Alphonse D'Amato, October 3, 1997). Had the $1.25 per capita limit been indexed for inflation since the inception of the LIHTC, as is commonly done in other Code provisions, it would be comparable to the $1.75 limit the Administration is proposing. According to the Joint Committee on Taxation, the Consumer Price Index measurement of cumulative inflation between 1986 and the third quarter of 1998 was approximately 49.5 percent. Using this index to adjust the per capita limit, it would now be approximately $1.87. The GDP price deflator for residential fixed investment indicates 39.9 percent price inflation, which would have increased the per capita limit to approximately $1.75. (See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* (JCS–1–99), February 22, 1999)

More affordable low-income housing is urgently needed. "Despite the success of the Housing Credit in meeting affordable rental housing needs, the apartments it helps finance can barely keep pace with the nearly 100,000 low cost apartments which were demolished, abandoned, or converted to market use each year. Demand for Housing Credits currently outstrips supply by more than three to one nationwide. Increasing the cap as I propose would allow states to finance approximately 27,000 more critically needed low-income apartments each year using the Housing Credit, helping to meet this growing need." (floor statement of Representative Nancy Johnson, January 6, 1999).

"And, as Adam Smith would have predicted, this incentive does the job. Since 1987, state agencies have allocated over $3 billion in Housing Credits to help finance nearly one million apartments for low income families, including 70,000 apartments in 1997. In my own state of Florida, the Credit is responsible for helping finance over 52,000 apartments for low income families, including 3,300 apartments in 1997. The demand for Housing Credits nationwide currently outstrips supply by more than three to one" (floor statement of Senator Connie Mack, May 12, 1999).

"In the state of Florida, for example, the LIHTC has used more than $187 million in tax credits to produce approximately 42,000 affordable rental units valued at over $2.2 billion. Tax credit dollars are leveraged at an average of $12 to $1. Nevertheless, in 1996, nationwide demand for the housing credit greatly outpaced supply by a ratio of nearly 3 to 1. In Florida, credits are distributed based upon a competitive application process and many worthwhile projects are denied due to a lack of tax credit authority" (floor statement of Senator Bob Graham, October 3, 1997).

"In 1996, states received applications requesting more than $1.2 billion in housing credits— far surpassing the $365 million in credit authority available to allocate that year. In New York, the New York Division of Housing and Community Renewal received applications requesting more than $104 million in housing credits in 1996—nearly four times the $29 million in credit authority it already had available" (floor statement of Senator Alphonse D'Amato, October 3, 1997). "The Housing Credit is the primary federal-state tool for producing affordable rental housing all across the country. Since it was established, state agencies have allocated over $3 billion in Housing Credits to help finance nearly one million homes for low income families, including 70,000 apartments in 1997. In my own state of Connecticut, the Credit is responsible for helping finance over 7,000 apartments for low income families, including 650 apartments in 1997" (floor statement of Representative Nancy Johnson, January 6, 1999).

Conclusion

Based on the foregoing, it is clear that it is time to increase the LIHTC. Increasing the availability of the LIHTC is one of the top legislative priorities of ACB. Our members have been in the forefront of those who have been using the LIHTC to profitably increase the housing stock of their communities and, by their use of the

LIHTC, our members are proving that it is possible to do well by doing good in their communities. ACB appreciates very much this opportunity to testify for the record of this important hearing and commends you, Mister Chairman, and the members of the Subcommittee for holding it. If you have any questions or if ACB can be of further assistance, please do not hesitate to call James O'Connor, at 202–857–3125.

Joint Statement of American Association of Colleges of Osteopathic Medicine, Chevy Chase, MD; and Association of American Medical Colleges

The Association of American Medical Colleges (AAMC) and the American Association of Colleges of Osteopathic Medicine (AACOM) are pleased to have this opportunity to comment on reducing the tax burden on individuals through increased education incentives.

We believe that there is a compelling public interest in exempting payments for tuition and education-related expenses under the National Health Service Corps (NHSC) Scholarship Program from gross income for tax calculation purposes. The NHSC Scholarship Program provides highly educated health care professionals to federally-designated health professional shortage areas, often in rural or inner city locations. By levying a tax on the tuition and fees portion of NHSC scholarships, participation in the program is jeopardized, threatening the ability of under-served health communities to secure needed medical providers.

The NHSC Scholarship Program was established more than 20 years ago to provide health professions students with funding to cover tuition and education related expenses, as well as a monthly stipend for living expenses, in exchange for a commitment to provide primary health care services in a federally-designated health professional shortage area (HPSA). During this time, the NHSC Scholarship Program has produced over 23,000 doctors, physician assistants, nurse midwives and other health care professionals. The program attracts a culturally diverse applicant pool—over 40 percent of recipients are minorities—who are more sensitive to the health care issues in underserved areas, but at the same time also are more sensitive to incurring debt. Because the imposition of tax on the scholarship drastically reduces the amount of the monthly stipend, students may be forced to find additional funding sources or look at other scholarship options, reducing the ability to fulfill the national priority of increasing access to health care in medically underserved areas.

On August 29, 1997, the NHSC sent notification to health professions schools and students of their intention, based on the result of a new Internal Revenue Service (IRS) interpretation, to begin withholding federal income tax on the entire amount of scholarships awarded to NHSC scholarship recipients. According to the IRS, taxation of the entire scholarship amount is required to comply with a change in the tax code, specifically a 1986 amendment to 26 USC 117 (c).

In 1994, the NHSC sought clarification of the 1986 amendment to section 117 (c) from the IRS. The IRS interpretation concluded that NHSC scholarships are awarded as payment for substantial future services and therefore are not excludable from gross income under section 117 (c). The IRS distinguishes NHSC scholarships from other award programs administered by the Department of Health and Human Services such as Scholarships for Students with Exceptional Financial Need (EFN), Financial Assistance for Disadvantaged Health Professions Students (FADHPS), and Mental Health Clinical Traineeship (MHCT). The IRS concluded that these programs "do not impose the same substantial quid pro quo service requirements on the participants as are imposed upon NHSC participants" and therefore are not subject to the same federal taxation.

Prior to 1986, NHSC scholarship recipients were required to pay federal tax only on the stipend portion of the scholarship. Tuition and related expenses were excluded from gross income. Although an unintended effect of the Tax Reform Act of 1986 was to levy tax on NHSC scholarships, the provision went unnoticed and unenforced until the NHSC's 1994 inquiry. To comply with the 1997 IRS interpretation, the NHSC began withholding the entire tax obligation from the stipend part of the scholarship, beginning December 1, 1997. Many NHSC scholarship recipients encountered drastic reductions in the amount of their monthly stipends as a result of the IRS interpretation.

A reduced stipend is likely to cause these students to seek supplemental financial assistance to meet their living expenses and creates a disincentive for students to participate in the program. The high cost of medical school tuition means that students could face thousands of dollars in tax payments on their scholarships. In addition, NHSC analysis shows that students in their second, third and fourth years of study are impacted to even greater degrees. In a worst case scenario, the NHSC estimates that a fourth year student at a high-cost institution would not only forfeit the entire stipend in federal tax payments, but additionally owe nearly $300.

Bipartisan legislation aimed at exempting NHSC scholarship payments from income for tax purposes was recently introduced in both chambers of Congress. Representatives Nancy Johnson (R–Conn.) and Karen Thurman (D–Fla.) introduced H.R. 1414 on April 14, 1999, and Senator Jim Jeffords (R–Vt.) introduced S. 288 on January 21, 1999. This version also exempts scholarships granted under the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program. The proposal is also part of Senate Finance Committee Chairman William Roth's (R–Del.) education tax break package which was approved by his committee on May 19, 1999. The section related to NHSC and Armed Forces scholarship exemptions was costed at only $8 million over the next 10 years. This is a minimal price to pay to increase access to high quality health care in underserved areas.

There also is no opposition to this proposal. The current congressional proposals include significant support from both sides of the aisle, and similar language was approved by both chambers in the 105th Congress before being vetoed by the president for unrelated reasons. However, the Administration included a similar proposal in the FY 2000 budget request as part of a larger administration proposal to expand education initiatives. In the Analytical Perspectives volume of the FY 2000 Budget Proposal, the Administration proposes to amend current law to provide that "any amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program are 'qualified scholarships' excludable from income, without regard to the recipient's future service obligation."

In conclusion, the AAMC and AACOM believe that taxing tuition and education related expenses under the NHSC Scholarship Program creates a disincentive to participation in a program that serves a compelling national public policy interest. As you compose legislation aimed at reducing the tax burden on individuals, we urge you to include a provision exempting these important scholarships from gross income for tax purposes.

The AAMC represents the nation's 125 accredited medical schools, some 400 major teaching hospitals and health systems, 86 professional and scientific societies representing 87,000 faculty members, and the nation's medical students and residents.

AACOM represents the 19 accredited colleges of osteopathic medicine in the United States as well as all osteopathic medical students and osteopathic interns and residents.

AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES
WASHINGTON, DC 20036–3690
June 14, 1999

The Honorable William Archer
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The Engineers Public Policy Council of the American Association of Engineering Societies strongly supports HR 1682, the Private Sector Research and Development Investment Act of 1999 that was introduced by Representatives Wilson and Ford. This legislation would make the federal Research and Experimentation Tax Credit permanent and expand the basic research credit component. Enclosed is a copy of our position statement, which we would appreciate being placed in the record of your committee's June 23rd hearing.

Federal policy should foster investment in research, both public and private, in order to ensure our nation's ability to compete in the market place of the 21st Century. Making the credit permanent should be a top priority for Congress to enable private industry to create long-term research plans that will benefit all of society.

The R&E tax credit provides a vital incentive for private companies to increase their R&D spending in the U.S. The credit is both a good investment in U.S. productivity and job growth, as well as a critical compliment to direct federal support for

R&D. Investment in engineering and science research is the lifeblood of technological innovation, which drives U.S. economic growth, environmental progress, and national security. Private firms fund almost two-thirds of the nation's engineering and science research.

AAES notes that only HR 1682 seeks to address the gross under-utilization of the basic research credit. The enhancements proposed by this legislation will spur private industry to undertake more basic research programs, many at our nation's research universities. The results will not only include great advances in our body of knowledge, but also the training of the next generation of researchers.

If you have any questions, please feel free to contact Pete Leon, AAES Director of Public Policy at (202) 296–2237.

Sincerely,

DR. THEODORE T. SAITO
1999 EPPC Chair

American Association of Engineering Societies Recommendations

MAKE THE R&E CREDIT PERMANENT

The R&E credit should be made a permanent part of the tax code. While the temporary nature of the credit was originally justified as a way to review the performance of the law, 17 years has been a more than adequate review period. A recent study by Coopers and Lybrand claimed that a permanent credit would stimulate $41 billion in additional R&D by 2010. While current budget constraints are cited as the principal barrier to permanence, we urge Congress to give more weight to the expected long-term gains to society of a permanent credit than is given to short-term revenue loss.

REFORM THE "BASIC RESEARCH CREDIT" TO PROMOTE COLLABORATIVE RESEARCH

Studies by the Office of Technology Assessment (OTA), Congressional Research Service (CRS), and others conclude that the current "Basic Research Credit" is ineffective. We believe this is due to its narrow definition of research and its incremental nature. According to OTA, basic research payments to universities and other qualified organizations represented only 0.4 percent of total qualified research in 1992.

The definition of research under this provision should be expanded to include all long-term, high-risk collaborative research. While one of the strengths of the R&E credit is that it leaves decisions on what research areas to fund to the private sector, a robust incentive for long-term collaborative research would increase the credit's spillover benefits to society. Such a credit should foster basic and long-term precompetitive research, which industry has cut back on, and promote company-to-company, company-to-university, and company-to-federal laboratory partnerships. It should also include expenditures for collaborative research involving nonprofit research centers.

Further, because this type of research does not represent a major portion of a typical company's R&D budget, an incremental design—as is currently used under the Basic Research Credit—is not likely to affect decisions on R&D strategies and, thus, not provide a sufficient incentive. By contrast, a 20% flat credit would be much simpler and would likely create the needed incentive for firm's to pursue more long-term research through joint ventures with universities, laboratories, nonprofit centers, and industry-wide consortia. Such research allows firms to share costs, hedge risks, and broaden their technological competence. It can also speed the rate of technology diffusion across firms and produce multiple societal benefits.

ADJUST THE BASE PERIOD

To be fair and effective, the base amount realistically has to account for changes in a firm's research intensity over time. The current 1984–88 period is both discriminatory and outdated. While some firms do very well with this base period, many others reap little or no benefit because their sales have grown faster (or fallen more slowly) than their qualified research expenses since the base period. The current 1984–88 base simply is not a reasonable benchmark for many companies given their current business conditions. One proposal worth considering is to permit companies to use any 4-year period within the previous 10 years, which would better match their current business environment while retaining the incremental nature of the credit.

Repeal the 50% Rule

The 50% rule reduces the value of the credit to firms that have substantially increased their R&D spending over their base period. This rule is particularly troublesome for small firms, which produce the lion's share of new jobs in the U.S. Under the 50% rule, many high-tech start up firms often see the effective rate of the R&E tax credit cut in half.

American Association of Engineering Societies

The Federal R&E Tax Credit

June 16, 1998

Summary Recommendations

- Make the R&D Tax Credit Permanent
- Reform the "Basic Research Credit" to Promote Collaborative Research
- Adjust the Base Period
- Repeal the 50% Rule

Introduction

Investment in science and engineering research is the lifeblood of technological innovation, which drives U.S. economic growth, environmental progress, and national security. Almost two-thirds of the nation's science and engineering research is funded by private firms. The federal share of total U.S. R&D investment has decreased steadily and currently represents 31% of total R&D spending, down from 57% in 1970.

The increasing role of the private sector in funding U.S. science and engineering R&D is likely to continue. Moreover, considering that private firms typically underinvest in R&D when responding solely to the marketplace and that real R&D growth in many manufacturing industries has declined, federal policies—both direct and indirect—that induce additional private R&D investment are essential. Currently, the Research and Experimentation (R&E) tax credit is the centerpiece of the federal government's indirect support for R&D.

The American Association of Engineering Societies (AAES) believes that the R&E tax credit provides an important, market-driven incentive for companies to increase their R&D spending in the U.S. The credit is both a good investment in U.S. productivity and job growth and a critical complement to direct federal subsidies for R&D.

How the R&E Credit Works

In 1981, Congress created the R&E tax credit to encourage business to increase their R&D spending in the U.S. Under section 41 of the Internal Revenue Code, a firm can claim a 20% tax credit on the amount by which its qualified research expenditures (QREs) exceed a base level. Such an incremental design, in principle, minimizes the likelihood of providing a tax subsidy to a firm for R&D that would have taken place in the absence of the credit.

The base amount is determined by multiplying a firm's "fixed base percentage" (the ratio of its combined QREs from 1984–88 to its combined gross income in that period) by its average gross income in the preceding 4 tax years.

QREs generally include salaries and wages, supplies, and 65% of the total amount paid for contract research. Basic research payments to universities and other scientific research organizations are also treated as QREs. The primary expenditures that do not qualify are property, plant, and equipment costs as well as depreciation on R&D capital goods. Qualified research, while not well defined under section 41, must be technological in nature and relate to the development of new or improved business components. Generally, roughly 50 percent of industry R&D expenditures qualify for the tax credit.

Importance to Engineers and Scientists

Because almost 70% of R&E tax credit dollars claimed are investments in the salaries of U.S. research employees, the credit benefits engineers and scientists directly by fostering high-skilled, high-paying jobs in the U.S. In addition to the direct benefit on jobs and wages of engineers and scientists, most studies show that the credit stimulates substantial amounts of additional science and engineering research, which improves productivity across virtually all industries and, thus, our economic strength and standard of living.

At a time when U.S. companies are looking increasingly to moving development of products for foreign markets offshore, the R&E tax credit encourages companies to keep a greater portion of R&D, and the related jobs, in the U.S.

Studies have shown that the credit benefits companies of all sizes and all sectors of the economy. Industries that particularly benefit include: electrical and electronic equipment, communications, chemicals and allied products, biotechnology, machinery, motor vehicles and equipment, instruments and related products, and business services.

Effectiveness of the R&E Credit

The U.S. General Accounting Office, Bureau of Labor Statistics, the National Bureau of Economic Research, and many private researchers agree that the R&E tax credit stimulates substantial amounts of additional R&D. Exactly how much spending is stimulated per dollar of revenue lost (the "bang-per-buck" ratio) varies. Many recent studies, however, support the conclusion that for each dollar lost in tax revenue, the credit stimulates a dollar of new R&D spending in the short run, and as much as two dollars in the long run. This implies long-run gains in productivity, wages, and GDP.

While this ratio is a useful barometer, more important is the net benefit the credit produces for society. Determining what type of research is stimulated by the credit is difficult, however, as is measuring the social rate of return on R&D. R&D investment, in general, provides substantial returns to society. In fact, economists estimate that half of U.S. economic productivity since WWII is attributable to technical progress driven by science and engineering research. And past studies suggest that the median social rate of return on R&D in general exceeds twice the median private rate of return

Most studies have shown that the structure of the R&E credit can also have a significant impact on its effectiveness. When Congress decided in 1990, for example, that taxpayers claiming the credit must forego the deductibility of those qualifying research expenses under a separate section of the tax code (Section 174), it essentially lowered the maximum effective rate of the regular credit from the statutory level of 20% to 13%. In addition, since the base amount can never be less than 50% of current year's QREs, the marginal rate of the credit is frequently capped at 6.5%. This "50% rule" particularly impacts small firms.

Perhaps the most important hindrance to the credit's effectiveness is its temporary status. The continuing short-term approach to stimulating long-term research is a more costly and much less efficient policy than a permanent credit. Many firms overlook the R&E credit when setting their research budgets because they cannot be certain of its future availability as they plan long-term research projects. Repeated on-again, off-again extensions dampen the very incentive value the credit was enacted to promote. This is particularly the case for companies with longer planning horizons, such as biotechnology firms. Allowing gaps in coverage to occur, as happened in 1996, reduces the incentive even further.

Statement of Jaime Steve, Legislative Director, American Wind Energy Association

The American Wind Energy Association,[1] or AWEA, respectfully submits this written testimony in support of a five-year extension of the existing 1.5 cent per kilowatt-hour production tax credit (PTC) for electricity produced using wind energy resources. An immediate extension of this provision is crucial if we are to see significant growth in the domestic wind energy industry. We are grateful for the opportunity to participate in the deliberations of the House Ways and Means Committee as it considers this important issue.

[1] The American Wind Energy Association, or AWEA, was formed in 1974 and has nearly 700 members from 48 states. AWEA represents virtually every facet of the wind energy industry, including turbine manufacturers, project developers, utilities, academicians, and interested individuals.

The Energy Policy Act of 1992 (EPAct) enacted the PTC as Section 45 of the Internal Revenue Code. The credit is phased out if the price of wind generated electricity is sufficiently high. In report language accompanying EPAct (H. Rpt. 102–474, Part 6, p. 42), the Ways and Means Committee stated, "The Credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources."

Since its inception, the PTC has supported wind energy development and production. In the 1980's, electricity generated with wind could cost as much as 25 cents per kilowatt-hour. Since then wind energy has reduced its cost by a remarkable 80% to the current levelized cost of between 4 and 5 cents per kilowatt-hour.

The 1.5 cent per kilowatt-hour credit enables the industry to compete with other generating sources being sold at 3 cents per kilowatt-hour. The extension of the credit will enable the industry to continue to develop and improve its technology to drive costs down even further and provide Americans with significantly more clean, emissions-free electricity generation. Indeed, experts predict the cost of wind equipment alone can be reduced by another 40% from current levels, with an appropriate commitment of resources to research and development and from manufacturing economies of scale.

Current PTC Provision: The Production Tax Credit (PTC) provides a 1.5 cent per kilowatt-hour credit (adjusted for inflation) for electricity produced from a facility placed in service between December 31, 1993 and June 30, 1999 for the first ten years of the facility's existence. The credit is only available if the wind energy equipment is located in the United State and electricity is sold to an unrelated party. Under current law, the tax credit qualification date would expire on June 30, 1999. A five-year extension would create a new sunset date of June 30, 2004.

Status: A five-year extension of this provision—through June 30, 2004—was introduced in the House (H.R. 750) by Rep. Bill Thomas (R–CA). H.R. 750 has been cosponsored by 26 Ways and Means Committee members, including Reps. Jim Nussle (R–IA), Jennifer Dunn (R–WA), Robert Matsui (D–CA), Jim McDermott (D–WA), John Lewis (D–GA) and Karen Thurman (D–FL). At present, H.R. 750 has 124 cosponsors. A similar bill (S. 414) has been introduced in the Senate by Senators Chuck Grassley (R–IA) and James M. Jeffords (R–VT) joined by 10 members of the Senate Finance Committee, including Sens. Frank Murkowski (R–AK), Kent Conrad (D–ND) and Bob Kerrey (D–NE). At present, S. 414 has 25 co-sponsors. A five-year extension of the wind tax credit is also contained within the Clinton Administration's FY 2000 budget proposal.

Contributions of Wind Power: Wind is a clean, renewable energy source which helps to protect public health, secure a cleaner environment, enhance America's national security through increased energy independence, and reduce pollution. In fact, reducing air pollutants in the United States will necessitate the promotion of clean, environmentally-friendly sources of renewable energy such as wind energy. Further, renewable energy technologies such as wind power should play an important role in a deregulated electrical generation market.

With the proper set up policies in place, wind power alone has the potential to generate power to provide the electric energy needs of as many as 10 million homes by the end of the next decade. The extension of the PTC will not only assure the continued availability of wind power as a clean energy option, but it also will help the wind energy industry secure its position in the restructured electricity market as a fully competitive, renewable source of electricity.

Significant Economic Growth Potential of Wind Power: The global wind energy market has been growing at a remarkable rate over the last several years and is the world's fastest growing energy technology. The growth of the market offers significant export opportunities for U.S. wind turbine and component manufacturers.

The World Energy Council has estimated that new wind capacity worldwide will amount to $150 billion to $400 billion worth of new business over the next twenty years. Experts estimate that as many as 157,000 new jobs could be created if U.S. wind energy equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Only by supporting its domestic wind energy production through the extension of the PTC can the U.S. hope to develop the technology and capability to effectively compete in this rapidly growing international market.

Finally, we must stress that the immediate extension of the PTC is critical to the continued development of the wind energy industry. Since the PTC is a production credit available only for energy actually produced from wind facilities, the credit is conditioned on permitting, financing and construction of the facilities. The financing and permitting requirements for a new wind facility often require two to three years of lead time. With the credit due to expire on June 30, 1999, wind energy developers *and investors are reluctant to commit to new projects without the assurance of the continued availability of the PTC.*

The American Wind Energy Association appreciates the opportunity to submit written testimony on this matter. We stand ready to assist the Committee in any way regarding the five-year extension of the wind energy Production Tax Credit.

Thank you.

JAIME C. STEVE
Legislative Director
American Wind Energy Association
Washington, DC 20001

Statement of AMT Coalition for Economic Growth

The AMT Coalition for Economic Growth is a broad-based coalition formed to advocate relief from the corporate Alternative Minimum Tax (AMT). The coalition is comprised of companies and associations representing the following manufacturing-related industries: automotive, builders and contractors, chemicals, energy, information technology, mining, paper, printing, steel, transportation and utilities.

Mr. Chairman, the Coalition commends you and this committee for recognizing the negative impact the corporate AMT has had on job creation, economic growth and workers in many basic manufacturing industries. In 1997, this committee approved meaningful reform of the AMT by partially eliminating the depreciation adjustment under the AMT. We share your view, however, that more relief is needed.

THE PROBLEMS:

Numerous adjustments, preferences and limitations under the AMT continue to hinder investments in important areas such as equipment, research and development, mining, energy exploration and production, pollution abatement and many others. Over the past 13 years, many companies have accumulated numerous AMT credit carryforwards. Due to current law limitations, they have not been able to fully recover these credits in a timely manner. Still others are hampered by arbitrary limitations such as the 90 percent limitation on net operating losses and foreign tax credits. This latter limitation results in a portion of an AMT payer's foreign earnings being taxed twice.

Even with the 1997 reforms, investments in plant and equipment are penalized by the difference between the 150 percent declining balance method allowed under the AMT and the 200 percent declining balance method of the regular tax. This depreciation method gap continues to place companies at a competitive disadvantage against their foreign competitors. Other accounting method differences under the current AMT that are discriminatory are the treatment of long-term contracts and LIFO inventory rules.

These problems are not unique to large businesses. Many small and medium size businesses continue to face the bite of the AMT as well. Subchapter S corporations cannot take advantage of the small business provisions enacted in the 1997 legislation. Still others continue to be subject to AMT because they are growing quickly, but their revenue stream has not yet caught up to their investment levels, or they face limitations on the use of work-opportunity tax credits. And most businesses continue to face the onerous recordkeeping burden of calculating their taxes using two different sets of rules to determine whether their alternative minimum tax liability exceeds their regular tax liability.

SUGGESTIONS FOR RELIEF:

In 1995, this committee and the U.S. House of Representatives approved legislation to phase-out the corporate AMT. Unfortunately that legislation was not enacted. The Coalition strongly supported the 1995 proposal. We believe it should serve as a model for future legislative action on AMT.

A critical element of the 1995 House passed phase-out was the preservation of the value of AMT credits, even after full repeal of AMT. The bill accomplished this by allowing companies to use AMT credits to offset up to 90 percent of their regular tax liability. AMT credits are carried as assets on a company's books, because they represent "pre-paid" taxes. The cash value of these credits is already being diminished due to the long period of time that may pass before the credits can be fully recovered. The Coalition firmly believes that any AMT reform efforts that would further restrict the use or reduce the value of these credits would penalize the very companies that have suffered the most detriment from the system.

If the Committee chooses not to repeal the corporate AMT, the Coalition would strongly urge the adoption of a proposal to allow faster utilization of AMT credits. The Coalition has united in its efforts to support this approach because the relief is broad-based and focused most directly on companies that have suffered the greatest harm. Specifically, a company with long-term, unused AMT credits, should be allowed to reduce its tentative minimum tax by a maximum of 50 percent using such credits. Long-term AMT credits would be defined as credits that are more than three years old. The credit portion to be allowed would be the lesser of: (1) the aggregate amount of the taxpayer's AMT credits that are more than three years old; or (2) 50 percent of the taxpayer's tentative minimum tax. Under this proposal a taxpayer would be required to use its oldest AMT credits first. The proposal would operate as an addition to the present-law ability of a corporation to use AMT credits to reduce its regular tax.

In addition, for taxpayers with AMT net operating losses (NOLs) in the current and two previous years, AMT NOLs could be carried back up to 10 years to offset AMT paid in previous years. This provision would help the most troubled firms, especially those in commodity-based industries.

The Coalition advocates this proposal because many companies continue to be penalized by the AMT in ways unintended by Congress; the AMT credit is a case in point. The original intent of the AMT credit was to provide a taxpayer which paid alternative minimum tax in any year, an alternative minimum tax credit in future years. This rule was intended to insure that companies did not, over time, pay more under the AMT than was owed under the regular income tax. Under current law, AMT credits may be used to reduce regular tax but not the alternative minimum tax.

In practice, the corporate alternative minimum tax continues to impose a significant long-term tax burden on capital intensive and commodity based industries. Given the high rate of tax in relation to profit margins for these industries, the alternative minimum tax operates to lock many U.S. firms into the AMT, burdening them with unused (and potentially unusable) AMT credits. The AMT adversely affects the profitability and cash flow necessary for American companies to invest and remain competitive in the world market. Many of the companies with significant long-term AMT credits have also felt the double whammy of depressed world-wide commodity prices due to the global financial crisis of the previous two years.

While some reform has occurred in the calculation of depreciation, no changes have been enacted to the numerous other investment-based adjustments and preferences, or to the arbitrary limitations on the use of foreign tax credits and net-operating losses. Furthermore, after years of paying the AMT, many companies have significant unused alternative minimum tax credits that cannot be used due to current law limitations. This proposed change would provide greater financial certainty that AMT credits could be recovered in a timely manner.

Mr. Chairman and Committee members, you are commended for having this hearing on reducing the tax burden to sustain our strong economy. The Coalition believes that AMT relief is a critical component of a growth oriented tax policy and urges it's inclusion in the Ways and Means Committee tax bill later this year.

Joint Statement of Hon. Robert Coble, Mayor, Columbia, South Carolina; and Hon. Stephen Creech, Mayor, Sumter, South Carolina

Chairman Archer and members of the Committee, thank you for this opportunity to submit testimony on the important tax legislation that you will consider this year. After years of surpluses and mounting debt, you must now tackle the pleasant question of how to work with a surplus. The recent predictions by the Congressional Budget Office and the Office of Management and Budget that the federal government will run a large non-Social Securitysurplus in the coming decade present you with many opportunities.

We appreciate the desire to use some of this surplus to give the American people a measure of tax relief. However, the previous decade's tremendous economic growth that led to these surplus forecasts also presents us with an historic opportunity to invest in our nation's most troubled neighborhoods. Although a decade of economic prosperity has led to investments in central city neighborhoods that would have seemed impossible ten years ago, the good times have yet to reach our distressed communities. For these reasons, we urge you to include full funding for the second round of Empowerment Zones, Enterprise Communities and Strategic Planning Communities.

This second round of Empowerment Zones were authorized by the Taxpayer Relief Act of 1997 (PL 105–34). The second round designations were awarded earlier this year. Thanks to the commitment and hard work of our citizens, Columbia and Sumter were awarded with one of these designations. As you can imagine, preparing an Empowerment Zone application requires a tremendous amount of time and resources. When we decided to embark on the application process, we were relying on the good faith of Congress and the Administration to provide the same level of funding given to the first round of Empowerment Zones. In his FY 2000 budget request, President Clinton requested full funding of $100 million over ten years for each of the 15 second round urban Empowerment Zones and $40 million over ten years for each of the five second round rural Empowerment Zones. Bipartisan legislation (HR 2170) mirroring that request has been introduced. We urge you to include that bill in any tax legislation produced by your Committee.

We are very excited about our plans for the Sumter-Columbia Empowerment Zone. That excitement is shared by broad segments of our community, including the business community. We are amazed at the broad support our Empowerment Zone enjoys and are confident that this will translate into success. For the first time our most distressed neighborhoods are looking at a brighter future. It would be a shame if this hope and excitement were dashed because of a lack of funding—funding we were counting on when we embarked on these ambitious plans.

In addition to funding for the second round of Empowerment Zones, there are a number of issues before this Committee that are an important part of our economic development plan. These include enhancement of the Low-Income Housing Tax Credit (HR 175, which enjoys overwhelming bipartisan support in this Congress and the support of our entire delegation), the extension of the Work Opportunity Tax Credit, the extension of the Welfare-to-Work Tax Credit, creation of a Commercial Revitalization Tax Credit, and the enhancement of industrial development bonds.

The surplus combined with our strong economy gives Congress an opportunity to make a difference in some of our nations' most distressed urban neighborhoods. We urge you to seize this opportunity. Thank you for your attention to our views on these important matters.

Statement of Construction Financial Management Association, Princeton, New Jersey

Mr. Chairman and Members of the Committee:

The Construction Financial Management Association (CFMA) is pleased to comment on various tax issues of importance to our members and to the construction industry. CFMA was established in 1981 and represents more than 6,500 financial managers in the construction industry. Our members are employed by 2,500 construction companies across the U.S. More than one-third of these companies have gross annual revenues ranging from $25–99 million.

As the Committee considers a tax package later this summer, CFMA supports the Committee's efforts to eliminate the estate and gift tax and provide tax relief for individuals and businesses. Additionally, CFMA encourages the Committee to include, in a tax-reduction package, proposals that would clarify and simplify the rules governing worker classification, clarify the use of the cash basis method of accounting for small businesses and provide relief from costly and time-consuming look-back calculations.

The cost and complexity of our Nation's tax law is imposing an onerous burden on construction companies at a time when Congress should be encouraging these companies to devote their resources to increasing productivity, promoting growth and encouraging job creation.

ESTATE TAX RELIEF

The Federal estate tax was first enacted in 1916 and was imposed primarily to finance our nation's involvement in World War I. The tax has evolved since then, and today, the estate, gift and generation-skipping transfer taxes form a unified transfer tax system. The estate and gift tax share a unified progressive rate schedule and an applicable "unified credit" that shelters a portion of the value of a decedent's estate. The unified credit, which, for 1999, effectively exempts the first $650,000 of a deceased taxpayer's estate and any gifts made during the current year from taxation will incrementally increase up to $1 million in year 2006. This exemption amount, however, will not be indexed for inflation after 2006.

Additionally, a change to the law in 1997 resulted in a limited exclusion for certain "family-owned business interests," from the taxable portion of an estate provided that such interests comprise more than 50 percent of a decedent's estate. This exclusion may be taken only to the extent that the exclusion, plus the amount effectively exempted under the unified credit does not exceed $1.3 million

Impact of the Estate Tax on the Construction Industry

Construction companies are generally family-owned enterprises and often do not have the liquid assets to pay taxes owed on an estate upon the death of the owner. Thus, the construction industry is particularly hard hit by the estate tax system. The burden imposed by the estate and gift tax is a leading reason why many family-owned construction companies are forced to sell or liquidate the business when there is a death in the family.

Under the current system, closely-held construction businesses devote significant resources to costly and complicated planning to minimize the estate tax. This effort diverts financial resources from hiring and business expansion. Additionally, planning for the estate tax is not a one-time event. The threat and uncertainty of the estate tax is a constant burden for small businesses, which must make costly and time-consuming decisions today if they hope to survive when the business is passed on to the next generation. There is no simple solution in estate planning. Business owners do not know when the tax will have to be paid and it is difficult to ascertain how much tax will be owed. Funds spent on attorney fees and insurance policies would be better spent if they were invested in new resources or on hiring and training new workers. This diversion of valuable human and financial capital achieves no economic benefit.

Eliminate the Estate and Gift Tax System

CFMA supports eliminating this confiscatory tax and encourages the Committee to support the efforts of House Ways and Means Committee Members Jennifer Dunn (R–WA) and John Tanner (D–TN), who have introduced H.R. 8, the Death Tax Elimination Act. H.R. 8 would phase out the highest current estate tax rate of 55 percent by five percentage points each year until it is completely eliminated in 2010.

Entrepreneurs and other visionary business leaders should be allowed to make financial decisions for business and investment reasons and not be punished for initiative, hard work and capital accumulation.

WORKER CLASSIFICATION

Classification of workers as either employees or independent contractors has been a perennial problem for all parties involved in this issue and CFMA supports efforts to clarify and simplify the myriad of rules, factors and circumstances that dictate current law.

The construction industry faces unique worker classification problems due to its fluctuating work demand and seasonal forces which affect employment levels. Many in the industry can not afford nor have the need to maintain specialized trade craftsmen as full-time, long-term employees. Such workers may be needed several times throughout the year but not enough to warrant full-time or even part-time employment. Independent contractors are often the best solution to a pressing demand for the special skills and expertise often required for short-term projects.

Congress adopted section 530 of the Revenue Act of 1978 in recognition that the rules on the classification of workers as "employees" or "independent contractors" were imprecise. For years before section 530 was enacted, the IRS increased its employment tax audits—leading to increased controversies between the IRS and businesses. Section 530 was a stopgap measure to provide Congress time to produce a permanent solution to the complexity of the independent contractor issue that would eliminate this source of controversy. Although Congress has made some progress on the issue, it has also learned the lesson learned earlier by business and the IRS: this issue eludes simple solutions.

Importance of Section 530 to the Construction Industry

Construction projects frequently involve an amalgamation of independent economic entities that come together under unique and complex legal arrangements for a specific job and then disperse. These entities are a combination of corporations, partnerships and sole proprietors who associate as general contractors, first and second-tier subcontractors, material and equipment suppliers and other vendors.

Within the construction industry, the general/subcontractor and subcontractor/sub-subcontractor relationships have always been the norm for doing business. Additionally, specialty trade contractors are hired on a project-by-project basis for short durations under varying contractual arrangements to complete certain assignments. These contracts can include lump-sum, fixed-fee, cost-plus, time and material, or labor-only agreements. Contractors can be selected on a competitive bid or negotiated basis depending upon the assignment.

The construction industry has always relied upon the existence of a contractor-subcontractor relationship to carry out construction projects. The industry must continue to rely on these relationships because:

- the requirements of each particular project differ so dramatically as to the scope of work to be performed, the degree of skills needed, the number of disciplines to be engaged, and the human resources to be allocated;
- general contractors cannot afford to hire the number and variety of trade specialists they need as full-time or even part-time employees; and
- construction work, by its very nature, is cyclical, unpredictable, intermittent and non-repetitive.

Removal of the section 530 "safe-harbor" would threaten the long-standing industry practice of subcontracting and would threaten the ordinary way of doing business for smaller contractors and, especially, sole proprietors.

If section 530 is not available for the construction industry, the IRS could attempt to recharacterize legitimate independent contractors as employees, producing uncertainty and confusion for the industry. To avoid such a result, industry practice would have to be changed. And, before those practices can be changed, many general contractors will find that—in the eyes of the IRS—they are not general contractors but employers.

For example, in construction management, it is long-standing industry practice for an owner to contract directly with a general contractor who will manage a project and enter into contracts with trade specialists and other independent contractors. However, it is also common industry practice for an owner to contract directly with a general contractor and with the trade specialists and other independent contractors. In both cases, under industry practice, the general contractors and the subcontractors are independent contractors.

If section 530 protection were removed, however, it is all but certain that some IRS agents will decide that owners who contract directly with subcontractors are employers under the common law "20 factor" test. Consequently, owners, general contractors, and subcontractors will be left in a situation where they can no longer feel confident when they have issued a contract or work order that the IRS will view the arrangement similarly.

In addition, it is important to note that many construction contracts are acquired on a competitive bid basis. By removing section 530 protection, contractors would have to either increase the price for this contingency or else assume that any changes would impact their bid profit. This situation simply adds risk to an already very risk-laden business.

CFMA contends that the majority of construction contractors use legitimate independent contractors for legitimate economic reasons. CFMA also recognizes that there are abuses in the system, but does not believe that these abuses are so widespread that the entire working structure of the industry needs to be dismantled. CFMA supports legislative initiatives that would simplify and clarify the law regarding worker classification. One of these approaches that merits review by the Committee was introduced in the Senate by Small Business Committee Chairman Christopher Bond (R–MO). S. 344 would provide a general safe harbor and protection against retroactive reclassification of an independent contractor in certain circumstances. The bill is designed to provide certainty for businesses that enter into independent-contractor relationships and minimize the risk of significant tax bills for back taxes, interest, and penalties if a worker is misclassified.

CASH BASIS METHOD OF ACCOUNTING

Currently, businesses are required to use the accrual method of accounting for income tax reporting if they are involved in merchandise sales and maintain an inventory. There is an exception that allows small businesses with less than $5 million in annual revenues to use the cash basis method of accounting. Cash basis accounting simply allows a business to recognize only those revenues it has actually received.

Unfortunately, the IRS has increasingly sought to challenge the use of cash basis accounting, forcing small construction companies to switch accounting methods, often at significant cost. One of the most difficult and onerous tax adjustments a construction contractor can face is an IRS imposed change in accounting methods. The cost involved with switching accounting methods, coupled with the mandatory interest and penalties that are often assessed by the IRS can severely impact the bottom line for these small businesses.

CFMA supports legislation introduced by House Small Business Committee Chairman James Talent (R–MO) and Ways and Means Committee Member Phil English (R–PA), that would clarify the use of cash accounting by small businesses. H.R. 2273 would provide that small business taxpayers with average annual gross receipts of $5 million or less for the prior three years would be entitled to use the cash method of accounting without limitation. Specifically, the legislation would provide that small business taxpayers shall not be required to use the accrual method of accounting because they sell merchandise or have inventory.

This clarification would greatly benefit small construction companies who currently use cash basis accounting and are concerned that the IRS could arbitrarily force them to change accounting methods.

LOOK–BACK METHOD OF ACCOUNTING

The *Tax Reform Act of 1986* included a provision that continues to unfairly impact the construction industry. Congress intended for the provision to target large defense and aerospace contractors by requiring "percentage of completion" and look-back accounting methods for contracts lasting more than one tax year. Under current law, contractors must estimate their costs and revenues and, upon completion of the contract, "look-back" and substitute the actual costs and revenues for those estimated at the conclusion of the prior tax years.

Unfortunately, construction companies can face look-back calculations numbering in the thousands, which results in a significant financial as well as manpower costs to comply with the law. Construction contractors spend thousands of dollars in accounting fees each year complying with look-back requirements. In an industry dependent on financial accuracy, look-back has little effect on "catching" under-reported revenues or gains. Construction contractors, by their very nature, are optimistic people. Owners' estimates of profits to be realized on any given project tend to be high, not low. Therefore, approximately 75 percent of the industry's look-back calculations result in refunds, not revenues!

CFMA strongly supports legislation (H.R. 2347) introduced by Committee Member Phil English (R–PA) that would repeal the look-back method for commercial construction contractors. The look-back method of accounting imposes costly and time-consuming reporting requirements on construction companies that result in virtually no additional revenue for the Treasury.

CONCLUSION

CFMA appreciates the opportunity to present to the Committee its views on tax issues that significantly impact the construction industry. The current estate and gift tax is one of the most onerous burdens facing family-owned construction companies, many of which must be sold, downsized or liquidated just to pay this "death" tax. Accounting for only one percent of annual revenues for Treasury, this tax is not worth the devastation is causes family-owned construction companies.

Worker classification continues to be a perennial problem for the construction industry and any efforts to simplify and clarify current law is supported by CFMA. Other changes beneficial to the construction industry include clarification of the use of the cash basis method of accounting for small businesses and relief from costly and difficult look-back calculations.

CFMA supports the Committee's efforts to relieve the excessive tax burden on small businesses and to preserve the accumulated savings of productive and hard-working citizens.

Statement of Hon. Paul D. Coverdell, a United States Senator from the State of Georgia

Chairman Archer and the other Members of the Committee. I would like to thank you very much for inviting me to appear before this Committee hearing to present my views on providing millions of hard-working American families the tax relief they deserve and need.

Today Congress confronts a dilemma most Americans never anticipated, a Federal budget surplus approaching one trillion dollars. This historic surplus affords us the rare opportunity to create the foundations of a permanent prosperity for generations of Americans.

In particular, I believe that we have an obligation to use the current Federal surplus to accomplish three important objections. First, we must ensure that we stop Washington's traditional urge to spend money from the Social Security Trust Fund on new federal programs. In that regard, we must make protecting Social Security our number one priority.

Second, because the current Federal surplus is the product of the prosperity created by the American people and their hardwork, we should make every effort to return as much of the non-Social Security surplus to the American people. We must stop the arrogance of Washington that refuses to relinquish its grip on the pursestrings and the pocketbooks of the American people.

And lastly, we must use part of the Federal surplus to give parents, families and communities the power and the resources they need to provide our nation's children with the world's best and most successful education opportunities.

Broad Tax Relief for Working Americans and Great Incentives to Save

Although the economy is strong, there are troubling signs. Personal bankruptcies and consumer debt are at record levels. The personal savings rate is at Depression-era lows and has actually fallen into the negative. Consumer prices jumped in April by 0.7 percent, the largest monthly gain in nearly nine years according to the Labor Department.

In the Senate, I have joined a bi-partisan group of colleagues to offer a substantial tax relief plan that returns the prosperity surplus to the American people as well as expands the options and incentives that families have to save for the future.

The plan I introduced, the Small Savers Act, is based on three principles to address these concerns. First, any tax cut should provide broad-based rate relief. Second, tax cuts should be targeted at savings and investment.

And third, that anything we do should simplify the code.

An unnoticed and un-wanted side effect of the soaring economy has been that middle class workers are forced into tax brackets never intended for them. Small Savers expands the 15% tax bracket by $10,000 over five years ($5,000 for singles) returning 7 million taxpayers to the lowest bracket. But, because more income will be taxed at a lower rate, 35 million taxpayers will gain tax relief.

To reverse the dangerous personal savings trend in this country, Small Savers would exempt the first $500 in a family's dividend and interest income from taxation. This would essentially make a $10,000 savings account tax-free. The Joint Economic Committee reports such a change would eliminate all taxes on savings for 30 million Americans.

Small Savers would do more than just take the government out of the business of taxing a family's savings. The plan also excludes the first $5,000 in long-term capital gains from taxation. The Federal Reserve Board's 1995 Survey of Consumer Finance reported that 75% of stockholders have incomes less than $75,000. The stock market is no longer simply a place where the wealthy get wealthier, but where lower and middle class families can build a secure retirement. By excluding capital gains, rather than reducing the rate, we can eliminate capital gains taxes for 10 million people.

The final aspect of Small Savers aimed at encouraging retirement security is a modest increase in the contribution limit for a deductible IRA from $2,000 to $3,000. Although we have taken steps previously to increase the availability of IRAs, the limit on contributions has remained at $2,000 since 1981. Had we been indexing the limit for inflation, individuals would be able to contribute nearly $5,000 a year to their retirement.

All too often small businesses cannot afford to establish pension plans for their employees. For their employees and the self-employed, the ability to contribute to an IRA is often the only means of retirement savings available. It is simply unfair to restrict them to an annual contribution of $2,000.

Lastly, Small Savers would simplify tax filing for millions of Americans. It is estimated that it takes the 67 million Americans with dividend and interest income over an hour just to fill out their Schedule B form for such income. Small Savers would eliminate that requirement for 7 million Americans. The Schedule D form for capital gains is even worse. An estimated 22 million Americans had capital gains or losses last year. For them, filling out the 54-line Schedule D took, on average, nearly 7 hours. Small Savers would eliminate this arduous requirement for 10 million Americans. Overall, Small Savers would return nearly 74 million man-hours formerly used to fill out tax forms into productive activities.

With a revenue impact of estimate $134.7 billion over 5 years and $345.7 billion over ten years, Small Savers will not interfere with seeking and meeting other tax relief goals—whether they be education tax relief, health tax relief, marriage penalty relief, business tax relief, etc. In the end, I believe that if the Federal government collects too much in taxes, it owes it to taxpayers to return some of their hard-earned dollars.

In short, Small Savers recognizes the problems of an unfair tax burden... lack of savings and investment and a tax code that is too complicated. It is the first step to restoring fundamental fairness to the millions of hard working, middle class families who deserve tax relief.

EDUCATING OUR NATION'S CHILDREN—PROVIDING NEW CHOICES FOR AMERICA'S FAMILIES

Educating our children is among the most important issue that we face as public servants. In that regard, I would like to wish the Committee well as it considers a number of very important tax measures designed to assist families and communities in their efforts to provide our children the quality education that they deserve.

Needless to say, the education of our nation's children is one of the most sacred and important issues that we as public servants can address. For much of the past century, America's place as a leading industrial and intellectual force in the world has been established by the pre-eminence of our nation's education system. Simply put, our schools were the best in the world, and as a result Americans started the Industrial Revolution, ushered in the Nuclear Age, and paved the Super Information Highway.

Unfortunately, just as the world economy and marketplace have become more competitive and interdependent, we have lost significant ground to other nations in the educational achievements of our children. For example, the results of the most recent International Math and Science Study reveal that U.S. seniors have lost their competitive edge over their counterparts in Western Europe in math and science. In physics, U.S. 12th graders seniors finished last behind 20 other countries, including Latvia and the Czech Republic. The Organization for Economic Cooperation and Development reported on November 13, 1998, that, even though the United States dedicates one of the largest shares of GDP to education, it has fallen behind other economic powers in high school graduation rates.

With these recent reports showing an alarming lack of academic achievement among an increasing number of American students, the Congress and the Administration must work together to develop a new path toward improving our nation's schools and ensuring that each and every child receives a first-class education.

During the State of the Union, however, the President outlined a litany of new programs that are very similar to a number of federal programs already on the books.

While these proposals may make for good newspaper copy, there are already more than 800 federal education programs spread across 39 federal agencies. New programs are not the answer. If new federal education programs were the answer to educational excellence, our schools would still be among the world's best.

I believe there is a better way to improve the quality of education our children receive.

Education Savings Accounts are a major step in a bi-partisan reform effort. Here's how they work: a parent, relative, friend, business, union, charitable organization—anyone—could contribute up to $2000 in an account which could be withdrawn tax-free if used for a child's K–12 education expenses.

Right now, the law allows parents to contribute up to $500 per year for a child's college education. We increase that amount to $2000 per year and allow for tax-free withdrawals for K–12 educational expenses, as well.

With education savings account, 14 million families (over 20 million kids) will take advantage of ESAs, generating $12 billion in education savings that might otherwise not exist.

You would think such a modest reform—which builds on a law signed by President Clinton—would be embraced by everyone. Not opponents of reform, however, who see allowing families to keep their own money as a great threat.

Those who oppose this bill, stand in the way on new opportunities for millions of children and their families. Just consider how many people benefit from our plan:

- 14 million families—20 million children—from benefiting from education savings accounts;
- $12 billion in savings from being pumped into K–12 education;

• 1 million college students in state pre-paid tuition plans from receiving tax relief;
• 1 million workers from receiving education assistance through their employers.
• Hundreds of local school districts from using more of their local money to build and repair new schools.

Those of us—Republicans and Democrats—who believe parents should have the ability to invest in their kids' futures believe we represent the most important special interest—children. And, in the end, we will prevail.

We have a great challenge before us. For too long, our children have been victimized by failing schools, growing bureaucracies and politicians who ignore their needs. During the 106th Congress, we can do better to help our children succeed. We must put aside our partisan differences, and join in a bipartisan effort to change a culture and system that for too long has let our kids down. I pledge to undertake that effort, I can only hope that my colleagues on the other side of the aisle will do so too.

Statement of Richard P. Walker, Managing Director, CSW Renewable Energy, Central & South West Corporation, Dallas, Texas

Mr. Chairman and other distinguished members of the committee, my name is Richard Walker. I am Managing Director of CSW Renewable Energy, a subsidiary of Central & South West Corporation of Dallas, Texas. I want to thank you for providing me with this opportunity to testify on the importance of extending the wind energy production tax credit (PTC) until the year 2004.

Central and South West Corporation (CSW) has been active in the research and development of wind energy for six years, and was named as the American Wind Energy Association's Utility of the Year in 1996. CSW owns and operates the first wind farm built as part of the U. S. Department of Energy's Turbine Verification Program in which state-of-the-art, U.S.-manufactured wind turbine technology is being tested. In addition, a 75 megawatt wind farm is currently being built near the west Texas community of McCamey in order to serve the customers of three CSW subsidiaries—West Texas Utilities Company, Central Power and Light Company, and Southwestern Electric Power Company.

CSW is an investor-owned electric utility holding company based in Dallas, Texas. CSW owns and operates four electric utilities in the United States: Central Power and Light Company, Public Service Company of Oklahoma, Southwestern Electric Power Company, and West Texas Utilities Company. These companies serve 1.7 million customers in an area covering 152,000 square miles of Texas, Oklahoma, Louisiana, and Arkansas.

CSW also owns a regional electricity company in the United Kingdom, SEEBOARD plc, which serves 2 million customers in Southeast England. CSW engages in international energy, telecommunications and energy services businesses through nonutility subsidiaries including CSW Energy, CSW International, C3 Communications, EnerShop, and CSW Energy Services. CSW is currently in the process of seeking regulatory approval for a merger with American Electric Power Company, based in Columbus, Ohio, and expects the merger to be completed sometime in the 4th quarter of 1999.

I want to commend Representative Bill Thomas, and all of the cosponsors of H.R. 750, for their leadership in supporting legislation to extend the wind energy PTC until the year 2004. H.R. 750 has broad, bipartisan support. H.R. 750 was introduced with sixty (60) original cosponsors, including 19 members of this committee. H.R. 750 is currently supported by 123 cosponsors, including 26 (two-thirds) of the members of this committee. The Senate companion bill, S. 414, has similar broad, bipartisan support, including a majority (11) of the members of the Senate Finance Committee. Additionally, a five-year extension of the PTC was included in the President's FY2000 Budget.

I hope the committee will include a five-year extension of the wind energy PTC in the tax bill the committee intends to mark-up next month. As the committee knows, the current PTC will expire next week, June 30, 1999.

I. BACKGROUND OF THE WIND ENERGY PTC

The wind energy PTC, enacted as part of the Energy Policy Act of 1992, provides an inflation-adjusted 1.5 cents/kilowatt-hour credit for electricity produced with wind equipment for the first ten years of a project's life. The credit is available only if the wind energy equipment is located in the United States and electricity is generated and sold. The credit applies to electricity produced by a qualified wind energy facility placed in service after December 3, 1993, and before June 30, 1999. The current credit expires next week, June 30, 1999.

II. WHY DO WE NEED A WIND ENERGY PTC?

A. *The Wind Energy PTC is Helping to Drive Costs Down, Making Wind Energy a Viable and Efficient Source of Renewable Power*

The efficiency of wind generated electric energy has increased dramatically since the early to mid–1980s. The machine technology of the 1980's was in its early stages and the cost of wind energy during this time period exceeded 25 cents/kilowatt-hour. Since that time, however, the wind industry has succeeded in reducing wind energy production costs by a remarkable 80% to the current cost of about 4.5 cents/kilowatt-hour. The 1.5 cents/kilowatt-hour credit enables the industry to compete with other generating sources currently being sold in the range of 2.5 to 3.0 cents/kilowatt-hour.

The industry expects that its costs will continue to decline as wind turbine technology and manufacturing economies of scale increase in efficiency. Through further machine development and manufacturing efficiencies, the wind energy industry anticipates the cost of wind energy will be further reduced to 3 cents/kilowatt-hour or lower by the year 2004, which will enable it to fully compete on its own in the marketplace.

The most significant factor contributing to the dramatic reduction in U.S. wind energy production costs over the years—since the early 1980s—has been the dramatic improvement in machine efficiency. Since the 1980's, the industry has developed three generations of new and improved machines, with each generation of design improving upon its predecessor. As a result, reduced costs of production of new wind turbines, blade designs, computer controls, and extended machine component life have been achieved. Proven machine technology has evolved from the 50-kilowatt machines of the 1980's to the 750-kilowatt machines of today that have the capacity to satisfy the energy demands of as many as 150 to 200 homes annually. Moreover, four new 1,650-kilowatt class machines have recently been installed in Texas that are expected to further improve the technology's efficiency and reduce wind power costs.

The wind industry anticipates that wind energy production costs will continue to decline in the future, and is confident that the next two generations of wind turbine design—estimated to be available by the year 2004 —will sufficiently lower costs in order to enable the industry to compete in the United States on its own merits with fossil-fueled generation. The five-year extension of the wind energy PTC will bridge the commercialization gap for the industry until it can compete on its own by the year 2004.

B. *Wind Power will Play an Important Role in a Deregulated Electrical Market*

The electrical generation market is going through significant changes as a result of efforts to restructure the industry at both the Federal and State levels. Renewable energy sources such as wind power are certain to play an important role in a deregulated electrical generation market. In Texas, for example, just last week, June 18, 1999, Governor George W. Bush signed into law restructuring legislation that provides for the addition of 2,000 megawatts of renewable energy generating capacity in Texas by the year 2009. Wind power will play a significant role over the next decade in enabling Texas to meet this new goal and the extension of the wind energy PTC will help in this effort by ensuring that Texans receive the lowest cost renewable energy possible.

C. *Wind Power Contributes to the Reduction of Greenhouse Emissions*

Wind-generated electricity is an environmentally friendly form of renewable energy that produces no greenhouse gas emissions. Several polls, surveys, and focus groups of our customers have made it clear that the use of environmentally friendly sources of electrical generation is very important to them. Renewable energy sources such as wind power are particularly helpful in reducing greenhouse gas emissions. Significant reductions of greenhouse gas emissions in the United States can only be achieved through the combined use of many new, energy-efficient technologies, including those used for the production of renewable energy. The extension of the wind energy PTC will assure the continued availability of wind power as a clean, renewable energy source.

D. *Wind Power has Significant Economic Growth Potential, Provides a Supplemental Income Source for Farmers, and Creates New Jobs in Local Economies*

1. Domestic—Wind energy has the potential to play a meaningful role in meeting the growing electricity demand in the United States. With the appropriate commitment of resources to wind energy projects, it is estimated that wind power could generate power to as many as 10 million homes by the end of the next decade. There currently are a number of wind power projects operating across the country. These projects are currently generating 1,761 megawatts of wind power in the following states: Texas, New York, Minnesota, Iowa, California, Hawaii and Vermont.

There also are a number of new wind projects currently under development in the United States. These new projects will generate 670 megawatts of wind power in the following states: Texas, Colorado, Minnesota, Iowa, Wyoming and California.

The domestic wind energy market has significant potential for future growth because, as the sophistication of wind energy technology continues to improve, new geographic regions in the United States become suitable for wind energy production. The top twenty states for future wind energy potential, as measured by annual energy potential in the billions of kWhs in environment and land use exclusions for wind class sites of 3 and higher, include:

1.	North Dakota	1,210
2.	Texas	1,190
3.	Kansas	1,070
4.	South Dakota	1,030
5.	Montana	1,020
6.	Nebraska	868
7.	Wyoming	747
8.	Oklahoma	725
9.	Minnesota	657
10.	Iowa	551
11.	Colorado	481
12.	New Mexico	435
13.	Idaho	73
14.	Michigan	65
15.	New York	62
16.	Illinois	61
17.	California	59
18.	Wisconsin	58
19.	Maine	56
20.	Missouri [1]	52

Source: *An Assessment of the Available Windy Land Area and Wind Energy Potential in the Contiguous United States,* Pacific Northwest Laboratory, 1991.

Sixteen states, including CSW's home state of Texas, have greater wind energy potential than California where, to date, the majority of wind development has taken place.

The increasing sophistication of wind energy technology has enabled the industry to open up new regions of the country to wind energy production. In addition to the recent growth of wind power in Texas, another area of the country that has been opened up to wind power production in the last few years is the Farm Belt. Since wind power projects and farming are totally compatible —a wind power plant can operate on land that is being farmed with little or no displacement of crops or livestock—wind power projects are now being sited on land in the Farm Belt that is also being used for crop and livestock production. The lease payments paid by wind project developers to landowners is a valuable source of steady, additional income for farmers. For example, a new wind plant soon to go on line in Clear Lake, Iowa will pay rent to fourteen different landowners who will be supplementing their income by leasing their land for the operation of the new wind plant without disrupting their farming operations. This is a win-win situation for farmers and consumers.

Electricity production from renewable resources takes advantage of local resources rather than those that may be imported. In addition to the lease payments discussed above, this results in several economic development opportunities such as increasing tax bases for counties, construction jobs, on-going operation and maintenance jobs, and manufacturing opportunities. The wind farms recently completed or currently being constructed in the U.S. have provided manufacturing opportunities in Champagne, Illinois, Tehachapi, California, Gainesville, Texas, Shreveport, Louisiana, Tulsa, Oklahoma, and El Paso, Texas, just to name a few.

2. International—The global wind energy market has been growing at a remarkable rate over the last several years and is the world's fastest growing energy technology. The growth of the market offers significant export opportunities for United

States wind turbine and component manufacturers. The World Energy Council has estimated that new wind capacity worldwide will amount to $150 to $400 billion worth of new business over the next twenty years. Experts estimate that as many as 157,000 new jobs could be created if United States wind energy equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Only by supporting its domestic wind energy production through the extension of the wind energy PTC can the United States hope to develop the technology and capability to effectively compete in this rapidly growing international market.

E. *The Immediate Extension of the Wind Energy PTC is Critical*

Since the wind energy PTC is a production credit available only for energy actually produced from new facilities, the credit is inextricably tied to the financing and development of new facilities. The financing and permitting requirements for a new wind facility often require up to two to three or more years of lead-time. With the credit due to expire next week, wind energy developers and investors are unable to move ahead with new projects. The immediate extension of the wind energy PTC is therefore critical to the continued development and evolution of the wind energy market. In addition, the five-year extension is also necessary to give wind industry manufacturers the confidence to invest in additional production facilities within the U.S.

III. CONCLUSION

Extending the wind energy PTC for an additional five years is critical for a number of reasons. The credit enables wind-generated energy to compete with fossil fuel-generated power, thus promoting the development of an industry that has the potential to efficiently meet the electricity demands of millions of homes across the United States. If the wind energy PTC is extended, wind energy is certain to be an important form of renewable energy in a deregulated electrical market, and is an environmentally-friendly energy source that can aid in the reduction of greenhouse gas emissions. The economic opportunities of the wind energy market are significant, both domestically and internationally. As such, we urge the committee to extend the wind energy PTC until the year 2004 so that the industry can continue to develop this important renewable energy resource.

Thank you for providing me with this opportunity to present CSW's views on the extension of the wind energy PTC.

Statement of Kenneth C. Karas, Chairman and Chief Executive Officer, Enron Wind Corp., Tehachapi, California

My name is Ken Karas, and I am the Chairman and Chief Executive Officer of Enron Wind Corp., a subsidiary of Enron Renewable Energy Corporation. Enron Wind Corp., the largest U.S. manufacturer and developer in the wind energy industry, offers a fully integrated range of services including wind assessment, project siting, engineering, project finance, turbine production, construction, and operation and maintenance of wind energy facilities. Enron Wind Corp. completed 300 megawatts of installed capacity in 1999. Over the last nineteen months, the company has installed 667 wind turbines for a total installed capacity of 500.25 megawatts. Most recently, we finished construction of a new 16.5 megawatt facility in California producing electricity to be sold into the green market. Other recent projects include development of new wind facilities in Minnesota and Iowa totaling approximately 239 megawatts. As a committed member of the wind energy industry, Enron Wind Corp. strongly endorses the broadly supported proposal to extend the Wind Energy Production Tax Credit ("PTC") for five years.

The current Wind Energy PTC, first enacted under the Energy Policy Act of 1992, provides a 1.5-cent-per-kilowatt-hour tax credit, adjusted for inflation after 1992, for electricity produced from wind or "closed-loop" biomass. The credit is available for wind energy production facilities placed in service prior to July 1, 1999, and applies to wind energy produced for the first ten years after the facilities are brought on line. However, the current credit is scheduled to expire as of June 30, 1999. The loss of the Wind Energy PTC would be a critical blow to the future of wind power in the United States at a pivotal time in its development as viable large scale energy technology.

A five year extension of the placed-in-service date for the Wind Energy PTC has been introduced in legislation in both the House and Senate as well as being included in the Administration's FY 2000 budget proposal. These proposals would extend the availability of the credit to facilities placed in service through June 30, 2004. H.R. 750, introduced by Representative Bill Thomas (R–CA), has been cosponsored by 26 members of the Ways and Means Committee and has 129 cosponsors in the House of Representatives. Companion legislation in the Senate, S. 414, introduced by Senators Charles Grassley (R–IA) and James M. Jeffords (R–VT) currently has 10 cosponsors on the Senate Finance Committee and 25 cosponsors in the Senate. A recent revenue estimate prepared by the Joint Committee on Taxation concludes that the legislation would have a modest revenue impact of $1 million in FY 1999, $5 million in FY 2000, and only $76 million over five years.

Wind energy has made phenomenal advances in the last fifteen years achieving improvements in reliability, efficiency, and cost per kilowatt hour. Energy Secretary Bill Richardson recently remarked, "We think that wind technology has the most potential of any renewable energy technology right now." This enhanced potential is driven by improved technologies, the vast amount of untapped wind resources in the United States, and an interest in green generation sources by consumers. Nonetheless, the cost of energy continues to be a key concern both to consumers and to utilities choosing to develop wind energy projects. Extension of the Wind Energy PTC now is essential to provide parity with fossil fuel technologies, and to achieve the economies of scale necessary to deliver energy to consumers at cost effective rates. As most wind energy projects require a minimum of two years to develop, extension of the Wind Energy PTC for five years is critical now to ensure the availability of long-term, low-cost financing for wind energy projects. Despite these difficulties, close to 900 megawatts will have been installed in the last year prior to the June 30, 1999 date for expiration of the credit.

Extension of the Wind Energy PTC is a targeted investment in renewable energy that will provide significant returns to the country, including:

• *Continuing to Reduce the Cost of Wind Power:* Dramatic advances have been made in the cost of wind power with some current projects currently based upon a cost of below 5 cents per kilowatt hour. Stimulating investment through the Wind Energy PTC will continue to bring these costs down as wind energy begins to achieve economies of scale, allowing the industry to compete head-to-head with other conventional generating sources;

• *Achieving Reduced CO2 Emissions:* The Department of Energy has cited wind power as one of the emerging electricity supply technologies needed to reduce the emissions of carbon dioxide (CO2) caused by burning fossil fuels; and

• Creating Jobs, Tax and Export Revenues: A healthy domestic wind energy industry creates the momentum to continue developing wind energy technologies for export abroad into the booming world market for renewable power, which in turn creates more jobs at home. Wind projects provide federal, state and local tax revenues that over time exceed the cost of the tax credits provided by the PTC.

We at Enron Wind Corp. are excited to be at the forefront of one of the most promising renewable energy technologies available, and believe that the Wind Energy PTC represents a sound investment in the American economy, renewable energy and our environment. I urge your support for this important and cost-effective initiative.

Statement of Hon. Elton Gallegly, a Representative in Congress from the State of California

Mr. Chairman, I appreciate this opportunity to testify on how to find ways to provide tax relief to strengthen the family and sustain a strong economy by sharing with you two bills I have introduced this Congress.

The first would modify or expand investment incentives for the American family. As the committee is aware, the U.S. savings rate fell into negative territory in September of last year and now we are at the lowest levels ever recorded. This means that, collectively, individuals not only did not save anything but actually raided their savings to pay current spending. The last time this occurred was in 1938, during the Great Depression.

The American family is actually saving less, and this will mean that there will be less money available in the retirement years for the working parents of today. We must provide incentives to the families now to prevent creating an exorbitant baby-boom tax on the families of tomorrow. To counter this alarming trend in negative family savings, I have introduced H.R. 1322-a bill which will provide investment incentives to encourage long-term savings by increasing the amount that may be contributed to individual retirement plans.

H.R. 1322 is simple and straightforward. The measure will raise the maximum annual contribution limit to traditional or Roth IRAs from $2,000 to $5,000. The amount taxpayers can deduct would remain at $2,000 but would be annually indexed to inflation.

The IRA is the most inspired investment incentive device to promote long term savings Washington has ever created. However, *Mutual Funds* magazine has reported that the IRA is receding in importance at the very moment it should be rapidly expanding. Merely to offset inflation since IRAs were introduced, annual IRA contribution limits would have to be raised to more that $5,000.

We ought to encourage long term investment and empower these individuals who desire to use IRAs to supplement their retirement. This legislation will make the IRA an even more effective way for American families to save.

In addition, providing a high quality education to our children is my highest priority. An educated populace is key to economic prosperity. To accomplish this goal, I have introduced H.R. 638, the Teacher Investment and Enhancement (TIE) Act.

While it is important to know how to teach, it is equally if not more important to know what you are teaching. However, many teachers are teaching "out-of-field" and, therefore, are not sufficiently knowledgeable in their subject area. Offering more education opportunities for our teachers is an investment in our children and one we cannot afford not to take. The TIE Act addresses this problem by providing secondary teachers the incentives to return to college to take courses in the classes they teach. This will be accomplished by doubling the current Lifetime Learning Tax Credit for tuition expenses for the continuing education of secondary teachers in their fields of teaching. This increase would allow such teachers to receive up to a $4,000 tax break for college tuition costs.

I look forward to working with the committee on both of these measures. I am hopeful the committee will include these proposals in any tax relief bill that is brought up for consideration.

Statement of Hon. Scott L. King, Mayor, Gary, Indiana

Chairman Archer, Ranking Member Rangel and Members of the Committee, I appreciate the opportunity to submit the following testimony as you hear and review the written statements of members of the public on how our government can most effectively reduce the tax burden on hardworking Americans and businesses.

Mr. Chairman the cities of Gary, Hammond, and East Chicago, Indiana are the proud recipients of a second round Empowerment Zone designation. I write today on behalf of the citizens of our three cities to ask that this Committee honor the work that we are doing, in partnership with 20 private sector businesses to bring long term economic revitalization to the Calumet region. As you begin crafting a tax package I ask that you include grant funding for the second round of Empowerment Zones, Enterprise, and Strategic Planning Communities.

The Calumet Area Empowerment Zone is home to approximately 48,889 residents, 40% of which live at or below the poverty line. In three of the neighborhoods included in the Zone, the percentage of individuals over the age of twenty-five that lack a high school diploma range from 25% in the Brunswick neighborhood to 45% in the Central/Mission neighborhood, and 44% in the Emerson community. The 1998 unemployment rates for the three cities range from 3.6% in Hammond, 6% in East Chicago to 7.1% in Gary, all three significantly above the state rate of 2.8%.

Mr. Chairman I urge you to consider these demographics in light of even more staggering economic trends for the Northwest Indiana region as a whole. Historically the region's economy has been centered primarily around heavy industry, steel in particular. Over the last three decades we have witnessed severe slumps in the region's economy due primarily to the downsizing of steel and related service industries. The downsizing of the steel industry resulted in marked reductions in the civilian workforce, population declines ranging from 20% in Hammond to 40% and 41% in Gary and East Chicago respectively, and a 42.7% reduction in the total number of manufacturing jobs region-wide.

Despite these alarming statistics, our region's leaders, citizens and businesses have come together to address our shared challenges and concerns. The future of our entire region rests on our ability to create jobs, foster economic opportunity, and attract new business investment to the Calumet region. The tax incentives provided to Empowerment Zones, Enterprise Communities, and our private sector partners under the Taxpayer Relief Act of 1997 will go a long way toward helping us achieve this end. These incentives will not only ease the burden of financing our revitalization plans by providing tax-exempt bonding authority, but will also provide much needed incentives for businesses to invest in distressed communities across this nation.

On the contrary, Mr. Chairman, the tax incentives provided under the '97 tax bill are simply not enough on there own, to allow us to do the kind of work that must be done to truly rebuild and stabilize our region's economy. I ask that you and the Members of this Committee, maintain your commitment to the distressed communities across this nation that received second round Empowerment Zone and Enterprise Community designations. I urge you to provide the $1.7 billion in mandatory funding that we desperately need to fully implement our revitalization plans, which we are confident will yield tremendous economic growth and opportunity for the Northwest Indiana region and other communities throughout the nation.

Mr. Chairman and Members of the Committee thank you again for your time and favorable consideration.

Statement of the Higher Education Community

Mr. Chairman and Members of the Committee, we greatly appreciate your holding this hearing in anticipation of the reconciliation tax bill expected next month. We particularly appreciate your dedicating time during this hearing for consideration of education-related tax issues.

The higher education associations listed below have identified the following tax items as priorities for the higher education community:

REMOVE CURRENT RESTRICTIONS ON CLAIMING THE STUDENT LOAN INTEREST DEDUCTION.

We are supportive of various bipartisan proposals to eliminate the 60-month limit on claiming the student loan interest deduction. Current law places several restrictions on claiming this deduction. Students who need to borrow to finance their education should not be restricted on claiming a tax deduction for interest on their borrowing.

We feel current restrictions should be lifted to allow more students and former students to qualify for this deduction that limit its use and greatly complicate the administration of this benefit. In addition to repealing the 60-month limit, which would allow the interest to remain deductible as long as the loan is outstanding, we also support an increase in the amount of interest allowable for the deduction. Under current law, the deduction cannot exceed $1,500 in 1999, $2,000 in 2000, $2,500 in 2001 and beyond. Finally, the income threshold for the phase-out of this deduction needs to be increased. Currently, taxpayers with incomes of $40,000 for single taxpayers and $60,000 for joint returns are phased-out of eligibility for this deduction. Certainly, students who financed their education through student-loans and subsequently graduate with high amounts of debt should not lose eligibility for this deduction based on an arbitrary income threshold that renders the deduction practically useless.

ENACTMENT OF CHARITABLE IRA ROLLOVER LEGISLATION THAT WOULD PROVIDE NEW INCENTIVES FOR DONORS TO GIVE FUNDS HELD IN VARIOUS RETIREMENT ACCOUNTS, SUCH AS 403(B), 401(K), AND KEOGH PLANS, DIRECTLY TO CHARITIES.

Under current law, an individual taxpayer may withdraw funds from an Individual Retirement Account (IRA) without penalty after age 59½, and must commence withdrawals by the April 1st following the year in which he or she attains age 70½. IRA withdrawals are fully taxable as income to the individual in the years they occur. A donor who withdraws IRA funds for transfer to a charity will be subject to tax on the entire withdrawal, offset to varying degrees by the charitable deduction.

Legislation recently introduced by Representatives Phil Crane and Richard Neal, H.R. 1311, would allow a donor to rollover IRA funds to a charity with favorable tax treatment, as either an outright gift or a life-income gift such as a charitable remainder trust, gift annuity or contribution to a pooled income fund. If the IRA funds are rolled over as an outright gift to the charity, the donor will not be subject to income tax at the time of withdrawal and transfer. If the IRA funds are rolled over as a life-income gift, the donor will be subject to taxes on subsequent income payments received for the gift. In either case, the donor would receive a charitable deduction only to the extent that the gift has "basis" as a result of after-tax contributions to the IRA.

Higher education and charitable organizations strongly support this proposal, which has the potential to unlock substantial new sources of funding for the charitable community from donors who hold billions of dollars in IRA and other retirement accounts.

PERMANENT EXTENSION OF SECTION 127, EMPLOYER-PROVIDED EDUCATION ASSISTANCE, FOR BOTH GRADUATE AND UNDERGRADUATE COURSE WORK.

For many Americans attempting to balance work, family, and economic priorities, Section 127 is the only feasible and affordable way that they can further their education and thereby improve their skills and remain competitive in today's job market. Section 127 is a purely private-sector initiative, and represents an important tool for encouraging employer investment in their workers' continuing education. Like any other employer benefit, it is purely voluntary, and is provided by many employers because they see value and a return on an investment in their employees' education. Section 127 is of special importance to women and minorities, as well as those at the bottom of the career ladder who need better skills to advance

Section 127 provides more appropriate tax treatment for this educational benefit than the new Lifetime Learning tax credit. The credit, equal to 20 percent of the first $5,000, does not fully offset the tax liability that arises if the benefit is considered taxable income. In addition, the credit is not sensitive to family size—the maximum tuition that may be counted towards the credit is $5,000, whether the taxpayer is single, married, or married with children in college. As a result, parents with a child in college who are continuing their own education at the same time will receive no benefit from the new Lifetime Learning tax credit, and will also be liable for additional taxes if any educational benefit they receive is not covered by Section 127.

The on-again, off-again status of Section 127 has prevented workers who need the educational assistance most from fully participating in the program. Some workers have postponed registering for classes because of uncertainty about whether the benefits would be taxable, while others have scaled back their education plans. We strongly support the permanent extension of this expiring provision for both graduate and undergraduate education.

TAX RELIEF FOR COLLEGE SAVINGS AND PREPAID TUITION PLANS.

In addition to supporting equal tax treatment for all types of plans, we are very supportive of expanding the tax relief to include tax free distributions from these plans. Section 529 of the IRC should be expanded to ensure fair tax treatment to all college savings and pre-paid tuition plans. In addition, to further encourage these as savings options for families, tax free distributions would be highly desirable. We appreciate and support the numerous bills Members of both the House and Senate have introduced to achieve such tax relief for these plans.

AN INCREASE IN THE ANNUAL CONTRIBUTION LIMIT TO EDUCATION IRAS.

Education IRAs (also known as Education Savings Accounts, or "ESAs") were created as part of the Taxpayer Relief Act of 1997 to provide a new savings option for families trying to plan ahead for future education expenses. ESAs were intended to appeal to the many individuals who are comfortable with traditional IRAs as a saving option. Unfortunately, the current $500 annual contribution limit is simply too low to enable families to build sufficient savings for higher education expenses. For this reason, ESAs have proved to be ineffective in their current form. We appreciate the wide support for increasing the contribution amount and hope appropriate language will be included in tax legislation at your next opportunity.

AMEND THE INTERNAL REVENUE CODE OF 1986 TO REPEAL OR SUBSTANTIALLY MODIFY THE INFORMATION-REPORTING REQUIREMENT RELATING TO THE HOPE SCHOLARSHIP AND LIFETIME LEARNING CREDITS.

We urge you to address the costly reporting requirements related to the Hope Scholarship and Lifetime Learning Credits. While we believe that repealing the requirements is in the best interest of both institutions and the IRS, significant modifications of the reporting requirements are another option to consider. IRS/Treasury temporarily reduced the reporting requirements in tax years 1998 and 1999 and may do so again for tax year 2000.

Making the current minimal reporting requirements permanent-and thus avoiding the pending requirement for schools to annually obtain the taxpayer SSN, name and address for dependent students-would be one such significant modification that falls short of repeal. We also urge you to modify the reporting requirements to limit the universe on whom tax reports must be sent. This would reduce institutional reporting by allowing schools to report on only those students who request such reporting and provide the school with adequate information to file such a report.

RESEARCH AND DEVELOPMENT TAX CREDIT

The higher education community perceives the objectives of the credit as twofold: first, to encourage sustained support from the private sector for the conduct of basic research by colleges and universities and, second, to involve colleges and universities to a greater extent in research oriented to practical applications. The credit also fosters the interaction between industry and the talents and skills available at colleges and universities.

Permanent extension of the R&D credit will contribute to increased research and development and higher annualized rates of return; and it will stimulate economic growth, improve productivity, and benefit the entire economy. The credit is also central to the continuation and expansion of partnerships between industry and universities, which will speed progress toward important scientific discoveries.

Thank you Mr. Chairman and Members of the Committee for allowing us the opportunity to submit this testimony for the record. We greatly appreciate your holding this hearing and focusing a portion of it on education-related tax provisions. We hope you will find our comments and recommendations useful as you continue building the next reconciliation package. We feel very strongly that inclusion of these items in upcoming tax legislation would present a well-rounded and much needed higher education tax relief package.

On behalf of:

Accrediting Association of Bible Colleges
American Association of Community Colleges
American Association of Dental Schools
American Association of Presidents of Independent Colleges
American Association of State Colleges and Universities
American Council on Education
Association of Advanced Rabbinical and Talmudic Schools
Association of American Universities
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Coalition of Higher Education Assistance Organizations
Council for Advancement and Support of Education
Council for Christian Colleges & Universities
Council of Graduate Schools
Council of Independent Colleges
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of the United Methodist Church
National Association of Student Financial Aid Administrators
North American Division of Seventh-Day Adventists
The Mennonite Board of Education

Joint Statement of IRA Charitable Rollover Working Group

Mr. Chairman and Members of the Committee, this written statement is submitted to the House Ways and Means Committee on behalf of the IRA Charitable Rollover Working Group, a coalition of nonprofit associations nationwide that was formed specifically in order to promote passage of the IRA Charitable Rollover Incentive Act (H.R. 1311, S. 1086). Passage of this legislation is also supported by two broad-based coalitions of charitable organizations throughout the nation—Charitable Accord, which is focused mainly on charitable giving issues, and Independent Sector, which addresses a wider range of charitable issues. Attached is a list of the members of the Working Group. In addition, Charitable Accord has a list of 200 members, and Independent Sector a list of 41 members, that endorse the enactment of H.R. 1311/S. 1086 into law. These endorsees represent the interests of service and religious groups, museums and arts groups, colleges and universities, private and community foundations, and other charitable organizations across the country.

Although charitable giving has increased in recent years, charitable organizations still face the continued challenge of meeting the needs of the people they serve. Over the past two decades, government funding for programs that serve social needs have been significantly reduced. According to a recent study prepared for Independent Sector, under the President's FY 1998–2002 budget proposal, inflation-adjusted federal spending for FY 2002 in budget functions of concern to nonprofits would decline 3% below FY 1995 levels. Moreover, if entitlement-driven spending for income security is excluded from the calculation, inflation-adjusted spending for the remaining categories of concern to nonprofits would decline 9% below FY 1995 levels. Among those services that will suffer the largest declines in the federal share of their funding from 1996 to 2002 are: services to the elderly (from 17% to 9%); nursing homes for the elderly (from 42% to 30%); housing, community development and other community services (from 50% to 31%); home healthcare (from 39% to 27%); and food services (from 46% to 36%). Consequently, the charitable sector, which is expected to fill this gap, must constantly seek additional resources, for example, through charitable gifts, or cut back on programs as social needs continue to grow.

Excess IRA assets represent a very large, untapped source of potential support for the nation's charities. According to Joint Tax Committee staff, there is currently more than $1 trillion in IRA accounts and $5 trillion in defined contribution accounts, which can be rolled into IRA accounts. In addition, economists estimate that more than $10 trillion in wealth will be transferred to the so-called baby-boomer generation from their parents. One result of this large generational transfer is that, for many individuals, IRA assets accumulated under favorable market conditions will be less necessary for their retirement and, at least in part, available for charitable giving. However, current law presents serious tax disincentives to such gifts.

Under current law, IRA withdrawals are fully taxable as ordinary income to the individual in the years they occur. A donor who withdraws IRA assets for transfer to a charity is subject to tax on the entire amount, offset to varying extents by the charitable deduction. Although charitable organizations frequently receive inquiries from potential donors about giving IRA assets during their lifetimes, the tax consequences are so significant a deterrent that such gifts are rarely made.

The following are selected examples from an informal survey that was designed to solicit anecdotal information about how current tax law inhibits donors interested in making charitable gifts from the rollover of IRA assets. A growing number of individuals report that they have satisfactory arrangements in place for their retirement income, and that they want to give a portion of their IRA assets to charity. In virtually all examples collected, when the potential donors were informed that they must pay ordinary income tax on any IRA assets they give to charity, they chose not to make such gifts.

- A national disease association with headquarters in Illinois has had two inquiries this year about gifts of approximately $1 million each from IRA assets. The first was from a widow with other assets, who considered establishing a charitable remainder trust that would not only "do some good for society" but also provide her with annual income to care for her disabled child. The second was from a highly successful businessman nearing retirement, who wanted to set up a charitable remainder unitrust. Because of the tax consequences, neither individual has made the proposed gift.
- A 71 year old male donor with a $1.3 million IRA wishes to make a life-income gift to a major public university in Texas. He would like to receive annual income payments that would help ensure the care of his wife, who is in the early stages of Alzheimers. Given the tax consequences of such a gift under current, the donor has not been willing to move forward.
- The husband of a hospital volunteer at a medical center in Tennessee would like to establish a charitable trust to benefit cancer research, which was responsible for the recent death of his wife. He wants to use retirement plan assets of $1.8 million to establish this cancer research fund, to provide himself with annual payments for retirement income, and to reduce the tax burden on his heirs, which would be greater for IRA assets than other appreciated securities. He has been advised against such a gift because of tax disincentives under current law.
- A successful entrepreneur, who is a board member of an Arizona foundation, proposed to make a life-income gift of up to $.5 million from excess qualified pension plan proceeds. This gift, in addition to providing retirement income for himself and his wife, would assist in financing two community hospitals, a children's dental clinic, a food bank, an adult day healthcare center, long-term and rehabilitative care facilities, and a host of other medical and social services. However, upon investigation, he concluded that the tax consequences were too unfavorable.
- A major university in Pennsylvania has recently received about 24 calls per year concerning gifts from IRA assets. Typical cases are in the $100,000 range, but one inquiry was regarding a $700,000 gift. To date, all except one of these donors have decided against making such a gift.

• In Maryland, an elderly couple, who had a lifetime commitment to volunteerism and a history of charitable giving to a hospital foundation, a community-based housing group, and a welfare-to-work training organization, inquired about establishing a charitable remainder trust from IRA assets. They wanted to benefit their philanthropic interests, but provide some additional income for whomever was the survivor. However, concern about the high level of taxation on assets withdrawn from their IRA prevented them from proceeding with the proposal.

• One major university in California has received at least 12 inquiries in the past year, and another received four inquiries, about making outright gifts or establishing charitable trusts by assigning IRA or other qualified pension assets. However, upon learning about the tax treatment of those actions, no prospect has actually made a gift.

• A major social welfare provider in Illinois was approached by a contributor who wanted to donate outright his total IRA assets of $650,000. Given the unfavorable income tax consequences under current law, he did not make he gift.

• A research university in New York has had six inquiries in the past two years about gifts in the $1.5 to $3.0 million range from IRA assets. Given the unfavorable tax consequence under current law, none of these gifts has materialized.

• A community foundation in California received an inquiry from a donor, wishing to use IRA assets to establish a $.5 million scholarship fund. However, when the tax implications were reviewed, the donor declined to create this fund.

In contrast, given passage of the IRA Charitable Rollover Incentive Act (H.R. 1311), if IRA assets were rolled over to charity as an outright gift, they would be removed from the donor's tax calculation of ordinary income. In addition, if IRA assets were rolled over as a life-income gift, the annual income payments from the gift would still be subject to taxation. In both cases, the donor would not receive a charitable deduction unless after-tax dollars had been contributed to the IRA.

The following example will illustrate the different tax consequences under current law and H.R. 1311. Mr. Smith, age 60, has accumulated approximately $1,000,000 in his IRA and other tax-favored retirement plans. While he believes he will only need about $750,000 for retirement, he plans to leave his IRA intact for another 10 years rather than pay tax on withdrawal of assets.

If legislation is enacted allowing charitable IRA rollovers with favorable tax treatment, Mr. Smith can transfer IRA assets he will not need for retirement to the charity as an outright gift or a life-income gift. Either way, these gifts will not be subject to tax upon withdrawal and transfer of his IRA assets to the charity. His gift would be tax-deductible only to the extent he had previously funded his IRA with after-tax dollars.

If Mr. Smith prefers a life-income gift, for example, he can transfer $250,000 to a 7% charitable remainder annuity trust, from which he will receive $17,500 in annual taxable income (a 7% return on the $250,000) for life. Over the first 10 years, Mr. Smith (assuming a 39.6% tax bracket) may pay income taxes totaling as high as $69,300 on income totaling $175,000.

By contrast, under current law, Mr. Smith could owe an initial tax of approximately $79,600 on the $250,000 withdrawal, even after taking into account the charitable deduction he may receive for contributing the net proceeds to the trust. Mr. Smith may then contribute only $170,400 to the trust, from which he will receive $11,900 in annual taxable income (a 7% return on the $170,400) for life. Over the first 10 years, Mr. Smith may pay income taxes totaling as high as $47,124 on the income totaling $119,000.

This proposed legislation is good public policy. Since other qualified retirement plans can now be rolled over tax-free into IRAs, this proposal would unlock substantial new resources for the support of charitable organizations and their public-service missions. In addition, this proposal would realign tax treatment on IRA assets to match current tax laws that apply to other assets donated to charity. Finally, to the extent that donors transfer IRA assets into life-income gifts soon after age 59—, rather than waiting until the required distributions at age 70—, this proposal would generate new tax revenues, partially offsetting revenue losses.

Implementation of H.R. 1311 will involve lost revenue, which was estimated by the Joint Tax Committee staff at $1.4 billion in the first five years. However, the revenue loss would be partially offset by life-income gifts (e.g., charitable remainder trusts or charitable gift annuities) that would accelerate revenue to the degree that individuals, before age 70—when withdrawals must begin, roll IRA funds into such gifts, which will generate taxes on the annual income payments. Attached are three charts illustrating that, in many cases, the tax revenue created by an IRA rollover to a life-income gift may exceed the tax revenue lost because of the tax exclusion permitted by the legislation. The illustrations reflect single and dual income recipients at ages 60, 70, and 80 together with their respective single and joint life expectancies. Current calculations show the federal income tax revenue "lost" and "found" under these three life-income arrangements.

Although IRA assets were originally intended as a supplement to retirement income, withdrawal is now allowed in order to assist in financing a home or a college education. It is equally, perhaps more, appropriate for public policy to allow financially successful individuals, who have reached a point where IRA and other tax-deferred retirement assets are not needed for retirement, to use those assets not to benefit personally, but to support charities that better the lives of others. Moreover, in the case of life-income gifts, a portion of the IRA assets would be retained as retirement income for the donor and his or her spouse alone, with the remainder passing to charity upon the death of the participants. Furthermore, since an IRA may now pass to charity at death by a direct or life-income gift, the proposal parallels the current tax code.

Some may incorrectly characterize H.R. 1311 as a tax break for the wealthy. The plain fact is that many middle-class Americans, including teachers, nurses, sales persons, retired military, and librarians, frequently express their desire to make gifts using IRA assets. Many retirement plans have multiplied well beyond anticipated needs and expectations as a result of favorable investment markets and moderate inflation. These donors want the removal of a tax disincentive, not a tax break, in order to complete their charitable objectives. Indeed, upper-bracket taxpayers can best afford, and are most likely to make, this type of wealth transfer to charity. However, if this proposal were passed into law, although the government would give up a tax worth 39.6% of the value of the asset, the donor would give up 100% of the asset. The government would not collect tax on the transfer of the asset to charity because the transfer does not financially benefit the donor. Thus, there is no income on which to levy a tax. Rather, this untaxed asset transfer will increase private support for public services that the government would otherwise be called upon to provide. Therefore, it is good public policy to create incentives that encourage individuals, including upper-bracket taxpayers, to support philanthropy through gifts of IRA assets.

The future of the charitable sector and of the public services it provides depends upon expanding financial resources to meet increasing social needs. The existing billions of dollars in IRA assets constitute a significant, untapped resource for charitable purposes. This proposal would allow individuals, who have assets in excess of requirements for their retirement, to make penalty-free donations of IRA assets to support the charitable sector and its public-service mission. For these reasons, we urge the passage of H. R. 1311.

IRA Charitable Rollover Working Group

American Arts Alliance
American Association of Museums
American Bar Association
American Council on Education
American Heart Association
American Hospital Association
American Institute for Cancer Research
American Red Cross
Association for Healthcare Philanthropy
Association of American Universities
Association of Art Museum Directors
Association of Jesuit Colleges and Universities
Baptist Joint Committee
CARE, Inc
Catholic Health Association
Charitable Accord
Council for the Advancement and Support of Education
Council on Foundations
Council of Jewish Federations
Goodwill Industries International
Independent Sector
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Committee on Planned Giving
National Health Council
National Multiple Sclerosis Society
National Society of Fund Raising Executives
The Salvation Army
United Way of America

Favorable Revenue Effects for IRA Rollovers Into Charitable Life Income Arrangements

Income tax effects of a $100,000 *5% Unitrust* under the IRA Charitable Rollover Incentive Act

Definitions

"Found" tax revenue:	Sum of federal income taxes over the presumed life of the plan attributable to Unitrust payments
"Lost" tax revenue:	Presumed $39,600 federal income tax on income inclusion, less tax savings from charitable deduction allowed under current law
Breakeven:	Time to recapture "lost" tax revenue with "found" tax revenue

Presumed Unitrust investment returns over the life of the trust [1]

Age(s)	Life expectancy	Effects: 8.5% net total return	Effects: 12.5% net total return
60	24 years	$ 54,616 "found" tax revenue 23,000 "lost" tax revenue Breakeven: 10.1 years	$ 121,595 "found" tax revenue 23,000 "lost" tax revenue Breakeven: 4.5 years
60, 60	29 years	$ 73,685 "found" tax revenue 24, 487 "lost" tax revenue Breakeven: 10.1 years	$ 185,191 "found" tax revenue 24,487 "lost" tax revenue Breakeven: 4.2 years
70	16 years	$ 30,544 "found" tax revenue 17,593 "lost" tax revenue Breakeven: 9.2 years	$ 57,069 "found" tax revenue 17,593 "lost" tax revenue Breakeven: 4.9 years
70, 70	20 years	$ 41,684 "found" tax revenue 25,124 "lost" tax revenue Breakeven: 12.1 years	$ 84,760 "found" tax revenue 25,124 "lost" tax revenue Breakeven: 5.9 years
80	9 years	$ 14,732 "found" tax revenue 11,951 "lost" tax revenue Breakeven: 7.3 years	$ 24,109 "found" tax revenue 11,951 "lost" tax revenue Breakeven: 5.9 years
80, 80	12 years	$ 20,983 "found" tax revenue 15,861 "lost" tax revenue Breakeven: 9.1 years	$ 36,253 "found" tax revenue 15,861 "lost" tax revenue Breakeven: 5.3 years

Assumptions

5% standard Unitrust funded May, 1999 with $100,000 cash withdrawn from IRA
Donor[s] is[are] also income recipient[s], so there are no federal gift tax consequences
Federal income tax brackets of 39.6% and 20.0%, plus 1.5% annual trust management fees
Life expectancies source: US Treasury 80CNSMT mortality factors

---

[1] Projected returns are presumed to be sharply lower than they have been during the most recent 10 years. Using a 70% stock and 30% bond portfolio weighting and returns of 19.0% (S&P 500) and 9.1% (Lehman Aggregate) respectively, the prior 10 year net annualized returns have approximated 14.5%. Calculations derived on software from PG Calc Incorporated, Cambridge, Massachusetts.

Favorable Revenue Effects for IRA Rollovers Into Charitable Life Income Arrangements

Charitable mid-term federal rate of 6.4% for April, 1999

Income tax effects of a $100,000 *8% Unitrust* under the IRA Charitable Rollover Incentive Act

Definitions

"Found" tax revenue:	Sum of federal income taxes over the presumed life of the plan attributable to Unitrust payments
"Lost" tax revenue:	Presumed $39,600 federal income tax on income inclusion, less tax savings from charitable deduction
Breakeven:	Time to recapture "lost" tax revenue with "found" tax revenue

		Presumed Unitrust investment returns over the life of the trust [2]	
Age(s)	**Life expectancy**	**Effects: 8.5% net total return**	**Effects: 12.5% net total return**
60	24 years	$ 44,126 "found" tax revenue	$ 100,357 "found" tax revenue
		28,804 "lost" tax revenue	28,804 "lost" tax revenue
		Breakeven: 15.7 years	Breakeven: 6.9 years
60, 60	29 years	$ 50,436 "found" tax revenue	$ 139,803 "found" tax revenue
		33,319 "lost" tax revenue	33,319 "lost" tax revenue
		Breakeven: 17.4 years	Breakeven: 4.2 years
70	16 years	$ 27,328 "found" tax revenue	$ 53,348 "found" tax revenue
		23,345 "lost" tax revenue	23,345 "lost" tax revenue
		Breakeven: 13.7 years	Breakeven: 7.0 years
70, 70	20 years	$ 35,513 "found" tax revenue	$ 74,673 "found" tax revenue
		28,521 "lost" tax revenue	28,521 "lost" tax revenue
		Breakeven: 16.1 years	Breakeven: 7.6 years
80	9 years	$ 14,186 "found" tax revenue	$ 24,603 "found" tax revenue
		16,811 "lost" tax revenue	16,811 "lost" tax revenue
		Breakeven: n/a	Breakeven: 6.1 years
80, 80	12 years	$ 19,620 "found" tax revenue	$ 35,726 "found" tax revenue
		21,822 "lost" tax revenue	21,822 "lost" tax revenue
		Breakeven: n/a	Breakeven: 7.3 years

Assumptions

8% standard Unitrust funded May, 1999 with $100,000 cash withdrawn from IRA

[2] Projected returns are presumed to be sharply lower than they have been during the most recent 10 years. Using a 70% stock and 30% bond portfolio weighting and returns of 19.0% (S&P 500) and 9.1% (Lehman Aggregate) respectively, the prior 10 year net annualized returns have approximated 14.5%.

Favorable Revenue Effects for IRA Rollovers
Into Charitable Life Income Arrangements

Donor[s] is[are] also income recipient[s], so there are no federal gift tax consequences
Federal income tax brackets of 39.6% and 20.0%, plus 1.5% annual trust management fees
Life expectancies source: US Treasury 80CNSMT mortality factors
Charitable mid-term federal rate of 6.4%

Income tax effects of $100,000 *gift annuities* under the IRA Charitable Rollover Incentive Act

Definitions

"Found" tax revenue:	Sum of federal income taxes over the presumed life of the plan attributable to Unitrust payments
"Lost" tax revenue:	Presumed $39,600 federal income tax on income inclusion, less tax savings from charitable deduction
Breakeven:	Time to recapture "lost" tax revenue with "found" tax revenue

Age(s)	Life expectancy	Annuity rate	Effects
60	24 years	6.7%	$ 36,105 "found tax revenue 24,993 "lost" tax revenue Breakeven: 16.6 years
60, 60	29 years	6.4%	$ 42,996 "found" tax revenue 31,168 "lost" tax revenue Breakeven: 21.0 years
70	16 years	7.5%	$ 23,178 "found" tax revenue 24,342 "lost" tax revenue Breakeven: 16.8 years
70, 70	20 years	6.8%	$ 27,090 "found" tax revenue 27,411 "lost" tax revenue Breakeven: 20.0 years
80	9 years	9.2%	$ 12,853 "found" tax revenue 20,813 "lost" tax revenue Breakeven: n/a
80, 80	12 years	8.0%	$ 15,549 "found" tax revenue 23,792 "lost" tax revenue Breakeven: n/a

Assumptions

Gift annuities funded May, 1999 with $100,000 cash withdrawn from IRA
Donor[s] is[are] also income recipient[s], so there are no federal gift tax consequences
Federal income tax brackets of 39.6% and 20.0%, plus 1.5% annual trust management fees
Life expectancies source: US Treasury 80CNSMT mortality factors
Charitable mid-term federal rate of 6.4%

Statement of Maria J. Jerardi, Third Year Student, Georgetown University School of Medicine; and Recipient, National Health Service Corps Scholarship

I am writing to you with my concerns about the impact of the new Internal Revenue Service (IRS) taxation policy on myself as well as on other National Health Service Corps (NHSC) scholarship recipients nationwide. I am appealing to you now for your assistance in changing this policy through support of H.R. 1414 and H.R. 324. While I acknowledge the importance of civic responsibility, which includes paying taxes, I believe that there are several issues that distinguish the case of NHSC scholarship recipients.

First, I completely agree with the tax liability of the monthly stipend NHSC Scholars receive to cover their living expenses ($915.00 per month), however it is generally the case that support received as a scholarship and used for tuition, books, and mandatory fees is tax-deductible. The recent decision by the IRS to require NHSC Scholars to pay taxes on the entire value of the scholarship has had several negative ramifications. It results in financial hardship for the recipients and undermines the purpose of the program while serving only to transfer funds from one federal agency to another.

It should be emphasized that I am currently a medical student and will soon be a resident and then a practicing physician. As a resident I will be employed by the hospital affiliated with my residency program and as a clinician I will work for a private, non-profit clinic. Consequently the argument by the IRS that NHSC scholars are receiving payment in advance, to support their education, in exchange for future services rendered makes no sense. I will not be employed by the NHSC or the Department of Health and Human Services during either my residency or the four year clinic placement which will immediately follow my residency. Clearly section 117 (c) of the Internal Revenue Code was not intended to penalize NHSC scholars and the current policy has resulted from a misinterpretation of this regulation by the IRS.

Due to the expense of attending a private medical school such as Georgetown University where tuition is over $26,000.00 per year, this new tax provision results in a significant reduction in the proportion of expenses covered by a NHSC scholarship. Currently, the monthly stipend of $915.00 per month which used to be reduced to approximately $800.00 per month after federal withholding has been reduced to $380.00 per month for Georgetown students due to increased tax liability. This amount covers less than a third of the budgeted monthly living expenses of a Georgetown medical student (estimated by the financial aid office to be approximately $1200.00 per month). Consequently, this scholarship which is supposed to be sufficient to cover the normal expenses of a medical student (tuition, books, supplies, fees, and living expenses) is no longer meeting this goal. Consequently, I was forced to take out approximately $11,500.00 in loans to cover living expenses for the 1998–99 school year. Additionally, as a Maryland state resident, I have incurred an additional state income tax liability requiring me to borrow an additional $6,600 in the middle of the past academic year to cover the cost of my state taxes.

The necessity of this type of lending is somewhat nonsensical, considering that the money I am now borrowing through federally-subsidized loan programs (from the Department of Education) is being used indirectly to pay taxes to a government agency (the Internal Revenue Service) on a scholarship I received from another government agency (the Department of Health and Human Services). Additionally, the necessity of these loans is undermining the whole purpose of the NHSC program. The NHSC strives to encourage health professions students to practice in medically-underserved rural and urban areas (MUAs) in the U.S. These are areas which are in great need of physicians and other health professionals in order to provide the access to health care deserved by all communities in our country.

The NHSC requires a year in an underserved area for each year of support received. However, the NHSC also encourages scholarship recipients to continue to serve in medically-underserved communities after the completion of the commitment required by the scholarship. The organization does this by striving to recruit those individuals who will continue to serve in such areas despite the challenges posed to one's work and lifestyle by work in rural or urban health professional shortage areas (HPSAs). One of the major drawbacks of working in such a region is the lower level of compensation offered by many of the federally-funded clinics in these communities. By removing the debt burden experienced by many medical students, this scholarship once enabled recipients to select positions after completion of their commitment somewhat independent of financial considerations. Now, with the prospect of having to borrow over $65,000 (if I am forced to continue my current level of borrowing to cover losses of stipend income to both state and federal tax liability) during my medical education in addition to the debt burden incurred by undergraduate and graduate school, I know that my ability to take future positions (following my scholarship commitment) in regions of the country that critically need my services will be limited by salary considerations. I may have to find a job which provides a sufficient salary to cover the much higher monthly payments required by my much increased level of indebtedness.

At the time I applied for an NHSC scholarship, these current tax issues were not apparent. I chose to attend Georgetown because of the superior clinical training I believe it provides. However, this decision was made with the expectation of receiving an NHSC scholarship. Now with this recent tax ruling by the IRS, my financial situation has changed dramatically. Had I known before of the debt burden that I would be forced to incur even with the NHSC scholarship, I would have made the choice to attend a less-expensive school and not participate in the NHSC program.

As the United States continues to deal with its apparent surplus of physicians, despite the fact that many rural counties in the midwest and southeast are without any physician services, the NHSC program can serve a valuable role. With increasing financial constraints on government spending, the maximization of cost-effectiveness of federal programs is vital. Why not allow NHSC scholarship recipients to receive the benefits which are supposed to be provided through this program? By allowing these students to pursue an education in the health professions with little or no debt burden, the program stands a much better chance of making a long-term impact on the physician maldistribution problem in our country and maximizing the program's cost-effectiveness. Without debt burden, the clinicians this program trains will stay in areas of critical need longer, thereby making a bigger contribution to the ultimate goals of the NHSC.

I thank you for your concern about the impact of these tax changes on my program of study and on my future as a community-oriented physician. More importantly I appreciate your concern for those communities in our country without adequate access to health care who will truly be most affected by these tax changes. For all of these reasons I ask you to please support the quick passage of H.R. 1414, a bill which seeks to reverse the taxation of the NHSC scholarship.

Sincerely,

MARIA J. JERARDI

Joint Statement of Victor Ashe, Mayor, City of Knoxville, Tennessee

As Mayor of the City of Knoxville, I am pleased to have the opportunity to communicate to this Committee a sense of the community support for the federal Empowerment Zone (EZ) initiative.

BACKGROUND

In 1994, hundreds of members of our community, spurred by the promise of the new Empowerment Zone/Enterprise Community (EZ/EC) program, came together to develop a strategic plan for the most distressed areas of our city. Residents and other stakeholders from throughout the community joined together to conduct an introspective evaluation of the strengths and problems of the city, and to develop strategies and relationships to tap those strengths and attack those problems. Citizens, local government, private businesses, and nonprofit organizations worked together to define and plan for the revitalization of an area that traditionally had been seen as past its prime at best, and not worth saving at worst.

That planning formed the basis for Knoxville's Round I application for EZ/EC designation. Although Knoxville was not selected as an EZ or an EC in 1994, the relationships formed during that planning process continued to grow and flourish. The planning process set in motion a new way of looking at Knoxville's central city and its potential as an investment opportunity. It laid the groundwork for more inclusive and open local planning. Best of all, it forged a plan backed by the commitment of residents, local government, and philanthropic organizations. It empowered the community to see what is possible in Knoxville, and it created some of the tools necessary to make that vision a reality.

The community could have seen all of the hard work on the Round I application as fruitless when Knoxville was not chosen as an Empowerment Zone, but that is not what happened. The city, with its public and private partnerships stayed committed to implementing as much of the 1994 EZ plan as possible without the federal EZ funding.

When the opportunity for Round II EZ designation became available in 1998, again the residents and other stakeholders in Knoxville's central city joined together to develop a plan. The 1998 effort built upon and expanded the 1994 planning process, incorporating the most promising ideas from that earlier effort. The result of the 1998 planning process was a plan with broad-based community support, a plan that promises genuine empowerment combined with new economic prosperity for our most challenged neighborhoods.

THE IMPORTANCE OF THE EMPOWERMENT ZONE TO KNOXVILLE

Knoxville's Empowerment Zone is not just a few isolated patches of poverty—it encompasses more than 20% of the total geographic area of the City and houses almost 30% of Knoxville's population.

Our Empowerment Zone faces the challenges common to many older urban areas. The Zone suffers from workforce obsolescence, a paucity of community capital, and weak civic attachment. Brownfields dot the Zone's industrial landscape. Virtually every Zone neighborhood faces blighted dilapidated housing and overgrown vacant lots. The majority of Zone residents need to develop new job skills, because the ones that once supported them have become unmarketable in the information age. Other residents have become dependent upon public assistance programs that will no longer sustain them and must engage in education and training that will challenge them to become contributors to our social and economic fabric.

THE IMPORTANCE OF THE EMPOWERMENT ZONE TO THE REGION

Knoxville's EZ carries tremendous significance as the historic, geographic, and economic heart of Southern Appalachia. The revitalization of the Zone and its reintegration into the economic and social fabric of East Tennessee are essential to the long-term vitality and commerce of the entire Southern Appalachian region, an area with more than six million residents and 86,000 square miles.

EMPOWERMENT ZONE AS INVESTMENT OPPORTUNITY

We here in Knoxville view our Empowerment Zone as an investment opportunity. It does have more than its share of competitive disadvantages, but these problems are neither too deeply rooted nor too overwhelming to solve. Since 1993, the community has been steadily assembling the resources needed for a renaissance in the Heart of Knoxville. Other investors have begun to see the possibilities of the Zone, but these investments need augmentation to sustain them. With the help of the federal government, the assets of this Zone can and will be developed into competitive advantages that will yield economic and social returns far greater than any initial investment.

Our successful shepherding of investment in our EZ will require us to adhere to some basic tenets of business practice. We will:

- Build on the competitive advantages and eliminate the competitive disadvantages of the Zone.
- Target resources to maximize neighborhood improvements.
- Increase the economic value of doing business in the Zone.
- Provide flexible, accountable, effective management of the Zone.
- Mobilize the private sector.

USE OF FEDERAL INVESTMENT IN EMPOWERMENT ZONE

Federal funding appropriated for the Empowerment Zone initiative will result in highly visible programs that achieve broad goals of economic opportunity and improved quality of life. Some examples of projects in Knoxville that need Empowerment Zone funding to become a reality:

- Redevelopment of Brownfields: A public/private partnership led by the City of Knoxville will pilot and then replicate a model for redeveloping contaminated or underutilized commercial and industrial sites within our Zone. This initiative will lead to the creation of 1,800 new jobs and will leverage an anticipated $98 million in private investment over the period of designation.
- Empowerment Bank: The City and its partners will establish an institution to provide comprehensive services for small businesses in the Empowerment Zone. It will be set up in one location and provide a wide-range of capital and technical as-

sistance under one roof. This initiative will leverage more than $2 million in private lending and create at least 50 jobs per year.

- Workforce Competitiveness: This initiative will provide Zone residents with training and match them with job opportunities in the Zone and the region. This initiative would build on current capabilities and would be one way of targeting our resources to achieve maximum results.
- Housing Affordability and Choice: Using the EZ funds to leverage a private pool of lending, this initiative would allow us to focus on mixed income financing with two components: a fund of private financing that can be used for purposes where it is normally difficult to obtain a loan; and subsidy funds that encourage existing residents to improve their homes, enable households that could not otherwise afford it to purchase, construct, or purchase/rehabilitate a home in the Zone. This effort would result in the construction of 1,000 new housing units and the rehabilitation of 500 additional homes over the period of designation.
- Preservation-based Housing Rehabilitation: Through this program, endangered historic homes will be acquired, stabilized, and marketed to low-and middle-income home buyers and other investors. This program will not only help to preserve our heritage and the historic character of our older neighborhoods, it will also attract new investment into the area. Empowerment Zone funding for this initiative can leverage $200,000 from the National Trust for Historic Preservation, $100,000 from local sources, and additional private investment in renovation and restoration.

EMPOWERMENT ZONE FUNDING AS A MEANS TO SPUR OTHER INVESTMENT

What all of the examples above illustrate is the concept of leverage: using federal funds as seed money to attract other investment. With the commitments already in place, a federal investment of $100 million in the Knoxville Empowerment Zone will leverage more than $550 million in additional private and public funding. In addition, the projects described above will attract private investment not yet committed to the Zone will in excess of $100 million. Over the ten year designation, I would expect that an investment of $100 million in federal EZ funding would result in $1 billion in total new investment in Knoxville's Empowerment Zone. This is a rate of return that any investor could be proud of.

WHY YOUR SUPPORT FOR THIS LEGISLATION IS SO IMPORTANT

Healthy cities have long been the foundations of our national economic life. The Empowerment Zone initiative offers a means of achieving revitalization for the most distressed parts of American cities. If we can work together to reverse the declines affecting these areas—redeveloping contaminated, underutilized industrial sites; attracting businesses to expand and hire Zone residents; fighting crime and lack of civic attachment; promoting community pride; preserving our heritage; improving our housing opportunities—we can help to ensure the long term health of our national economy.

Like all of the Round II Empowerment Zones, Knoxville has assembled a large group of committed partners. Residents, businesses, financial institutions, philanthropic organizations, nonprofit organizations, educational institutions, and governmental entities have all come together to support Knoxville's EZ initiative. This broad-based group has carefully developed a plan that can bring lasting health and vitality back to an area that has suffered significant disinvestment. They have pledged their time, energy, and financial resources to making the plan become a reality. But they cannot do it without support from the federal government. You can provide the seed money and tax incentives that leverage tremendous amounts of private funding. You can provide the resources that will bring new partners to the table. With $100 million in EZ funding, we can leverage a $1 billion revitalization effort. Without your support, the promise offered by our EZ plan cannot become a reality.

Thank you for your consideration of this very important issue.

Respectfully submitted,

VICTOR ASHE

2308 RAYBURN HOUSE OFFICE BUILDING
Washington, DC 20515–0505
July 2, 1999

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20510

Dear Mr. Chairman,

I am writing to bring your attention to an issue related to the Hope Scholarship and Lifetime Learning tax credits affecting colleges and universities in a manner unintended by Congress. Provisions of the Taxpayer Relief Act of 1997 require colleges to file an information return with the IRS, supplying a copy to the student or to the taxpayer who claims the student as a dependent, for all students for whom tuition and fees were received in the tax year. This requirement is imposed without regard to whether the students will be eligible for the tax credits or will choose to take advantage of them.

The IRS issued interim guidelines for colleges and universities to follow for the 1998 and 1999 tax years and is in the process of drafting regulations that will increase the amount of data those institutions are required to supply. This reporting standard has created a problem for all postsecondary institutions. In my state of California it is particularly burdensome for the California Community College system because the number of reports that must be filed far exceed the number of students who will utilize the tax credits.

I have received correspondence from the Chancellor of the California Community Colleges in support of changes to these IRS requirements and in support of HR 1389, the Higher Education Reporting Relief Act introduced by Congressman Manzullo. I request that this letter be included as part of the Committee's hearing record for June 23, 1999 on "Providing Tax Relief to Strengthen The Family and Sustain a Strong Economy."

In addition, I am cosponsoring HR 1389 with Mr. Manzullo, and I hope that the Ways and Means Committee will give full consideration to this measure in this session of Congress.

Thank you for your consideration on this important matter.

Sincerely,

ROBERT T. MATSUI
Member of Congress

STATE OF CALIFORNIA
CALIFORNIA COMMUNITY COLLEGES
CHANCELLOR'S OFFICE
Sacramento, CA 95814–3607
June 21, 1999

The Honorable Donald Manzullo
United States House of Representatives
Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Manzullo:

I am writing to thank you for your continuing efforts to repeal provisions of the Taxpayer Relief Act of 1997 (TRA) that require institutions of higher education to devote significant resources to providing data to the Internal Revenue Service in a manner that is inconsistent with serving student needs. The California Community Colleges are strong supporters of H.R. 1389, the Higher Education Reporting Relief Act, and I am anxious to do whatever I can to help you and Congressman Matsui secure passage of this legislation in the 106th Congress.

The California Community Colleges are eager to assist all students who can qualify for the higher education tax benefits to take advantage of them. However, current law requires the colleges to file an information return with the IRS, supplying a copy to the student or to the taxpayer who claims the student as a dependent, for all students from whom tuition and fees were received in the tax year. This requirement is imposed without regard to whether the students will be eligible for the tax credits or will choose to take advantage of them. This reporting standard has created a problem for all postsecondary institutions, but nowhere is the inefficiency of the statutory approach more clear than in the California Community Colleges system, where colleges are required to report on more than 2 million students but, because of our uniquely low enrollment fees, only one-third of those students are likely to claim the tax credits. My office has estimated that the annual accounting, system programming, printing, mailing, and student services support costs to comply with these requirements is likely to average $108,000 for each of the 106 California Community Colleges. Thus the colleges in our system are expected to spend more than $11 million per year in order to provide less than $51 million in student tax benefits.

I am attaching a table that displays our calculation of tax credit utilization and reporting costs. Based on consultation with management information systems staff in my office, I also want to briefly outline where we see the major data processing costs arising and delineate our concerns about the usefulness of the data we will provide so that you will better understand the problems that institutions like ours are facing and the weaknesses in the current statutory reporting approach.

Detailed Issues:

IDENTIFYING STUDENTS IN THEIR FIRST TWO YEARS OF POSTSECONDARY EDUCATION

Institutions are required to indicate those students who, as of the beginning of the taxable year, have not completed the first two years of postsecondary education at an eligible educational institution. Colleges cannot accurately determine who those students are because a student may have taken units at other colleges, may have taken advanced placement courses in high school, may be concurrently enrolled in more than one college, may have changed majors, and may have even completed a degree at another institution before enrolling at a community college. Unless a student's prior units are applicable to their current educational objective, colleges do not record their postsecondary history. Therefore, community colleges are likely to report all enrolled students in this category, since we do not provide programs that extend beyond the first two years of postsecondary education. This calls into question the validity of the assumptions about Hope tax credit eligibility the IRS can make from the data.

EXCLUDING CERTAIN TYPES OF STUDENTS

The statute excludes from eligibility students who have been "convicted of a federal or state felony offense for the possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed." Colleges do not have access to this kind of law enforcement information and will report students to the IRS who may fall into this category.

IDENTIFYING STUDENTS WHO ARE ENROLLED IN AN ELIGIBLE DEGREE OR CERTIFICATE PROGRAM

The California Community Colleges do not enroll students into specific programs, but rather provide the opportunity for students to fulfill a variety of educational objectives. From an information systems perspective, the determination as to whether or not a student is enrolled in a degree or certificate program is not made until the student has completed the program. While financial aid and counseling offices monitor students' progress toward a specific goal within an eligible program for the 15 percent of students who receive federal Title IV student financial aid, there is no mechanism to make an accurate determination about enrollment in a specific program for the general student population.

EXCLUSION OF FEES FOR CERTAIN COURSES

The statute and IRS guidelines provide that "qualified tuition and related expenses" does not include expenses that relate to any course of instruction that involves sports, games, or hobbies unless the course is part of the student's degree program or, in the case of the Lifetime Learning tax credit, the student is enrolled in the course to acquire or improve job skills. Colleges have no mechanism to make this determination on a student-by-student basis and are likely to report all instructional fees as "qualified tuition and related expenses." Thus, the IRS will not have reliable data on which to determine tax credit eligibility.

RECONCILING THE ACADEMIC YEAR AND THE TAX YEAR

Virtually all college record-keeping is on a term and academic year basis. Extensive programming is required to conform student fee and financial aid data to a calendar year/tax year reporting schema. Accomplishing this is complicated by the fact that a student may pay fees in one calendar year for a term that begins in the next calendar year and then, because enrollment fees are charged on a per-unit basis, receive a refund of some or all of their fees in the next calendar year if their enrollment plans change. Taxpayers in 1999 and subsequent years will be required to report refunds of amounts claimed as "qualified tuition and related expenses" in a prior tax year; they may also report any reduction of previously reported educational assistance. Under current statute, colleges can be required to annually report both types of prior-year adjustments, necessitating additional expansion of institutional recordkeeping. Because the reporting timeframe required by the IRS occurs in the middle of the adjustment period for the typical fall term (January and February), adjustments after the tax year will be the norm rather than an exception.

AGGREGATING "QUALIFIED TUITION AND RELATED EXPENSES"

The IRS Restructuring and Reform Act of 1998 (H.R. 2676) responded to college concerns about their ability to report net out-of-pocket expenses as required in the original statue by defining "qualified tuition and related expenses" as a distinct element and limiting institutional responsibility for reporting educational assistance that offsets tax credit eligibility to grants processed through the institution. However, reporting "qualified tuition and related expenses" in a single record for each student remains problematic because community colleges frequently maintain separate components, such as extension campuses, noncredit programs, community service courses, contract education, and others, that are not unified into a single database or information system. Bringing those together and reporting a single student record to the IRS requires extensive systems development and programming. Although the H.R. 2676 Conferees authorized the Treasury to exempt colleges from filing information returns for non-degree students enrolled exclusively in non-credit courses, and IRS interim guidelines did not require the reporting of any fee information for 1998, institutions are not free to exclude community service and other noncore enrollments from their TRA databases because a credit-enrolled student who is also taking a non-credit community service class is entitled to include the community service course fees as part of "qualified tuition and related expenses."

MATCHING TAXPAYERS AND STUDENTS

The statutory requirement that colleges provide information returns to taxpayers who are not students but are eligible to claim a Hope or Lifetime Learning tax credit for a dependent student assumes that colleges posses information that is not collected. If students are required to provide eligible taxpayer information to colleges as a condition for the 1098–T to be sent to the taxpayer, it will involve creation of a database that colleges need for no other purpose and will increase programming and mailing costs. If colleges are required to assertively collect eligible taxpayer information from all students in order to comply with the letter of current statute, those costs will be magnified. This is a clear example of burden that should appropriately be placed on the Treasury being diverted to colleges and universities.

INTERIM GUIDELINES AND INCREMENTAL IMPLEMENTATION ADDS TO TOTAL COSTS

Colleges are grateful for Congressional efforts and the Treasury Secretary's willingness to delay full implementation of the TRA reporting requirements, and appreciate the intent that issues of institutional cost and burden be taken into consideration as final regulations are drafted. However, colleges have been put in the position of having to simultaneously comply with IRS interim requirements that are inconsistent with the statute; anticipate, as institutional systems are developed, future IRS requirements based on the statute; and be responsive to students and parents seeking information needed in the preparation of their tax returns. These functions are not complementary. For example, interim IRS guidelines relieved colleges of the statutory responsibility to include financial information on the 1998 1098–T forms provided to students, but required them to send the forms to virtually all students, including hundreds of thousands of students in our system with no or minimal tax credit eligibility. Because colleges were required to include a college telephone number for taxpayers to seek additional information, colleges had to have available for students, parents, and professional tax preparers the financial information that IRS did not require. Furthermore, college personnel had to respond to inquiries from ineligible taxpayers who assumed the tax credit was available to them because they received the 1098–T form.

I have heard it suggested that full implementation of the statutory reporting requirements should simply be delayed for another year, but that provides a solution for no one. From our perspective, colleges and universities will continue to be in an untenable position until their responsibilities under the TRA are clearly defined. And from what I understand to be the Treasury's perspective, while the extensive institutional reporting requirements in the TRA were designed to prevent widespread taxpayer fraud, information received by the IRS under the interim reporting procedures does little more than confirm a taxfiler's college enrollment. If enrollment verification is sufficient to meet the Treasury's needs, there are much simpler and less costly ways to achieve that objective than what is currently required.

Repeal of the TRA institutional reporting requirements would allow colleges to focus their efforts on providing information about the tax credits to students and parents and assisting those that can benefit from them to obtain the information necessary to claim them. The California Community Colleges, operating on the lowest margin of revenues per student of any public institutions of higher education in the nation, simply cannot afford to expend resources that do not contribute to the educational programs and services needed by our students without there being consequences for student access and program quality. The resources we are now forced to divert to serving the needs of the IRS represent resources that are denied to our students. Passage of the Higher Education Reporting Relief Act will result in better service to those students and families who will actually benefit from the higher education tax credits and enable colleges to focus their efforts on fulfilling their educational missions. Please be assured that I will make every effort to help you gain its passage.

If my office can be of any assistance to you as this legislation advances, please do not hesitate to contact me directly or contact Linda Michalowski, Director of Federal Relations, at (916) 327–0186. You can also feel free to call on Bob Canavan at our Federal Liaison Office at (202) 462–5911.

Sincerely,

THOMAS J. NUSSBAUM
Chancellor

cc: The Honorable Robert Matsui
Board of Governors President Schrimp
Vice Chancellor Walters

Statement of National Association of Home Builders

On behalf of the 197,000 member firms of the National Association of Home Builders (NAHB), we would like to express our support for Chairman Archer (R–TX) convening a hearing on proposals that would reduce the tax burden on individuals and businesses. NAHB appreciates the Chairman's willingness to listen to the concerns of individuals, businesses and organizations such as ours on the tax proposals that reduce the burden on our members the most.

INCREASE THE ANNUAL STATE AUTHORITY FOR THE LOW INCOME HOUSING TAX CREDIT

NAHB's top tax policy priority for the 106th Congress is to increase the annual state authority for the Low Income Housing Tax Credit (LIHTC) to $1.75 per capita. The current LIHTC cap of $1.25 per capita has not been adjusted since the program's inception in 1986, while inflation has eroded the credits' purchasing power by approximately 45%. As a result, twelve million American households eligible for this program are not benefiting and are still paying too much of their income for rent or living in substandard housing. Therefore, the need for an increase in the credit is critical.

NAHB therefore, endorses H.R. 175, introduced by the Chair of the House Ways and Means Subcommittee on Human Resources, Representative Nancy Johnson (R–CT) along with Ranking Member Charles Rangel (D–NY). H.R. 175 or "The Affordable Housing Opportunity Act of 1999," will increase the annual authority for the Low Income Housing Tax Credit program from $1.25 per capita to $1.75 per capita and index the amount for inflation. The bill currently has 324 cosponsors including 74% (29 of the 39 members) of the Ways and Means Committee. Additionally, an identical bill in the Senate, S. 1017, was introduced by Senators Connie Mack (R–FL) and Bob Graham (D–FL) and has 61 cosponsors including 60% of the Finance Committee.

Created by Congress in 1986 and made permanent in 1993, the Low Income Housing Tax Credit is the nation's primary tool for building affordable rental housing. It is responsible for having produced 95% of all units and over 900,000 homes. The LIHTC has also been a cornerstone of revitalization in low-income communities and contributes to economic growth, generating approximately 70,000 jobs, $2.3 billion in wages and $1.2 billion in federal, state and local taxes annually.

Reforms to the Low Income Housing Tax Credit Program

Rep. Nancy Johnson is planning to introduce another bill that will increase the LIHTC to $1.75 per capita and reform the program. NAHB would like to include a reform in this bill that would level the playing field between non-profits and for profit developers of low income housing credit projects.

NAHB would like to minimize the taxpaying status of the sponsor as a factor in determining LIHTC allocations without eliminating the 10% set aside for nonprofit organizations. In 1997, 24 states had more than 30% of their LIHTC allocations go to non-tax paying entities, 10 states had more than 50% go to non-profits, 7 of which allocated over 70% of their credits to non-profit sponsors. These numbers show that most non-profit sponsors can compete head-to-head with taxpaying developers without preferential treatment. As a result, Rep. Nancy Johnson proposes to eliminate the additional selection criteria preference for non-profits in Section 42(m)(1)(C) of the Code without eliminating the current 10% set-aside for non-profit developers. NAHB has agreed with this concept and fully supports Rep. Nancy Johnson's efforts.

Another programmatic reform that NAHB would like to see included in this year's tax package is a provision to provide finality for the amount of tax credits issued by the state agencies. The LIHTC program provides to each state a limited amount of tax credits that are used to finance, in part, the building of affordable housing. Developers of Section 42 affordable housing must submit to an underwriting process by the state allocating agency at three different times in order to be awarded housing tax credits. The three determinations include an assessment of all the sources of financing and the total development costs for the project. This assessment of sources and uses results in a calculation by the state as to the minimum amount of credits necessary to fill the "funding gap" to make the project financially viable. Once the state agency issues the final amount of tax credits, in the form of an 8609 determination, the developer then sells those credits to investors at a discount which raises the necessary equity funds to build the project.

The continued success of the program is dependent upon the certainty, stability and finality of the tax credit allocations by the state. However, the certainty, and therefore viability, of the LIHTC has been threatened by the IRS, which has begun auditing LIHTC projects and recalculating the amount of credits awarded by the state causing instability for the affordable housing credit industry.

Recently, the IRS released a new LIHTC Audit Guide which makes it clear that the IRS will not treat allocations of the tax credits by state agencies as final. In its 1989 amendments to the housing credit program, Congress imposed on state agencies the burden of determining the appropriate amount of credit. Over the last two years, the IRS has begun second guessing state allocations by auditing projects and reevaluating the amount of credits awarded by the state agencies. This has resulted in the retroactive recalculation of what costs are included and excluded in the "formula" used to determine the appropriate amount of tax credits that can be claimed by an applicant.

This retroactive recalculation and ultimate recapture of tax credits by the IRS is unfair and contravenes congressional intent. The states received the affordable housing units for the tax credits issued and the IRS is coming in to reclaim the tax credits after the public benefit intended by Congress has been bestowed by the private sector. There are no assertions by the IRS that the housing has not been occupied by qualified low income residents or that the costs in dispute have not or should not have been incurred. It is simply an after the fact calculation of which costs were included in the "eligible basis."

The LIHTC program must have a certain and predictable base for making the calculation of the amount of tax credits that any project may need. The "eligible basis" concept in Section 42 involves many factual determinations and potential disputes over whether a cost associated with a project is either "eligible" or "ineligible" for inclusion in the calculation of the basis. The largest area of dispute with the IRS has been professional and developer fees. The IRS is taking a position that certain portions of the developer and professional fees should not be considered eligible for tax credit equity financing. This has not been the practice in the affordable housing industry and if true, would not produce enough credit equity funds to finance the building of most projects. By excluding portions of developer and professional fees, the IRS is creating instability and uncertainty about credit allocations. When allocations are uncertain, it threatens the continued viability of the program and must be addressed now in order to prevent the capital markets from fleeing the industry.

IMPACT OF THE NEW IRS AUDIT GUIDE

The result of some IRS audits has been a recapture of tax credits which does not increase funds for affordable LIHTC housing. A recapture by the IRS does not return the funds to the states for reallocation. Therefore, no increased affordable housing results and the recaptured credits are lost from the housing program completely.

When the formula for tax credit allocations is uncertain, the allocations are unstable. Without the reliability of allocations, the ability to plan for the development of housing with private financing is restrained. The success of the LIHTC program depends on leveraging private corporate funds to produce affordable housing that reaches a policy goal set by Congress. Private capital and capital markets, however, are very sensitive to risks and potential risks. Therefore, the possibility that an IRS audit will result in the recapture of tax credits may have a negative influence on the capital markets and cause potential investors to flee the market based on the perception of the high risk of recapture.

In addition to a slow down or reduction in capital flows to LIHTC projects, the prices paid for credits may decline to compensate for the increased risk of recapture and loss of credits to the investor. When the discount paid by investors increases and the price for credits declines, there will be fewer housing units or lesser quality units built for the same revenue offset to the Treasury.

THE SOLUTION

The housing credit industry needs a legislative solution that defines what is in, or out of, eligible basis for purposes of calculating the 8609 tax credit allocation. As a result, NAHB would like to work with Congress to develop a legislative proposal that does the following three things: 1) increases certainty for determining eligible basis and hence tax credit allocations, 2) protects existing tax credit allocations and 3) provides finality for future tax credit allocations.

NAHB believes that as a part of the solution Congress should provide legislative finality in the area that has the largest potential for tax credit recalculation and recapture and limit the amount of retroactive recaptures. Thus, NAHB would like Congress to clarify that reasonable fees for development, architectural and other services are included in a building's adjusted basis, without regard to whether a portion of the services involved might be attributable to aspects of the development process which are not includable in basis. In doing so, Congress would recognize that these types of services performed in the course of a project's development are, in themselves, critical to the production of qualified low-income housing projects, and therefore, that the reasonable fees for such services are properly chargeable to capital accounts and includable in eligible basis. Although a particular element of a developer's, contractor's or architect's services, for example, may involve an aspect of the development process which is not, itself, includable in depreciable basis (e.g., landscaping or obtaining financing) does not make the particular services less important to the project or less appropriate for treatment as capitalized costs. Congress must clarify that it expects that, in determining the reasonableness of fees, the Treasury Department will be guided by the policies and determinations of the housing credit agency with authority over the building(s) at issue.

Additionally, NAHB would like Congress to make final the state agencies determination that a building was developed in a timely manner in accordance with the requirements of the Code. The purpose of the 10% test and the two year in-service rule of Code section 42(h)(1)(E) is to assure that projects receiving carryover allocations of tax credit authority are ready to proceed and will be placed in service in a timely fashion. Once a project is actually placed in service, these objectives have been achieved. Congress should make it clear that after a housing credit agency determines that a building has been placed in service, the allocation to that building may not be challenged, absent fraud, on the technical ground of a deficiency in the carryover allocation. Adoption of this solution will provide greater certainty to investors, thereby increasing the efficiency of the tax credit, and will reduce legal fees and other transactional costs.

NAHB would like to work with Congress in formulating a legislative solution to resolve these issues and ensure the continued success and viability of the LIHTC program.NAHB would like to work with Congress in formulating a legislative solution to resolve these issues and ensure the continued success and viability of the LIHTC program.

Private Activity Bond Increase

NAHB also supports H.R. 864, introduced by Representative Amo Houghton Jr. (R–NY), Chair of the House Ways and Means Subcommittee on Oversight. H.R. 864 will increase the private activity bond cap to $75 per resident or $255 million, if greater, and index it for inflation by the year 2000. Senators John Breaux (D–LA) and Orrin Hatch (R–UT) introduced S. 459 an identical bill in the Senate.

Currently the Internal Revenue Code limits the amount of tax-exempt private activity bonds that each state may issue to $50 per resident of the state, or $150 million if greater. This cap is severely restricting the ability of states and localities to meet pressing housing, economic development, and other investment needs of the citizens and communities.

Although last year the private activity bond cap was increased, it does not begin to take effect until 2003. The 1998 Omnibus Appropriations Bill, H.R. 4328, increased the state private activity bond cap to $55 per capita or $165 million starting in 2003 with a phased in increase to $75 per capita or $225 million annually by 2007 for each state. This increase is too slow to keep up with the growing need for private activity bonds.

The demand for private activity bonds far exceeds the supply in most states, leaving many individuals without an opportunity to achieve the American dream of home ownership. One example is the overwhelming demand in almost every state for Mortgage Revenue Bonds (MRBs), issued primarily by state housing finance agencies (HFAs) to finance modestly-priced, first time homes for lower income families. According to the National Council of State Housing Agencies (NCSHA), in 1996, state HFAs issued almost $7.5 billion in MRBs for nearly 100,000 mortgages. The NCSHA estimates that in 1996, State HFAs could have used an additional $2 billion in bond cap authority. Unfortunately, this causes home ownership to remain out of reach for thousands of other families many of which could be better served by the MRB program.

Energy Efficiency Homes Tax Credit

Another NAHB tax policy priority is H.R. 1358, "the Energy Efficiency Affordable Home Act of 1999" which was introduced by Congressman Bill Thomas (R–CA), a member of the House Ways and Means Committee. This bill provides a flat $2000 tax credit for the purchase of any new energy efficient home that exceeds the 1998 International Energy Conservation Code (IECC) by 30%. It also offers a credit of 20% for the cost of an upgrade project, up to $2000, for a homeowner who upgrades the energy efficiency of his or her home by 30%. NAHB supports this bill because it encourages voluntary energy efficiency, provides for a cleaner environment, lower utility costs and reduced carbon emissions and pollution.

The Clinton Administration is also interested in this issue and has proposed its own tax credit proposal; however, the amount of the credit is tiered to reflect the energy efficiency level achieved over the IECC. Also, the administration's proposal does very little to address existing home energy efficiency. Last year, Representative Robert Matsui (D–CA) introduced the administration's proposal.

Contributions in Aid of Construction

Finally, Congress should also include a change in this year's tax bill that would treat Contributions in Aid of Construction (CIAC) as non-taxable contributions to capital. The taxation of CIAC creates an unnecessary and unfair burden on economic growth. It requires utilities to pay taxes on the contributions of land and utility infrastructure from the builders which raises the ultimate price of the utility to the customer.

Prior to 1986, CIAC were considered non-taxable events. However, the Tax Reform Act of 1986 changed the treatment of CIAC by making those capital contributions taxable income to the utility. The result of the CIAC tax has been the increased cost of new development for both private and public facilities by more than 50 percent. CIAC taxes tax-exempt entities such as municipal governments, school districts, charitable institutions and even the federal government.

In many states, the utility is required to assess the CIAC tax on the capital contribution at the time of the contribution or payment. The result is that when a new customer pays the cost or contributes property to connect to the utility system, that cost to the customer must be "grossed up" to cover the utility's tax liability. The amount of the gross up varies with federal and state tax rates, but it can increase the cost by over 50 percent. In other states, the utility may pass CIAC tax onto its other customers in higher utility bills. In both cases, the CIAC tax unnecessarily and improperly increases the cost of extending utility services to new customers on the system. In many cases, the tax is high enough to stop the transaction entirely.

In 1996, Congress reversed the requirement that taxes be paid on CIAC for regulated public utilities providing water and sewage disposal services. NAHB would urge Congress to grant an equal tax exclusion for all CIAC including electric energy and gas distribution.

Independent Contractor Issue

We also want to bring to your attention our opposition to Congressman Kleczka and Houghton's bill, H.R. 1525, the "Independent Contractor Clarification Act." NAHB is opposed to this bill for several reasons. First, this bill will turn back the clock 20 years and undermine the current law regarding whether an individual is an independent contractor or an employee. This bill begins with the statutory presumption that an individual is an employee unless the parties can prove otherwise. Current law is neutral and does not, in theory, present a preference either way although, in practice, there is a bias against independent contractors. By creating a statutory preference towards employees, Congress would ignore a national policy that places the utmost importance and value on independent contractors and the small businesses that utilize their services.

Secondly, the bill provides a three-prong test to determine employment status that does not simplify the test but only complicates it further. The test consists of three elements: the service recipient must lack control, make their services available to others and have entrepreneurial risk. Neither "control" nor "entrepreneurial risk" is defined in the bill. Although the bill repeals the common law test, the new test would be even more subjective than current law, and would create even greater uncertainty and confusion because the new test lacks clear definition and guidance.

Thirdly, the bill repeals Section 530, a safe harbor provision that allows small businesses and the independent contractors they may engage to rely on "long standing industry practice" as a guide to the appropriate classification of individuals. H.R. 1525 repeals Section 530 and replaces it with a narrower safe harbor, reliance on substantial authority. There have been few favorable IRS rulings over the years that might constitute substantial authority. What makes this repeal so damaging is that it will return us to an era when the IRS had the tools, the authority and power to stifle the entrepreneurial spirit or independent contractors and small businesses and was subject to the mercy of the enforcers.

What NAHB and other small businesses are looking for is clarity and surety regarding the classification of the service provider and protection against retroactive reclassification. A bill S. 344, the "Independent Contractor Simplification and Relief Act of 1999" sponsored by Senator Kit Bond does achieve that goal. Please consider other avenues to address worker classification because H.R. 1525 is not the answer.

NAHB appreciates your attention to issues of concern to our members and look forward to changes in the tax code that include the priorities mentioned in this testimony.

Statement of Steven A. Wechsler, National Association of Real Estate Investment Trusts®

As requested in Press Release No. FC–11 (June 9, 1999), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Committee on Ways and Means' review of tax relief proposals to sustain a strong economy. NAREIT thanks the Chairman and the Committee for the opportunity to share its views on several important issues affecting REITs and publicly traded real estate companies.

NAREIT's comments address (1) H.R. 1616, the Real Estate Investment Trust Modernization Act of 1999; (2) the Administration proposals to modify the treatment of closely held real estate investment trusts ('REITs") and amend section 1374 [1] to treat an "S" election by a large C corporation as a taxable liquidation of that C cor-

[1] For purposes of this Statement, "section" refers to the Internal Revenue Code of 1986, as amended.

poration; (3) H.R. 844; and (4) at risk rules applying to nonsecured public debt. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for REITs and publicly traded real estate companies. Members are REITs and publicly traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 200 REITs and publicly traded real estate companies, as well as over 1,600 industry professionals who provide a range of legal, investment, financial and accounting-related services to these companies.

EXECUTIVE SUMMARY

REIT Modernization Act. Congress created REITs in 1960 to make investment in income producing real estate easily and readily available to investors from all walks of life, yet current law prevents REITs from providing needed and emerging services to their tenants, putting them at a competitive disadvantage in the real estate marketplace. In addition, current law requires REITs to use indirect and inefficient methods in order to provide services to third parties. The Administration's Fiscal Year 2000 Proposed Budget contains a proposal to address these issues by authorizing REITs to own and operate taxable REIT subsidiaries. Because it is a better solution to the competitive limitations facing REITs today, NAREIT strongly supports H.R. 1616, the Real Estate Investment Trust Modernization Act of 1999 cosponsored by Messrs. Thomas, Cardin and 31 other members of the House of Representatives.

H.R. 1616 would incorporate the principles of the Administration's Fiscal Year 2000 proposal to allow a REIT to own stock in taxable REIT subsidiaries, with four significant exceptions. First, H.R. 1616 would require taxable REIT subsidiaries to fit within the current, unified 25% asset test, rather than the complex and cumbersome 5% and 15% assets tests under the Administration proposal. Second, H.R. 1616 would limit interest deductions on debt between a REIT and its taxable subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intraparty interest deductions. Third, H.R. 1616 would prohibit a taxable REIT subsidiary from operating or managing hotels, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at market levels, (b) the rents are not tied to net profits, and (c) the hotel is operated or managed by an independent contractor. Fourth, H.R. 1616 would not apply the new rules on taxable REIT subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects taxable REIT subsidiary status for its existing third party subsidiaries. Conversely, the Administration proposal would apply to current arrangements after an undefined period of time. H.R. 1616 also would make other beneficial and modernizing changes to the REIT tax rules, such as restoring the distribution requirement to 90% from 95%.

Closely Held REITs. The Administration proposes to prevent any entity from owning 50% or more of the vote or value of a REIT's stock. NAREIT supports the Administration's intention to craft a new ownership test intended to correspond to a REIT's primary mission: to make investment in income-producing real estate accessible to ordinary investors. However, we believe that the Administration's proposal is too broad, and therefore should be narrowed to prevent only non-REIT C corporations from owning 50% or more of a REIT's stock (by vote or value). In addition, the new rules should not apply to so-called "incubator REITs" that have proven to be a viable method by which small investors can access publicly traded real estate investments.

Built-in Gain Tax. The Administration proposes to deny S corporations, mutual funds and REITs worth more than $5 million from using the 10-year deferral rule under section 1374. Congress has rejected the Administration's call for a change in the section 1374 rules for three straight budgets. NAREIT recommends that Congress again reject this proposal. We also ask Congress to conduct oversight of the IRS to ensure that it does not do administratively what it has not been able to achieve by legislation.

Tenant Improvements. NAREIT strongly supports H.R. 844, which would change the depreciation period of certain tenant improvements to 10 years to better approximate their true economic lives.

At Risk Rules. NAREIT urges Congress to update the qualified nonrecourse financing rules to include publicly traded debt.

BACKGROUND ON REITS

A REIT is a corporation or business trust combining the capital of many investors to own, operate or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95% of their taxable income to shareholders; (2) most of a REIT's assets must be real estate; (3) REITs must derive most of their income from real estate held for the long term; and (4) REITs must be widely held.

In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to meet their business needs. Instead, capital for growth and significant capital expenditures largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

Despite the purpose of the REIT structure, the industry experienced very little growth for over 30 years mainly for two reasons. First, at the beginning REITs were seriously constrained by policy limitations. REITs were mandated to be passive portfolios of real estate. REITs were permitted only to own real estate, not to operate or manage it. This meant that REITs needed to use third party independent contractors, whose economic interests might diverge from those of the REIT's owners, to operate and manage the properties. This was an arrangement the investment marketplace did not accept readily or warmly.

Second, during these years the real estate investment landscape was colored by tax shelter-oriented characteristics. Through the use of high debt levels, which created artificial bases for depreciation, interest and depreciation deductions significantly reduced taxable income—in many cases leading to so-called "paper losses" used to shelter a taxpayer's other income. Since a REIT is geared specifically to create "taxable" income on a regular basis and a REIT, unlike a partnership, is not permitted to pass "losses" through to its owners, the REIT industry could not compete effectively for capital against tax shelters.

In the Tax Reform Act of 1986 (the "1986 Act"), Congress changed the real estate investment landscape. On the one hand, by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses," the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant, going forward, that real estate investment needed to be on a more economic and income-oriented footing.

On the other hand, as part of the 1986 Act, Congress modified a significant policy constraint that had been imposed on REITs at the beginning. The Act permitted REITs not merely to own, but also to operate and manage most types of income producing commercial properties by providing "customary" services associated with real estate ownership. Finally, for most types of real estate (other than hotels, health care facilities and some other activities that consist of a higher degree of personal services), the economic interests of the REIT's shareholders could be merged with those of the REIT's operators and managers.

Despite Congress' actions in 1986, significant REIT growth did not begin until 1992. One reason was the real estate recession in the early 1990s. Until the late 1980s banks and insurance companies kept up real estate lending at a significant pace. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990 the combined impact of the Savings and Loan crisis, the 1986 Act, overbuilding during the 1980s by non-REITs and regulatory pressures on bank and insurance lenders, led to a nationwide depression in the real estate economy. During the early 1990s commercial property values dropped between 30 and 50%. Credit and capital for commercial real estate became largely unavailable. As a result of this capital crunch, many borrowers defaulted on loans, resulting in losses by financial institutions and expense to the federal government.

Against this backdrop, starting in 1992, many private real estate companies realized that the best and most efficient way to access capital was from the public marketplace utilizing REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate—assuming recovering real estate markets were just over the horizon. They were right.

Since 1992, the REIT industry has attained impressive growth as new publicly traded REITs infused much needed equity capital into the over-leveraged real estate industry. Today there are over 200 publicly traded REITs with an equity market capitalization exceeding $150 billion. These REITs are owned primarily by individuals, with 49% of REIT shares owned directly by individual investors and 37% owned by mutual funds, which are owned mostly by individuals. But REITs certainly do not just benefit investors.

The lower debt levels associated with REITs compared to real estate investment overall have had a positive effect throughout the economy. Average debt levels for REITs are 40–50% of market capitalization, compared to leverage of 75% and often higher used when real estate is privately owned. The higher equity capital cushions REITs from the negative effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs better to withstand market downturns should have a stabilizing effect on the real estate industry and its lenders, resulting in fewer future bankruptcies and work-outs. Consequently, the general economy will benefit from reduced real estate losses by federally insured financial institutions.

Consistent with the policy underlying the REIT rules, many believe that, over time, the U.S. commercial real estate economy will move toward more and more ownership by REITs and publicly traded real estate companies. Yet, future growth may be significantly limited by the inability of REITs under current law to be able to provide more services to their tenants than they are currently allowed to perform. Although the 1986 Act largely married REIT management to REIT assets and the Taxpayer Relief Act of 1997 included additional helpful REIT reforms, REITs still must operate under limitations that increasingly will make them non-competitive in the emerging, customer-oriented real estate marketplace. NAREIT looks forward to working with Congress and the Administration further to modernize and improve the REIT rules so that REITs can continue to offer investors from all walks of life opportunities for rewarding investments in income-producing real estate.

I. REIT MODERNIZATION ACT OF 1999

A. Taxable REIT Subsidiaries

As part of the asset diversification tests applied to REITs, a REIT may not own more than 10% of the outstanding voting securities of a non-REIT corporation pursuant to section 856 (c)(5)(B).[2] The Administration's Fiscal Year 1999 Budget proposed to amend section 856(c)(5)(B) to prohibit REITs from holding stock possessing more than 10% of the vote *or* value of all classes of stock of a non-REIT corporation.[3] The Administration's Fiscal Year 2000 Budget proposed an exception to this vote or value rule for taxable REIT subsidiaries.

1. *Background and Current Law*. The activities of REITs are strictly limited by a number of requirements that are designed to ensure that REITs serve as a vehicle for public investment in real estate. First, a REIT must comply with several income tests. At least 75% of the REIT's gross income must be derived from real estate, such as rents from real property, mortgage interest and gains from sales of real property (not including dealer sales). In addition, at least 95% of a REIT's gross income must come from the above real estate sources, dividends, interest and sales of securities.

Second, a REIT must satisfy several asset tests. On the last day of each quarter, at least 75% of a REIT's assets must be real estate assets, cash and government securities. Real estate assets include interests in real property and mortgages on real property. As mentioned above, the asset diversification rules require that a REIT not own more than 10% of the outstanding voting securities of an issuer (other than a qualified REIT subsidiary under section 856(i)). In addition, no more than 5% of a REIT's assets can be represented by securities of a single issuer (other than a qualified REIT subsidiary).

---

[2] The shares of a wholly-owned "qualified REIT subsidiary" ("QRS") of the REIT are ignored for this test.

[3] Since it is a disregarded entity for tax purposes, a qualified REIT subsidiary would be excepted from the requirement that a REIT not own more than 10% of the vote or value of another corporation.

REITs have been so successful in operating their properties and providing permissible services to their tenants that they have been asked to provide these services to non-tenants, utilizing expertise and capabilities associated with the REIT's real estate activities. In addition, mortgage REITs are presented with substantial opportunities to service the mortgages that they securitize. The asset and income tests, however, restrict how and to what extent REITs can engage in these activities. A REIT can earn only up to 5% of its income from sources other than rents, mortgage interest, capital gains, dividends and interest. However, many REITs have had the opportunity to maximize shareholder value by earning more than 5% from third party services.

Starting in 1988, the Internal Revenue Service ("IRS") issued private letter rulings to REITs approving a structure to facilitate a REIT providing a limited amount of services to third parties.[4] These rulings sanctioned or permitted a structure under which a REIT owns no more than 10% of the voting stock and up to 99% of the value of a non-REIT corporation through nonvoting stock. Usually, managers or shareholders of the REIT own the voting stock of the "Third Party Subsidiary" ("TPS," also known as a "Preferred Stock Subsidiary"). The TPS typically either provides to unrelated parties services already being delivered to a REIT's tenants, such as landscaping and managing a shopping mall in which the REIT owns a joint venture interest, or engages in other real estate activities, such as development, which the REIT cannot undertake to the same extent. A TPS of a mortgage REIT typically services a pool of securitized mortgages and sells mortgages as part of the securitization process that has the effect of lowering homeowners' interest rates.

The REIT receives dividends from the TPS that are treated as qualifying income under the 95% income test, but not the 75% income test.[5] Accordingly, a REIT continues to be principally devoted to real estate operations. While the IRS has approved using the TPS for services to third parties and "customary" services to tenants the REIT could otherwise provide, the IRS has not permitted the use of these subsidiaries to provide impermissible, non-customary real estate services to REIT tenants.[6]

2. *Administration Proposal*. In 1998, the Administration proposed changing the asset diversification tests to prevent a REIT from owning securities in a C corporation that represent 10% of either the corporation's vote *or* its value. The proposal would have applied with respect to stock acquired on or after the date of first committee action. In addition, to the extent that a REIT's ownership of TPS stock would have been grandfathered by virtue of the effective date, the grandfather status would have terminated if the TPS engaged in a new trade or business or acquired substantial new assets on or after the date of first committee action.

In its Fiscal Year 2000 Budget, the Administration again proposed to base the 10% asset test on either vote or value. However, it also proposes an exception for two types of taxable REIT subsidiaries ("TRS"). A qualified business subsidiary ("QBS") would be the successor to the current TPS and could engage in the same activities as can a TPS today. A REIT could not own more than 15% of its assets in QBSs. The second type of TRS would be a qualified independent contractor subsidiary ("QIKS"), which could provide non-customary services to the affiliated REIT's tenants. A REIT could not own more than 5% of its assets in QIKSs as part of its 15% TRS allocation.

Under the Administration's proposal, a TRS could not deduct any interest payments to its affiliated REIT, and 100% excise tax penalties would be imposed to the extent that any pricing between a TRS and either its affiliated REIT or that REIT's tenants was not set on an arms'-length basis. The new TRS rules would apply to all existing TPSs after a time period to be determined by Congress.

3. *Statement in Support of H.R. 1616*. The REIT industry has grown significantly during the 1990s, from an equity market capitalization under $10 billion to over $150 billion. The TPS structure is used extensively by today's REITs and has been a small, but important, part of recent industry growth. These subsidiaries help ensure that the small investors who own REITs are able to maximize the return on their capital by taking full economic advantage of core business competencies developed by REITs in owning and operating the REIT's real estate or mortgages. The Administration appropriately recognized that it makes sense to allow a REIT to uti-

[4] PLRs 8825112, 9340056, 9428033, 9431005, 9436025 9440026. *See also* PLRs 9507007, 9510030, 9640007, 9733011, 9734011, 9801012, 9808011, 9835013.

[5] The REIT does not qualify for a dividends received deduction with respect to TPS dividends. I.R.C. § 857(b)(2)(A).

[6] *But see* PLR 9804022. In addition, the IRS has been flexible in allowing a TPS to engage in an "independent line of business" in which it provides a service to the public and a minority of the users are REIT tenants. *See*, *e.g.*, PLRs 9627017, 9734011, 9835013.

lize these core competencies through taxable subsidiaries so long as the REIT remains focused on real estate and the subsidiary's operations are appropriately subject to a corporate level tax.

In addition, the Administration's proposal recognizes that the REIT rules need to be modernized to permit REITs to remain competitive. By virtue of the "customary" standard in defining permissible REIT rental activities, REITs must wait until their competitors have established new levels of service before providing that service to their customers. This "lag effect" assures that REITs are never leaders in their markets, but only followers, to the detriment of their shareholders. Under the Administration proposal, the REIT could render such services to its tenants through a subsidiary that is subject to corporate tax.

The Administration's TRS proposal is a serious and very significant step in the right direction, but NAREIT requests Congress instead to enact H.R. 1616. This bill parallels the Administration's subsidiary proposal, but improves and clarifies this concept in four major ways.

First, H.R. 1616 would require taxable REIT subsidiaries to fit within the current, unified 25% asset test, rather than the unnecessarily complex and cumbersome 5% and 15% assets tests under the Administration proposal described above. Requiring two types of TRSs would cause severe complexity and administrative burdens, such as allocating costs between a QBS and a QIKS without incurring a 100% excise tax. Further, the Code should encourage, rather than prohibit, the same TRS providing the same service to its affiliated REIT's tenants and to third parties to make it easier to ensure that the pricing of those services is set at market rates. Moreover, the 5% and 15% limits are unnecessarily restrictive given the fact that the subsidiary is subject to a corporate level tax on all of its activities. H.R. 1616 adopts the better approach of treating TRS stock as an asset that must fit within the current 25% basket of non-real estate assets a REIT that can own, along with other non-real estate assets such as personal property.

Second, H.R. 1616 would limit interest deductions on debt between a REIT and its taxable REIT subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intra-party interest deductions. Congress confronted very similar earnings stripping concerns in the 1980s with respect to foreign organizations and their U.S. subsidiaries and resolved those concerns by enacting section 163(j). This section permits interest deductions on objective, modest amounts of related party debt. Section 163(j) is easily implemented, and guidance has been provided by final regulations. H.R. 1616 would adopt even stricter rules for REITs and their subsidiaries by limiting the interest deductions to market rates, or else suffer a 100% excise tax. Clearly, REITs should not be forced to comply with an absolute denial of legitimate interest deductions when foreign organizations in similar circumstances are not so limited.

Third, the Administration's proposal does not address whether REITs could use a TRS to own or operate hotels or health care facilities. H.R. 1616 would prohibit a taxable REIT subsidiary from operating or managing hotels and health care facilities, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at market levels, (b) the rents are not tied to net profits, and (c) the hotel is operated or managed by an independent contractor.

Fourth, H.R. 1616 would not apply the new rules on subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects, on a timely basis, taxable REIT subsidiary status for such TPS. Conversely, the Administration proposal would become effective after an undefined period of time. REITs have planned their operations based on IRS rulings starting in 1988 that have sanctioned or permitted TPSs and should not be penalized for following established policy. H.R. 1616 would adopt the approach to an effective date contained in last year's Administration's budget proposals that acknowledged the IRS' earlier acquiescence to the TPS structure.

Other Provisions in H.R. 1616

NAREIT strongly endorses the other important modernization provisions contained in H.R. 1616: (1) restoration of the distribution requirement to the 90% level that applied to REITs from 1960 to 1980 (and that has at all times applied to mutual funds); (2) providing more flexibility for a REIT to hire an independent contractor to operate nursing homes, etc. without a lease for up to six years when the REIT takes back a health care property at the end of a lease and cannot re-lease it; (3) in the case of a publicly traded corporation being tested as an independent contractor, H.R. 1616 only would examine shareholders owning more than 5% of the corporation's stock; and (4) to prevent some traps for the unwary, H.R. 1616 would make some technical changes about how a company computes pre-REIT earnings and profits that it must distribute to its shareholders after electing REIT status or having a C corporation merge into it.

II. OTHER ADMINISTRATION PROPOSALS AFFECTING REITS

A. *Closely Held REITS*

The Administration's Fiscal Year 2000 Budget proposes to add a new rule, creating a limit of less than 50% on the vote or value of stock any entity could own in any REIT.

1. *Background and Current Law*. As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer individuals cannot own more than 50% of a REIT's stock.[7] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership of the stock by individuals. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders. Both tests do not apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of each subsequent taxable year of the REIT.

The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs doing "step-down preferred" transactions for various tax planning purposes, which the Administration finds abusive, such as the "liquidating REIT" structure curtailed by the 1998 budget legislation.[8] The Administration proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" (*i.e.*, a corporation, partnership or trust, including a pension or profit sharing trust) from owning stock of a REIT possessing 50% or more of the total combined voting power of all classes of voting stock or 50% or more of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

Statement Providing Limited Support for Administration Proposal on Closely Held REITs. NAREIT generally shares the Administration's views and concerns. We believe that the REIT structure is meant to be widely held and that it should not be used for abusive tax avoidance purposes. Therefore, NAREIT fully supports the intent of the proposal. But we are concerned that the Administration proposal casts too broad a net, prohibiting legitimate, temporary use of "closely held" REITs and fails to recognize that ownership by another pass-through entity is widely held. A limited number of exceptions are in order to allow certain "entities" to own a majority of a REIT's stock. For instance, NAREIT certainly agrees with the Administration's decision to exclude a REIT's ownership of another REIT's stock from the proposed new ownership limit.[9] NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow transactions necessary to foster the future REIT marketplace and to recognize the widely held nature of certain non-REIT entities.

First, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Such an "incubator REIT" sometimes is majority owned by its sponsor to allow the REIT to accumulate a track record that will facilitate its going public. The Administration proposal would prohibit this important approach which, in turn, could curb the emergence of new publicly traded REITs in which small investors may invest.

Second, there is no reason why a partnership, mutual fund, pension or profit-sharing trust or other pass-through entity should be counted as one entity in determining whether any "person" owns 50% of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity is usually ignored for tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-

[7] I.R.C. § 856(h)(1). There is no apparent reason why the proposed ownership test similarly should not be aimed at limiting *more than* 50% stock ownership, rather than 50% or more as now proposed.

[8] NAREIT supported the Administration's and Congress' move to limit the tax benefits of liquidating REITs.

[9] If the proposed test remains applicable to all persons owning more than 50% of a REIT's stock, then Congress should apply the exception for a REIT owning another REIT's stock by examining both direct and indirect ownership so as not to preclude an UPREIT owning more than 50% of another REIT's stock.

through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership. Similarly, the Code already has rules preventing a "pension held" REIT from being used to avoid the unrelated business income tax rules, and therefore the new ownership test should not apply to pension or profit-sharing plans. Instead, NAREIT suggests that the new ownership test apply only to non-REIT C corporations that own more than 50% of a REIT's stock.[10]

III. SECTION 1374

The Administration's Fiscal Year 2000 Budget proposes to amend section 1374 to treat an "S" election by a C corporation valued at $5 million or more as a taxable liquidation of that C corporation followed by a distribution to its shareholders. This proposal also was included in the Administration's Fiscal Year 1997, 1998 and 1999 proposed budgets.

A. *Background and Current Law*

Prior to its repeal as part of the Tax Reform Act of 1986, the holding in a court case named *General Utilities* permitted a C corporation to elect S corporation, REIT or mutual fund status (or transfer assets to an S corporation, REIT or mutual fund in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the *General Utilities* doctrine in 1986, such transactions arguably would have been immediately subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election pays any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets only if and when those assets are sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, works to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88–19, 1988–1 C.B. 486 (the "Notice"), the IRS announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of *General Utilities* through the use of REITs and regulated investment companies ("RICs," *i.e.* mutual funds). In addition, the IRS noted that those regulations would enable the REIT or RIC to be subject to rules similar to the principles of section 1374. Thus, a C corporation can elect REIT status and incur a corporate-level tax only if the REIT sells assets in a recognition event during the 10-year "recognition period."

In a release issued February 18, 1998, the Treasury Department announced that it intends to revise Notice 88–19 to conform to the Administration's *proposed* amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, these comments address the proposed amendment as if it applied to both S corporations and REITs.

B. *Statement in Support of the Current Application of Section 1374 to REITs*

As stated above, the Administration proposal would limit the use of the 10-year election to REITs valued at $5 million or less. NAREIT believes that this proposal would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. 3–4 (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this Congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election is to allow C corporations to make S corporation

[10] As under the current "five or fewer" test, any new ownership test should not apply to a REIT's first taxable year or the first half of subsequent taxable years. *See* I.R.C. §§ 542(a)(2) and 856(h)(2).

and REIT elections when those elections are supported by non-tax business reasons (*e.g.*, access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The 100% prohibited transactions tax on REITs complements the 10-year election mechanism.

Second, while S corporations may have no more than 75 shareholders, a REIT faces no statutory limit on the number of shareholders it may have and is required to have at least 100 shareholders. In fact, some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's fiduciary responsibility to each of those shareholders preclude the use of a REIT as a vehicle primarily to circumvent the repeal of *General Utilities*. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

The consequence of the Administration proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets' infrastructure, comprised of investment banking specialists, analysts, and investors, that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. In both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owners of such properties. The capital intensive nature of REITs makes the $5 million threshold essentially meaningless for REITs.

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Due to the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make taxable distributions of 95% of their income each tax year.

Moreover, the Administration justifies its *de facto* repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its [sic] conversion of a C corporation to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the material differences between REITs and partnerships.

Unlike partnerships, REITs cannot (and have never been able to) pass through losses to their investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs *are* C corporations. Thus, REITs are not susceptible to the tax avoidance concerns raised by the 1986 repeal of the *General Utilities* doctrine.

We note that on March 9, 1999, the Treasury Department and the IRS released their 1999 Business Plan, in which it listed a project for "[r]egulations regarding conversion of C corporation to to [sic] RIC or REIT status." On February 22, 1996, the Treasury Department issued a release stating that "the IRS intends to revise Notice 88–19 to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal." We urge the Congress to use its oversight authority to be certain that the Treasury Department does not by-pass Congress and enact the "built-in gain" tax on REITs and RICs administratively. Any such action would directly contravene Congress' repeated rejection of any statutory change in this area.

C. Summary

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be widely held and a long-term holder of assets, current law assures that the REIT is not a vehicle for tax avoidance. The proposal's two level tax would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted. Further, the Administration should not contravene the Congress' clear intent in this area by attempting to impose this double level tax on REITs and RICs by administrative means.

IV. TENANT IMPROVEMENTS

As an essential part of meeting customer demands, landlords routinely construct improvements to leased space to conform to a tenant's requirements. The average lease term (and therefore the usefulness of the "build out" for the tenant) ranges from five to ten years. However, since the Tax Reform Act of 1986, landlords must depreciate these "tenant improvements" over the tax life of the entire building: 39 years.

H.R. 844 and S. 879 would ameliorate this disconnect between the tenant improvement's economic life and its tax write-off period. For the purposes of simplicity, under H.R. 844 and S. 879 a lessor would depreciate its tenant improvements over ten years.

NAREIT joins the other national real estate trade associations in strongly urging the Committee to incorporate H.R. 844 in its mark-up of tax legislation this year. H.R. 844 would remove disincentives currently in place that discourage landlords from updating buildings, and would more closely conform the tax Code to economic realties.

V. AT RISK RULES

In 1986, Congress extended the at risk rules for the first time to real estate. However, it created an exception for "qualified nonrecourse financing," since it recognized that loans made by an unrelated party in the lending business would not be used to create the "tax shelters" targeted by the underlying rules.

Congress modernized the REIT rules in the 1986 Act, and the REIT industry has blossomed from less than $10 billion in equity market capitalization to about $150 billion today. As REITs have matured into full-fledged public companies, they have used the financing techniques long traditional to public companies. More than two thirds of the publicly traded REITs now have investment grade rating from the credit agencies and routinely issue nonsecured corporate debt. The use of such debt benefits the economy because the rating agencies require a conservative level of debt.

However, as with the rest of the real estate sector, REITs routinely use partnerships to own and operate real estate holdings. Under the current at risk rules, a REIT's partners are penalized by the REIT's use of unsecured debt because the money is lent by the public markets rather than an entity engaged in the business of lending money.

Even though the Internal Revenue Service has issued some private letter rulings that provide some limited relief in these situations, NAREIT strongly recommends that Congress update the at risk rules to include a publicly traded debt as being eligible as qualified nonrecourse financing. Such debt should include a debt instrument which either is traded on an established securities market or is readily tradable on a secondary market (or the substantial equivalent thereof).

NAREIT thanks the Committee for the opportunity to comment on these important proposals.

THE NATIONAL COALITION FOR PUBLIC EDUCATION
Washington, DC 20005–4905
June 22, 1999

Members of the House Ways and Means Committee
Washington, D.C. 20515

Dear Committee member:

It is expected that your June 23rd hearing on Tax Reduction Proposals will address many tax-related issues including those related to education incentives. We understand that the committee could consider education tax subsidies as part of an education-related tax package. The following members of the National Coalition for Public Education urge you NOT to support education savings accounts or any similar measure designed to create a tax subsidy for K–12 private and religious schools' tuition, homeschooling and other education expenses. The National Coalition for Public Education opposes funneling scarce tax revenues to private and religious schools through such mechanisms as K–12 education tax subsidies, tax credits and education savings accounts.

NCPE's opposition to education tax subsidies was bolstered by a recent analysis conducted by the Joint Committee on Taxation on a Senate tax subsidy proposal. It found that the benefit to students in public school would be $5 a year for a program which would cost taxpayers more than $2.6 billion over the next ten years. However, the IRA accounts would only exist for a few years because the accounts' benefits expire in 2003. These education tax accounts are designed to help wealthy families pay for private school tuition. Families unable to save, including most families earning less than $55,000 a year, would not benefit at all. Higher income families who already send their children to private schools would gain most of the benefits. For all children the tax benefits would be minimal. According to the Joint Committee on Taxation's analysis of a similar proposal debated last year, families with students in private schools would receive a benefit of $37 annually.

The federal government should be focusing its efforts and public funds towards our nation's public schools where 90% of America's children are educated. Real investments are needed, such as tax credits to subsidize $25 billion of public school construction bonds, which would make a real difference in our childrens' education. Tax subsidies do nothing to raise academic standards for all children, provide safe learning environments, increase teacher quality or increase parent involvement in schools.

The undersigned groups urge you to oppose the inclusion of education tax subsidies in any future tax bill. This proposal is merely a scheme to use public money to offset the cost of private and religious schools for wealthy families.

Sincerely,

American Association of Educational Service Agencies
American Association of School Administrators
American Association of University Women
American Civil Liberties Union
American Federation of State, County and Municipal Employees (AFSCME)
American Federation of Teachers
American Humanist Association
American Jewish Committee
American Jewish Congress
Americans for Religious Liberty
Americans United for Separation of Church and State
Council of Chief State School Officers
Council of the Great City Schools
Mexican American Legal Defense and Education Fund
National Association of Elementary School Principals
National Association of School Psychologists
National Association of State Boards of Education
National Association of State Directors of Special Education
National Council of Jewish Women
National Education Association
National PTA
National Rural Education Association
National School Bards Association
New York City Board of Education
People for the American Way
Service Employees International Union AFL–CIO
Union of American Hebrew Congregations
Unitarian Universalist Association
United Auto Workers International Union
Women of Reform Judaism

COVERDELL ESAs VS. SCHOOL CONSTRUCTION

The $5 Fallacy versus the $25 Billion Better Schools Initiative

Coverdell Education Savings Accounts

- Costs taxpayers over $2.6 billion, but the average annual benefit would only amount to $5 for families with children in public schools and $37 for families of private school students.[1]

- Disproportionately benefits the wealthiest families, while providing little or no benefit to middle or lower income families. The top wealthiest 20% of taxpayers would reap 70% of the tax benefits from this proposal. Families unable to save, including most families earning less than $55,000 a year would not benefit at all.[2]

- Sunsets in 2003, not giving families enough time to let their tax-free earnings accumulate.

- Provides little help to students in public schools where ninety percent of all children are educated. Families with children already in private school would only benefit marginally.

- Does nothing to raise academic standards for all children, provide safe learning environments, improve teacher quality or increase parent involvement in schools.

Submitted for the Record before the House Ways and Means Committee Hearing, June 23, 1999. Prepared by the National Coalition for Public Education and the Rebuild America's Schools Coalition. Submitted – for more information call 202-289-6790 or 202-462-5911.

School Construction & Modernization

- Addresses the critical need across American for school construction and modernization. Provides tax credits to pay the interest on nearly $25 billion in state and local bonds to help build and renovate up to 6,000 public schools. In 1995, the GAO estimated that just to repair buildings would cost $112 billion. An additional $73 billion is needed to build classrooms to relieve overcrowding.

- Maximizes relatively small federal investment of $3.1 billion by leveraging $25 billion in local school construction and modernization.

- Focuses limited resources on the public school system and recognizes that ninety percent of the students of this country attend public schools.

- Provides assistance to strengthen schools so that children across America will be able to learn in safe, modern, well-equipped schools. These bonds will also help schools reduce class size, which will offer enhanced learning environments for children.

- Involves no federal interference in local school decisions. The design and selection of the construction and modernization projects will be totally within the discretion of State and local public school officials. This concept has always enjoyed bipartisan support.

- Targets scarce resources at assisting communities to help overcome projected enrollment increases. A record 52.7 million children are enrolled in elementary and secondary schools today, and this number will climb to 54.3 million by 2008. At least 2,400 new public schools will be needed by 2003 to accommodate rising enrollments and to relieve overcrowding.

See attachment for state-by-state allocations under S. 223, H.R. 1660, & H.R. 1760

[1] In 1999 and 1998 studies conducted by the Joint Committee on Taxation

[2] According to both the Joint Committee on Taxation and Treasury Secretary Robert E. Rubin

ESTIMATED STATE ALLOCATIONS UNDER SCHOOL MODERNIZATION PROPOSALS

(ALL NUMBERS IN THOUSANDS OF DOLLARS)

STATE	LAUTENBERG S. 223 (65 % for states)	RANGEL (50 % for states)	JOHNSON (100 % to states)
ALABAMA	392,301	373,179	400,927
ALASKA	57,423	45,552	64,511
ARIZONA	363,902	321,189	408,495
ARKANSAS	241,428	191,361	245,83
CALIFORNIA	2,907,510	3,029,203	2.903,581
COLORADO	221,296	203,299	300,203
CONNECTICUT	213,065	195,615	254,874
DELAWARE	58,975	46,746	61,920
DISTRICT OF COLUMBIA	82,008	113,625	53,952
FLORIDA	1,113,574	1,337,671	1,167,501
GEORGIA	643,569	606,081	673,887
HAWAII	62,684	49,685	86,208
IDAHO	70,430	55,825	100,877
ILLINOIS	1,026,467	1,125,357	1,104,455
INDIANA	373,594	326,773	463,496
IOWA	170,579	135,205	224,658
KANSAS	174,659	154,208	218,512
KENTUCKY	393,101	344,582	385,447
LOUISIANA	592,906	596,956	534,443
MAINE	96.904	76,808	105,433
MARYLAND	320,029	351,517	392,425
MASSACHUSETTS	452,878	402,027	497,343
MICHIGAN	1,103,148	1,001,250	999,098
MINNESOTA	280,665	266,123	379,040
MISSISSIPPI	397,440	327,445	344,803
MISSOURI	411,202	386,832	465,917
MONTANA	79,388	62,924	85,630
NEBRASKA	104,535	82,857	137,341
NEVADA	74,887	90,274	114,220
NEW HAMPSHIRE	56,588	44,910	84,678
NEW JERSEY	534,770	526,789	618,124
NEW MEXICO	200,567	185,062	193,292
NEW YORK	2,270,306	2,750,541	1,918,630
NORTH CAROLINA	452,302	390,043	566,492
NORTH DAKOTA	58,975	46,746	61,026
OHIO	944,167	949,239	1,018,608
OKLAHOMA	293,197	270,233	304,804
OREGON	216,621	191,113	263,073
PENNSYLVANIA	1,027,762	1,007,919	1,073,440
PUERTO RICO	803,249	636,673	641,893
RHODE ISLAND	77,475	81,320	83,476
SOUTH CAROLINA	308,976	261,777	328,893
SOUTH DAKOTA	60,460	47,922	68,980

STATE	LAUTENBERG S. 223 (65 % for states)	RANGEL (50 % for states)	JOHNSON (100 % to states)
TENNESSEE	409,941	396,843	449,881
TEXAS	2,162,260	2,149,680	2,020,899
UTAH	106,981	84,796	177,790
VERMONT	55,207	43,847	56,945
VIRGINIA	362,710	317,458	478,363
WASHINGTON	338,671	285,098	443,947
WEST VIRGINIA	224,259	177,753	197,784
WISCONSIN	417,187	418,781	471,282
WYOMING	54,412	43,236	52,869
OUTLYING AREAS	52,410	42,054	250,000
BIA SCHOOLS	400,000	400,000	0
POTENTIAL RESERVE FOR ADDITIONAL DIRECT ALLOCATION TO LEAs	520,000	750,000	0
TOTAL	24,800,000	24,800,000	25,000,000

NOTE: Numbers may not add due to rounding. Distributions for Lautenberg and Rangel prepared by U.S. Department of Education. Distributions for Johnson prepared by Congressional Research Service.

Table prepared by NEA Government Relations
4/21/99

NATIONAL CONFERENCE OF STATE LEGISLATURES
June 10, 1999

Representative Bill Archer, Chair
House Ways and Means Committee
1102 Longworth House Office Bldg.
Washington, DC 20510

Re: FY 2000 Tax Legislation

Dear Chairman Archer:

We write on behalf of the National Conference of State Legislatures (NCSL) to urge you to include tax items of critical importance to state legislatures in your Chairman's mark of reconciliation legislation.

Efforts by the Congress and the administration over the last several years, including passage of the 1997 balanced budget agreement, have produced federal budget surpluses that are expected to continue well into the future. These past budget decisions have prompted discussion of possible tax changes among members of Congress and the administration.

We are concerned that federal tax relief not come at the expense of federal support for vital state-federal programs and partnerships. NCSL continues to support the objectives of the bipartisan budget agreement, yet we are well aware that the agreement places steep constraints on the construction of the thirteen appropriations bills for FY 2000. In the past, states shared disproportionately in federal efforts to reduce the deficit with major cuts to state-federal programs and partnerships. On the tax side, numerous tax changes made for deficit reduction purposes eliminated or significantly reduced preferential tax treatment in areas of importance to state and local governments.

As you prepare your mark, NCSL trusts that you will give major consideration to our tax priorities which we believe strengthen the intergovernmental partnership as well as advance our shared goals of simplification, ensuring fairness and encouraging work and savings.

NCSL asks that you include the following provisions in your mark of tax legislation:

1) Pension Portability and Simplification: Proposals forwarded by Representatives Rob Portman and Benjamin Cardin, Senators Charles Grassley and Bob Graham and the President would make significant strides to increase the national savings rate, encourage retirement savings, simplify pension administration, and increase

compensation limits reduced in the 1980s for deficit reduction purposes. Specifically, NCSL urges your inclusion of provisions that would:

• Enhance existing portability in public sector defined benefit plans, as well as allow portability between all retirement plans when employees change employment.

• Provide much needed clarity, flexibility and equity to the tax treatment of benefits and contributions under governmental 457 deferred compensation plans.

• Restore benefit and compensation limits that have not been adjusted for inflation and are generally lower than they were fifteen years ago.

• Repeal compensation-based limits that unfairly curtail the retirement savings of relatively non-highly paid workers.

• Allow those approaching retirement to increase their retirement savings and further enhance their retirement security through catch-up provisions.

2) Pubic School Construction and Modernization: NCSL supports efforts by the Congress and the administration to increase support for school construction and modernization. We urge you to include in your mark tax provisions for school construction that conform to existing state constitutional and regulatory requirements in order to maximize the impact of these provisions. Further, we urge inclusion of provisions supported in both the House and Senate that would treat qualified public educational facility bonds as exempt facility bonds and provide additional increases in the arbitrage rebate exception for governmental bonds used to finance education facilities. Current arbitrage rules essentially tax interest income on these bonds at a rate of 100% and thereby limit the states' ability to leverage infrastructure funds for school construction and modernization.

3) Private Activity Bond Volume Cap: Volume caps have unduly restricted the use of bonds for projects that have increasingly become governmental responsibilities. The Omnibus Reconciliation Act of 1998 included a partial, phased-in increase of the bond cap. NCSL supports H.R. 864 and S. 459, which would accelerate the increase of the volume cap and provide for an inflationary adjustment of the cap.

4) Low-Income Housing Tax Credit: NCSL has long supported this important tax credit. H.R. 175 and S. 1017 provide an increase in the tax credit to $1.75 per capita and provide for an inflationary adjustment in the credit.

While the President's budget proposal includes recommendations that, if adopted, will have a significant and positive impact on the delivery of specific services, we strongly disagree with several of the President's recommendations for tax offsets. We urge you not to include these offsets in your mark:

1) State Bank Exam Fees: We are hopeful that these fees, rejected by the Congress in the past, are not taken as an offset for federal priorities. The Administration's proposal would constitute a double tax on state-chartered banks for exams conducted by state banking departments and which are used by both the Federal Deposit Insurance Corporation and the Federal Reserve Board. The proposed fee would create an inequity in our nation's dual banking system as national chartered banks would not be assessed this double charge.

2) Leasing to State and Local Government: The President's proposal would limit the "tax benefits for lessors of tax-exempt use property" The Administration contends that in certain cross-border transactions involving tax-exempt entities, lessors have inappropriately applied certain tax benefits. Since introduction of the proposal in February, the Treasury has exercised its authority to shut down these cross-border transactions through the issuance of Revenue Ruling 99–14 and Final Section 467 Regulations. The application of the Administration's proposal to tax-exempt state and local governments which lease equipment such as 911 emergency systems, school busses, police vehicles, computers and other high cost technology, would severely increase the cost of these leases for state and local government entities and likely eliminate leasing as a cost effective equipment acquisition option for state and local governments.

As lawmakers, we understand the magnitude of the challenge that balancing the federal budget and determining how best to preserve or use the federal surplus presents. We know the decisions that must be made to address the challenge are difficult. As well, we understand that many exceptional tax relief proposals may be more difficult to implement in FY 2000. We would urge you to consider phasing in these proposals, as additional funds become available. State and local governments have much at stake in the method of financing the federal budget as federal and state tax systems are inextricably linked. We stand willing to help at all stages of the process.

We look forward to cooperating with you as the reconciliation process moves forward. If we can provide additional information, please contact Gerri Madrid (202–624–8670) or Michael Bird (202–624–8686).

Sincerely,

REPRESENTATIVE DANIEL T. BLUE, JR.
Senior Majority Leader, North Carolina House Representatives
President, National Conference of State Legislatures

REPRESENTATIVE PAUL S. MANNWEILER
Minority Leader, Indiana House of Representatives
President Elect, National Conference of State Legislatures

Statement of the National Council of Farmer Cooperatives

The National Council of Farmer Cooperatives (NCFC) supports and is working for the inclusion of H.R. 1914 into the upcoming tax bill. H.R. 1914 allows a farmer cooperative to bypass the dividend allocation rule, a regulatory rule that negatively impacts the amount of the patronage dividend deduction taken by a cooperative.

As cooperatives look to the 21st Century, it is important for the industry to have the appropriate tools so it can continue to give value to its farmer owners. In today's world, businesses need to be adequately capitalized if they hope to remain competitive. Farmer cooperatives have a difficult time raising capital. The reason is that they generally have only two sources of capital—their farmer owners and borrowing from a lending institution. Farmer cooperatives do not raise capital from financial markets by issuing voting common stock because members hold this stock.

However, farmer cooperatives are allowed to issue a class of non-voting preferred stock that can be used to raise equity from sources other than its farmer owners. When issuing a dividend bearing class of nonvoting preferred stock on which a dividend payment is made, a cooperative must comply with the "dividend allocation rule," which has an adverse tax affect on the cooperative and has been one reason why farmer cooperatives must heavily rely on debt financing.

What is the dividend allocation rule? The dividend allocation rule applies when a cooperative pays a dividend on its capital stock or other proprietary capital interests (a "Capital Stock Dividend"). The rule causes a portion of the capital stock dividend to be allocated to the patronage operation and reduces the amount of the patronage dividend deduction, thereby creating additional taxable income for the cooperative.

This rule has a long history going back to the 1920s, and currently is interpreted under Treasury Regulation § 1.1388–1(a)(1). It has evolved over the years to go beyond the particular situations in which it was developed to become a general rule that has a devastating effect on the industry's ability to raise equity capital. The prohibition established by the rule is one of the main reasons why cooperatives are heavily dependent on debt capital for their financing today.

H.R. 1914:

NCFC has been working with Representative Bill Thomas in attempting to change this regulation. Congressman Thomas has introduced H.R. 1914, a bill that, if enacted, would repeal the "dividend allocation rule."

H.R. 1914 adds the following sentence to § 1388 and effectively changes the regulation:

(a) IN GENERAL-Subsection (a) of section 1388 of the Internal Revenue Code of 1986 (relating to patronage dividend defined) is amended by adding at the end the following: 'For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.'

The language of H.R. 1914 is straightforward. It reverses the language of the regulation if agreed to by the patrons of the farmer cooperative. The effect of the language would allow a farmer cooperative to pay a "capital stock dividend" without first reducing the patronage earnings of the cooperative's patrons.

H.R. 1914 allows cooperatives and their members to bypass the rule by agreeing in the articles, bylaws, or other contract that a Capital Stock Dividend would first be paid from nonpatronage and accumulated earnings of the cooperative before patronage dividends would be reduced. This would allow the cooperative, for example, to create a class of nonvoting preferred stock and pay dividends on this stock exclusively from nonpatronage earnings. The cooperative would not reduce the amount of its patronage dividend deduction by any portion of the Capital Stock Dividend.

The benefits of this legislation for cooperatives could be substantial. Among other things, a cooperative could more easily:

- (1) raise capital from outside investors without having the farmer members who patronize the cooperative lose control;
- (2) create a class of nonvoting preferred stock that could be traded on capital markets, thereby providing liquidity to the cooperative's interests;
- (3) create a preferred stock program for management and employees that would improve incentive programs;
- (4) repurchase a departing member's interests for dividend paying stock, rather than debt; and
- (5) increase the amount of patronage earnings paid to the farmer owners.

For these reasons, NCFC supports and is working for the inclusion of H.R. 1914 into the upcoming tax bill, and we look forward to working with the Ways & Means Committee on this issue.

NCFC is a nationwide association of cooperative businesses owned and controlled by farmers. Its membership includes nearly 70 major farmer marketing, supply and credit cooperatives, plus the state councils of cooperatives in 31 states. NCFC's members, in turn, represent nearly 4,000 local cooperatives, with a combined membership that includes approximately 1.6 million farmers in the United States. NCFC members handle almost every type of agricultural commodity produced in the United States.

Farmer cooperatives are self-help organizations that were formed, and operate today, to meet the needs of farmers for reliable and fairly-priced sources of farm supplies (fertilizer, seed, feed, petroleum products, herbicides and pesticides), services and credit, and to provide farmers assistance in effectively marketing the commodities that they produce. Some cooperatives focus on serving a single function—providing farm supplies to members (referred to as "supply cooperatives"), or helping members market a particular kind of crop (referred to as "marketing cooperatives"). Others perform several different functions for their members. Whatever their function, farmer cooperatives are an extension of the farming operations of their members. Their importance to agriculture is demonstrated by the fact that most American farmers are affiliated with one or more cooperative.

Statement of National Education Association

Mr. Chairman and Members of the Committee:

On behalf of the 2.4 million members of the National Education Association (NEA), we thank you for the opportunity to submit our views on education-related tax proposals.

As you move forward to consider a comprehensive tax package, we urge you to include meaningful proposals to strengthen public education by addressing the critical needs of students and schools. NEA strongly supports inclusion in any tax package of tax credits to subsidize interest paid on school construction and modernization bonds. We believe such tax credits offer the best tax-related avenue for improving public education. In addition, NEA supports proposals to extend and expand tax exemptions for employer-provided educational assistance (Sec. 127) and to remove time limits on deductions for student loan interest payments. NEA strongly opposes proposals to permit tax-free withdrawals from education IRAs for K–12 private, religious, and home-school education expenses.

Tax Credits for School Modernization

Public school construction and modernization is a top NEA priority. We urge Congress to provide significant federal assistance for school construction and modernization as part of any tax package.

NEA members routinely express concern about the state of school buildings and facilities. Stories of leaking roofs, holes in walls, and overcrowded schools forced to hold classes held in temporary trailers are commonplace. The disrepair of our public schools is a nationwide problem that demands nationwide attention.

The average school building in America is nearly 50 years old. Schools are in worse shape than any other part of the nation's infrastructure, according to a 1998

American Society of Civil Engineers study. Almost 60 percent of our nation's public schools report at least one building feature—such as roofs, exterior walls, windows, plumbing, heating/ventilation, electrical power, and lighting—in need of extensive repair, overhaul, or replacement. Every day 14 million children attend schools in inadequate buildings. The problem affects urban, suburban, and rural areas. A 1995 study by the General Accounting Office (GAO) found that 38 percent of urban school districts, 29 percent of suburban school districts, and 30 percent of rural school districts have at least one building needing extensive repair or total replacement. Yet, while Congress just last year provided $216 billion for roads, bridges, and mass transit, to-date virtually no federal funds have been made available to improve school buildings.

Overcrowded classrooms and structurally unfit school buildings impair student achievement, diminish student discipline, and compromise student safety. A 1996 study by the Virginia Polytechnic Institute and State University found an 11-point difference in academic achievement between students in substandard classrooms and demographically similar children in a first-class learning environment. Similarly, a 1995 study of North Dakota high schools found a positive correlation between school condition and both student achievement and student behavior. A 1995 study of overcrowded schools in New York City found students in such schools scored significantly lower on both mathematics and reading exams than did similar students in underutilized schools.

Ensuring all of our nation's students access to safe, modern schools that are not overcrowded will require a significant federal investment. Although school construction is, and will remain, primarily a state and local responsibility, states and school districts cannot meet the current urgent needs without federal assistance. In 1995, GAO estimated that just repairing existing school facilities would cost $112 billion. Wiring and equipping schools for technology will require billions more. In addition, building new facilities to meet the demands of surging enrollments could cost as much as $73 billion. States and localities simply cannot finance this magnitude of repair and construction without federal assistance.

NEA strongly supports the Public School Modernization Act (H.R. 1660), sponsored by Representatives Charles Rangel with 150 bipartisan cosponsors, and the America's Better Classrooms Act (H.R. 1760), sponsored by Representative Nancy Johnson with 17 bipartisan cosponsors. These critical bills recognize the urgent need for federal school modernization assistance by providing tax credits to subsidize interest paid on $25 billion in school construction bonds.

"Zero-interest school modernization bonds" offer a sensible, flexible, cost-effective approach for modern schools and better learning:

- Tax credits for school modernization bonds would create an effective local/state/federal partnership. The federal government would provide the necessary resources but leave decisions about which schools to build or repair to states and localities.
- Tax credits would create no additional bureaucracy. Existing government departments would implement the program.
- Zero-interest modernization bonds are fiscally sound. Three billion dollars in federal tax credits would generate $25 billion in bonds, with every dollar going for repair or construction.
- The tax credits would free up local monies normally spent on bond interest for additional investments in teaching and learning. As an example, the state of Connecticut paid over $100 million in interest on school debt in 1997–98. The interest on a typical 30-year tax-exempt bond almost equals the amount borrowed. Even on 15-year bonds the interest totals about 35 percent of the amount borrowed. Thus, the tax credits for bond interest would result in substantial savings for local districts. Such fiscal relief for school districts would help relieve pressure on property taxes, and thus make it easier to convince local voters to pass school bond referenda.

In addition to the $25 billion in zero-interest school modernization bonds, NEA supports the School Construction Act of 1999 (H.R. 996), sponsored by Representative Bob Etheridge, which would provide $7 billion in bonds to states with high enrollment growth. States and localities will need to build some 6,000 new schools to serve additional students in the next decade. H.R. 996 would help meet some of this need by targeting additional resources to areas with the greatest projected growth.

NEA recognizes that some Members of Congress—including Chairman Archer—seek to address school modernization needs through "arbitrage relief" proposals. Such proposals would allow school districts to retain earnings on bond proceeds for an additional two years, instead of rebating the funds to the federal government.

While NEA commends the Chairman's interest in addressing the school modernization issue, we believe that arbitrage relief will not provide the type of meaningful assistance necessary to meet nationwide school modernization needs. While arbitrage relief might benefit some schools, it would fall well short of the need and would fail to leverage new investments for construction. Under an arbitrage relief plan, school districts would have to delay construction for at least two years to receive any benefit. Thus, areas with the most urgent needs would not be helped. In addition, arbitrage relief would provide little, if any, assistance for rural areas, as many rural schools are already exempt from arbitrage requirements. Even for those schools that can stretch out construction for two additional years, arbitrage profits would only amount to $10 on average for each $1000 of bond principal.

The American public overwhelmingly supports a significant federal investment in school buildings. Americans' support for a federal investment in public school repair, renovation, and modernization transcends partisanship and geography. As demonstrated by a 1998 survey conducted by Republican pollster Frank Luntz, Republicans, Independents, and Democrats, in cities, suburbs, and rural areas want safe, modern school facilities. NEA believes that zero-interest school modernization bonds offer the best approach to ensuring all our students such safe, modern schools.

PRIVATE SCHOOL EDUCATION TAX SUBSIDIES

NEA strongly opposes proposals to permit tax-free withdrawals from education IRAs for K–12 private, religious, and home-school education expenses. We believe these proposals, such as Representative Hulshof's Education Savings and School Excellence Act of 1999 (H.R. 7), represent bad tax and education policy.

Education tax subsidies would disproportionately benefit private school students. Although families with children in private school represent only 7 percent of families eligible for the education IRA, they would receive more than half (52%) the tax benefits. Such subsidies would also disproportionately benefit wealthier families. Almost 70 percent of the benefits would go to the wealthiest 20 percent of families. In addition, although the cost to taxpayers would be over $2.6 billion, the average tax benefit to families with children in public schools would only be $5. For families with children in private school, the average tax break would be $37. The majority of working families earning less than $50,000 would get an annual tax cut of only $2.50. Such a small benefit would not create any incentive for families to increase savings.

Despite rhetoric to the contrary, tax subsidies do not offer parents "school choice." Private schools retain the freedom to deny admission to anyone they choose—especially children with costly special needs such as a learning or physical disability or limited-English proficiency. Tax subsidies also do not give choices to working families who cannot afford to pay or save for their child's private school tuition.

Unlike tax credits for school modernization bonds, proposed tax subsidies for education IRAs fail to address the real problems confronting our nation's schools. They merely use the tax system to subsidize private school tuition and costs, while doing nothing to raise academic standards for all children, reduce class sizes, provide safe learning environments, improve teacher quality, or increase parent involvement in schools. Education tax subsidies divert attention away from a real debate on how to improve public schools and offer instead only a minor benefit to those who least need it. We urge you to reject such tax subsidy proposals in favor of proposals, such as tax credits for school modernization bonds, which will make a real difference for the majority of students and schools.

ADDITIONAL EDUCATION-RELATED TAX PROPOSALS

In addition to tax credits for school modernization bonds, NEA supports several tax proposals to assist college students in meeting educational expenses. We support the Employee Educational Assistance Act of 1999 (H.R. 323)—sponsored by Rep. Levin, and 125 bipartisan cosponsors, which would permanently extend the tax exclusion for employer-provided educational assistance and restore the exclusion for graduate level educational assistance. This proposal would benefit not only students seeking to continue their education but employers, who will benefit substantially from sending employees to school to acquire additional skills. Extending and expanding the exclusion for employer-provided educational assistance could also have a significant impact on teacher quality, as more teachers would be able to take graduate courses to enhance their skills and learn new technologies without facing tax consequences for the employer-provided assistance.

NEA also supports repealing the limit on the number of months during which interest paid on a college student loan is deductible. This proposal will help students facing overwhelming student loan debt and will eliminate complexity and administrative burdens for borrowers and financial institutions. Many teachers will benefit from this proposal. Lowering the tax burden for teachers—who often face large student loan debts but receive low salaries compared to other professions—will be of great assistance. Removal of the time restriction on student loan deductibility was proposed in the President's budget and is the cornerstone of legislation sponsored by Representatives Hulshof and English (H.R. 2141).

Both extending and expanding the exclusion for employer-provided educational assistance and eliminating the 60-month limit on deducting student loan interest enjoy broad bipartisan support. Both proposals offer practical solutions to helping students meet the rising costs of education. NEA urges inclusion of both proposals in the final tax package.

CONCLUSION

NEA believes that a tax package offers an important opportunity to make real strides toward improving public education. We urge you to reject efforts to divert public funds for the benefit of a small number of students in private schools and instead to craft an education tax package providing real benefits to the majority of students in public schools.

We thank you for the opportunity to offer our views and hope we can now move forward to address the critical needs of our public schools.

Statement of Kristine S. Arnold, MS–II, University of Health Sciences, College of Osteopathic Medicine; on behalf of National Rural Health Association

My name is Kristine Arnold, and I am representing the National Rural Health Association (NRHA). I want to thank the Chairman, and the members of the House Ways and Means Committee for allowing me the opportunity to submit written testimony regarding the Committee's hearing on reducing the tax burden on individuals and families.

The NRHA is a national nonprofit membership organization that provides leadership on rural health issues. Through discussion and exploration, the NRHA works to create a clear national understanding of rural health care, its needs, and effective ways to meet them. The association's mission is to improve the health of rural Americans and to provide leadership on rural health issues through advocacy, communication, education and research. As you are well aware, rural areas are unique. They differ from urban communities in their geography, population mix and density, economics, lifestyle, values and social organization. Rural people and communities require programs that respond to their individual characteristics and needs.

The membership of the NRHA is a diverse collection of individuals and organizations, all of whom share the common bond of an interest in rural health. Individual members come from all disciplines and include hospital and rural health clinic administrators, physicians, nurses, dentists, non-physician providers, health planners, researchers and educators, state offices of rural health and policy-makers. Organization and supporting members include hospitals, community and migrant health centers, state health departments and university programs.

I would like to share with you the NRHA's support for a change in the tax code that would exclude from federal income and FICA taxation tuition and other educational related expenses for National Health Service Corps (NHSC) scholars.

The NHSC is helping to improve our nation's health, one community at a time. NHSC primary care providers represent many disciplines, including allopathic and osteopathic physicians, nurse practitioners, certified nurse-midwives, physician assistants, dentists, dental hygienists, clinical social workers, psychiatric nurse specialists, and marriage and family therapists. Over the past 25 years, more than 20,000 NHSC clinicians have spent all or part of their careers going where others choose not to go, serving the poorest, the least healthy, and the most isolated of our fellow Americans. There are currently 2,821 primary medical health professionals shortage areas (HPSAs). Today, 4.6 million people who would otherwise lack access are receiving high-quality primary care from over 2,400 dedicated NHSC professionals.

I am currently an NHSC scholar and second year medical student at the University of Health Sciences, College of Osteopathic Medicine in Kansas City, Missouri. Beginning December 1997, the Internal Revenue Service (IRS) began withholding taxes on NHSC scholarships to comply with a 1986 change in the tax code. This move by the IRS has been devastating to NHSC scholars because it places us in a higher tax bracket, and drastically reduces our living stipends. The monthly stipend for an NHSC scholar is currently $935. Each month $547 of that $935 is withheld from my stipend, leaving me with $388 to pay for my living expenses. (This number varies from school to school depending on the cost of tuition and fees). As a result I have been forced to take out a loan to pay for the majority of my living expenses. In April, I filed my federal and state income taxes and found that my reported income was in excess of $40,000; consequently I owed more than $5,000 in additional taxes. Again, I had to turn to a loan from the federal government to pay for the tax.

One of the major incentives for participating in the NHSC scholarship program is the opportunity to graduate from medical school without debt. In return, NHSC scholars agree to serve in a federally designated HPSA for a number of years. Serving in one of these areas might otherwise prove to be financially impossible considering that the average debt for medical school graduates in the United States is currently $80,000. The burden the taxation of NHSC scholarships places on potential NHSC scholars may be a significant deterrent to interested and motivated students and clinicians who might otherwise be recruited to live and work in those areas most desperate for health professionals.

The taxation of National Health Service Corps scholarships by the IRS is in direct conflict with the mission of the program. In order to resolve this problem, Congress must provide the IRS with the legislative authority required to continue to exclude from gross income any amounts received under the tuition and related expenses portion of the NHSC scholarship. This provision would make the NHSC Scholarship Program comparable to the Veteran's Administration (VA) Scholarship program.

Last year, the House of Representatives included a provision to remedy this issue in a broader education bill that was later passed by the Congress, but vetoed by President Clinton for reasons other than this provision. Currently, legislation has been introduced in both the House and the Senate (H.R. 1344 and S. 980) that would exclude tuition and related expenses under the NHSC scholarships from taxation. The NHSC tax provision is supported by the Senate Rural Health Caucus, the House Rural Health Care Coalition, and the Department of Health and Human Services. In addition, a number of outside organizations support passage of this provision including the National Organization of State Offices of Rural Health, the American Psychological Association, the National Association of Community Health Centers, and the American Medical Student Association.

In closing the NRHA encourages the Committee members to include this important provision in an omnibus tax reform measure or other legislative vehicle considered by the Congress this year. Enactment of this provision would enable the NHSC to carry out its continuing mission of bringing health care to 47 million underserved Americans.

Statement of David Goldstein, Energy Program Co-director, Natural Resources Defense Council, San Francisco, California

Mr. Chairman and Members of the Committee:

The Natural Resources Defense Council appreciates the opportunity to provide written testimony following the hearing of 23 June, 1999. We will comment concerning two pieces of legislation before your Committee, H.R. 1358, sponsored by Representative Bill Thomas, and H.R. 2380, sponsored by Representative Robert Matsui.

The Natural Resources Defense Council is a national environmental organization with over 400,000 members and contributors. NRDC has promoted energy efficiency at the state, regional, national and international levels for 25 years, and has pioneered the development of market transformation programs to promote efficiency through overcoming market barriers.

NRDC's analysis, summarized below, concludes that the Thomas Bill, while well intentioned, fails to meet most of this criteria for effective market transformation. NRDC therefore opposes this legislation. The Matsui Bill does satisfy the criteria and we urge the Committee to support it.

Improving energy efficiency is a policy that has broad support from stakeholders in the environmental movement, the utility industry, citizens' groups, private companies, business organizations, states and cities, and others. Over 5% of the nation's GDP is spent on energy, but this could be reduced by half or more at a net profit. Increasing energy efficiency provides new business opportunities, improves the competitiveness of the American economy, provides increased numbers of jobs, and saves money for consumers, while at the same time providing cleaner water, cleaner air, and less pressure on limited energy resources.

Even though energy efficiency is cheaper than continuing to pay bills for energy supply, many of the technologies that would provide these savings are not widely available in the marketplace. In part, this market failure occurs because many consumers do not make the fundamental decisions concerning their own energy efficiency. Members of Congress and their staffs, along with much of the business world, work in office spaces where they do not pay their own utility bills. An investment in energy efficiency would not make sense for them, no matter how quick the payback, because someone else is paying the energy bills. Consumers who rent their houses have the same problems, as do those citizens who purchase energy-using products such as refrigerators or washing machines on the used market. Few new homeowners are able to make important energy efficiency decisions that will affect their energy bills.

Because of these and other persistent market barriers, many of the most promising technologies are not even offered to the consumer.

But, many state energy offices and utilities working with businesses, builders, and homeowners, have learned how to overcome these barriers during the past 25 years through a number of programs and policies.

One important new policy is market transformation. By offering targeted incentives for high levels of energy efficiency and maintaining them for a long enough time to make new product introduction worthwhile, market transformation can bring forth new products that would not otherwise be available. Once sold and mass produced, the price comes down, and these products can succeed with reduced or even eliminated policy intervention.

Tax credits provide an opportunity to extend these state-level successes while reducing the tax burden of individual households or businesses. But, as we learned in the 1970's, carelessly drawn up tax credits can simply contribute to inefficiency in the tax system: by paying for behavior that was going to happen anyway, with little effect once they have expired. In contrast to market transformation, where a small amount of "seeding" with federal money leads to large and continuing benefits, poorly structured tax credits leave no lasting effect and are wasteful of taxpayer's money.

What are the criteria that market transforming tax credits should meet?

- The tax credits must be enforceable and workable: it must be simple to determine compliance with the credit and simple to apply for the credit and verify that the application is correct.
- The tax credit should make economic sense: the value of the credit should be commensurate with the cost of the technology it is attempting to bring forth and with the benefits to the consumer from the technology.
- The tax credits should introduce technologies that would not otherwise be purchased in significant numbers, or create new infrastructure that would not otherwise be there.
- The tax credits should be competitively fair: they should not favor one fuel or another (for technologies using utility-supplied fuels), or one technology approach over another, when both would be equally effective in protecting the environment and saving money for consumers.
- They should be based on programs that have a track record of working and learn from the experience of programs that have failed.
- They should minimize free ridership: people who qualify for the tax credit without doing anything different.

THE THOMAS BILL

While superficially the Thomas Bill appears to meet several of the criteria for market transformation, the structure and actual language is fatally flawed in a number of different ways:

- *The bill is not workable in its current form.*
- For new homes complying by prescriptive methods, the legislation allows builders to self-certify. No oversight procedure is establish to see whether this self-certification works.
- If builders say they installed something different than what they are really installing, there is no obvious way to check this. The IRS does not know much about energy efficiency technologies, and does not have the staff expertise to review building plan documents, particularly since no standardized format for submitting results to the IRS is provided for in the legislation.
- Even if new buildings are *designed* in a way that qualifies with the criteria for the tax credit, there is no mechanism for assuring that houses are *constructed* to meet these plans.
- Since the tax credit goes to the builder and not to the home buyer, the buyer is not assured a means by which to know whether or not his or her home qualified for the tax credit. If the consumer's utility bills are no lower than those of his neighbors, he would not realize that anything is amiss.

• For new homes complying using the performance approach, a number of different options are offered for how to do the calculations. Experience at the state level has shown clearly that builders will “shop around” for the method that gives them the most credit for the least amount of work. Builders and their consultants have been very creative in applying the rules for how to perform performance calculations. Energy savings of 30% in theory could be 10% or even smaller in practice.

• For existing buildings, contractors can self-certify to the taxpayer both the cost of the improvement attributable to energy efficiency and the extent of compliance with the prescriptive regulations. The temptations to “fudge” should be self-evident.

• For existing houses, the legislation is unclear on what actual criteria the contractor has to meet. In many climates, it is quite possible that very little physical improvements have to be made in order to qualify for the tax credit. The concern is that home repairs made for other purposes will be construed by the contractor to have been made for the purposes of energy efficiency.

• The legislation does not provide for regulatory oversight of the programs; even if we know after the first year that qualifying houses are being built that hardly save any energy, there is no regulatory mechanism for changing things to fix the problems.

• In summary, the lack of firm rules opens the door to waste and abuse. Fraud would be unnecessary because the taxpayer can abuse the system as much as he or she wants without breaking any explicit rules.

• *The value of tax credit is excessive compared to the amount of energy saved.* The value of energy savings for reducing heating and cooling costs by 30% would be about $150 per year. A $2,000 tax credit would take over 15 years to pay back, even on a societal cost basis. This is excessive, particularly considering the fact that in many regions, the cost of meeting the criteria for this bill as intended is less than $700 (and the cost for meeting the requirements *as written* will, of course, be substantially less because the results will be less.

• *The Thomas proposal is not fuel neutral.* It will cause many homes to switch from gas to electricity in order to qualify more easily for the tax credit. In some cases, depending on how the rules are made or interpreted, the shift could be in the reverse direction. In any event, it does not enhance, but rather restricts competition between fuel suppliers.

• There may be significant problems with free ridership, particularly in regions of the country where strong energy codes are already being enforced, such as Oregon, California, and Florida.

• The legislation could undercut the emerging Home Energy Rating Systems (HERS) industry by allowing less qualified new entrants to make certifications on the same basis as existing, legitimate organizations.

THE MATSUI BILL

The Matsui Bill does a good job of building on the successes of state programs and avoiding the mistakes of earlier failed programs. This bill covers a number of different technologies; our comments are not intended to be comprehensive.

For new housing, the Matsui Bill offers a tiered approach with increasing tax credits for increasing savings. This is an approach that has been used successfully by utility programs.

The lower tier, which is equivalent in savings to the Thomas Bill, provides a relatively easily achievable target with commensurately less reward. The highest tier provides an ambitious target with a more substantial financial incentive. The builder gets to choose which level of incentive he or she is aiming for. The housing section of the Matsui Bill has the following attributes:

• The implementation of the tax credits program is simple and effective; it builds on the experience of over a million houses in complying with similarly structured state energy efficiency building codes:

• Compliance is determined by experts certified by private sector firms. The Department of Energy is given authority to regulate the quality assurance and training programs of these firms based on a private sector model cited in the legislation.

• As in the Thomas Bill, a simple prescriptive path is offered for compliance. The Department of Energy is charged with developing this path. Because it is determined by regulation, mid-course corrections can be made to make the path more usable or to solve problems that occur in the field.

• A more flexible performance-based approach is allowed based on oversight by the Department of Energy. This oversight follows the successful experience of implementing performance-based approaches in a simple-to-enforce fashion in California and Florida. By relying on these states' software-based approach, all of the complexity is taken away from both the users (the home energy raters) and the government auditors. The complexity is all "hidden" in the software. Software eligible to determine compliance must be certified by the Secretary of Energy.

• Since the certifications must be prepared by a third party, and given to the homeowner (taxpayer), there is a clear record that the house is supposed to be energy efficient and concerning what measures the builder took to make it energy efficiency. This establishes responsibility based on the consumer's self interest in assuring that energy efficiency measures are real.

• The highest level of tax credit, $2,000, is paid for savings of 50%. These savings may be in the neighborhood of $300/year or greater, so the tax credit is not out of proportion with the level of financial benefits that are being achieved.

• The higher tiers are easiest to meet using new construction methods for leak-free ducts and tightly constructed houses. To verify these results, a new home diagnostics industry will need to be created. The tax credits legislation can cause this industry to come into existence. Once it is there, the high economic attractiveness of these measures make it likely that they will continue to be used even after the tax credit expires.

• The legislation explicitly calls for fuel neutrality, so that there is no incentive to switch from gas or oil to electricity, or in the reverse direction. The performance-based approach provides the maximum level of competition between different technologies.

The Matsui Bill also provides tiered tax credits for more efficient heating, cooling, and water heating equipment. These tax credits are similar to programs that have worked with extremely high effectiveness in bringing forth more efficient refrigerators, air conditioners, and water heaters, based on utility rebates. The tax credit programs are likely to be more effective than the utility programs because the manufacturers who are required to make the investments to bring forth these advanced technologies can be assured of several years' worth of tax credit, as opposed to utility programs that can only be committed to one year at a time.

The Matsui Bill does not cover existing homes as the Thomas Bill does. NRDC believes that this is unfortunate, since a higher level of energy savings can be achieved in existing houses than in new houses. We believe that existing houses that meet the component requirements established for new houses—for example, the insulation levels in the ceiling, or the windows, or the walls—should qualify for a pro-rata fraction of the tax credit for new homes. This should not be a major budgetary impact, because it is difficult to meet these advanced levels designed for new houses in existing homes.

The Matsui Bill also provides tax credits for energy-saving renewable technologies, such as solar water heating systems. While this is a good idea, the implementation in the bill is flawed. The legislation, as it stands, pays for a fraction of the expenditures on the device, rather than the results achieved by the device. As is the case in the housing and equipment sections of the Matsui bill, it is better to pay for achieving performance goals than for spending money.

The Matsui Bill also provides incentives for energy efficient new automobiles. This section is structured imperfectly because it tends to "pick winners" among technologies and focuses only on improvements in the drive train, as opposed to all of the other areas of the car where fuel economy improvements can be made. Nevertheless, this bill would encourage technology advancement for the purpose of fuel economy in automobiles adding export value to fuel-efficient U.S. vehicles.

Fuel consumption in cars causes multiple problems in the United States, including the nation's highest level of dependence on imported fuels. The seriousness of this problem commends support of even imperfect approaches towards solving this immense economic and geopolitical as well as environmental problem.

Summary and Conclusions

NRDC believes that tax credits have an important role to play in a diversified portfolio of policies to improve energy efficiency in an economically justified way. The Thomas Bill, while well intended, is so structurally flawed that NRDC opposes this bill. The Matsui Bill is both structurally and technically more workable and worthy of enactment. Although NRDC has suggestions for improvements to the bill, we support it and urge the committee to include it in its markup.

Statement of Hon. Paul D. Fraim, Mayor, City of Norfolk

Chairman Archer and Members of the Committee, I am Paul Fraim, Mayor of the City of Norfolk, Virginia. I appreciate the opportunity to submit my comments in writing to you on an issue of importance not only to our community but to the many other communities participating in Round II of the Empowerment Zone/Enterprise Community (EZ/EC) program.

I am writing to urge you to include HR 2170, cosponsored by Reps. Rangel and Foley which completes the funding for the Round II EZECs in any tax bill which passes your committee this year. This program has been crucial to our local community in strengthening families and enabling more of our citizens to participate in the benefits of a strong economy.

BACKGROUND:

The Omnibus Budget Reconciliation Act of 1993 (P.L. 103–66) authorized 11 Empowerment Zones (EZs) and 94 Enterprise Communities (ECs) to receive tax relief benefits and federal funding of $100 million for each urban EZ, $40 million for each rural EC, and $3 million for each EC to implement local plans.

Four years later, in 1997, 20 new Empowerment Zones were authorized as part of the tax reconciliation package in the Balanced Budget Act (15 Round II urban and 5 Round II rural EZs). These were selected and announced in January 1999. Unlike the first round, this second round of 20 new EZs were not authorized to benefit from the employer wage tax credit.

In his budget for FY99 President Clinton proposed to fund the 20 new EZs at virtually the same level as the first round of EZ/ECs, requiring such funding to be mandatory and flowing through the Title XX Social Services Block Grant (SSBG). In the absence of a tax bill last year, $60 million in appropriations were provided to start up the program: $3 million each for the 15 new urban EZs, $2 million each for the 5 new rural EZs, and $250,000 for each of 20 new rural ECs.

This year the President's Budget for FY 2000 contained about $1.7 billion (over nine years) to fully fund the EZs and ECs and to provide $3 million each for 15 new Strategic Planning Communities (SPCs). Funding for the program is contained in HR 2170.

NORFOLK, VIRGINIA:

Norfolk was fortunate to have been chosen to be an Enterprise Community during the first round of EZ/EC designations. The central focus of our program has been to enable substantial numbers of our citizens, who would not otherwise have had the means to do so, to achieve economic self-sufficiency in our community. Working in concert with and through our existing neighborhood centers and with the help of the City's business leaders and a number of existing training

organizations, we have been able to offer our citizens services ranging from basic job readiness training and even specialized training using existing and new programs, to job placement, and on-the-job support.

Our job placement rate is about 60% with another 16% pursuing additional training or educational opportunities. Nearly 900 individuals have been employed over the last four years, with a retention rate of 75%, above the norm for average employees. The word is spreading that a better life is available and demand for training exceeds supply. The cost per person trained and employed is only $3,654—substantially lower than most employment training programs.

Chartered first as a town in 1682, Norfolk is one of the nation's older cities which means aging public schools and infrastructure, and little undeveloped land to attract new business. Our inability to grow and our age are exacerbated by the fact that almost 50% of our land is tax exempt, in large part due to being home to the world's largest naval base and the second largest commercial—but tax exempt—port on the East Coast. We are ranked first among Virginia's 140 cities and counties for "fiscal stress," a well accepted state measure of imbalance between fiscal requirements and tax resources.

Despite all this, Norfolk is a city that is aggressively and creatively working to solve our problems, to make Norfolk a great place to live, work and visit. Hardly a day passes that we don't encounter a visitor who remembers Norfolk as it was twenty years ago and cannot believe how positively we have changed. We have revitalized our waterfront and in the last ten years increased our tax base ten-fold.

Meeting these significant challenges has not been easy. The City is in a constant financial struggle to meet the needs of our constituents within the resources available while maintaining our AA bond rating. For these reasons, the EZ/EC program is vital to Norfolk and to those who live here.

In addition to the tax incentives and federal funds provided in the program, federal EZ/EC designation triggers state tax benefits and grants which supplement federal support. By requiring the state zone to conform with the federal zone, we have been also been able to expand the number of eligible businesses from 600 to 1700.

EZEC FUNDING IS NECESSARY TO COMPLEMENT TAX INCENTIVES:

Other communities may have had a different experience but, for Norfolk, the expanded use of tax-exempt private activity bonds for our EC has not been of significant value in attracting new business to Norfolk. We have been told the bonds are too restrictive and complicated, especially for small businesses. Incentives for businesses to locate in ECs or EZs need to be attractive enough to realistically enable the community to compete with other regions of the country and adjacent jurisdictions.

Tax incentives for businesses to hire EZ/EC residents are beneficial but, unfortunately, the new

EZs do not receive the Employer Wage Credit which was available to the first round of EZs.

Conceptually, the Work Opportunities Tax Credit (WOTC) should provide similar advantages but in Norfolk it is not used extensively. Employers tell us it is too burdensome and overly bureaucratic.

Because most of our effort has been devoted to job readiness training and placement for our citizens, it has been the federal funding that has made the big difference in our community. This view is shared by other mayors and local government leaders who competed successfully for an EZ and EC designation.

Norfolk was instrumental in organizing the "EZ/EC Round II Coalition" (Attachment) which meets regularly to share information on progress to convince Congress that it has an obligation to complete the process already undertaken regarding this program. All of us invested a great deal to compete for the new EZ and EC designations in good faith with the understanding that the plans for our local communities would be funded by the Congress that authorized Round II of this program.

Finally, Mr. Chairman and Members, your desire to reduce the tax burden on families and keep the economy strong can be realized in part by completing the funding for the EZ/EC communities—communities which represent populations that have not benefitted from the strength of the current economy as much as all of us would like.

Thank you for your consideration of our request.

Attachment

EZ/EC II COALITION MEMBERS

Empowerment Zones—
Thomas M. Menino, Mayor—Boston, MA
Michael Parolli, Mayor—Bridgeton, NJ
Anthony Campanella, Mayor—Vineland, NJ
Roxanne Qualls, Mayor—Cincinnati, OH
Robert D. Coble, Mayor—Columbia, SC
Stephen M. Creech, Mayor—Sumter, SC
Gregory S. Lashutka, Mayor—Columbus, OH
Carlos M. Ramirez, Mayor—El Paso, TX
Scott King, Mayor—Gary, IN
Robert A. Pastrick, Mayor—East Chicago, IN
Jean Dean, Mayor—Huntington, WV
Robert A. Cleary, Mayor—Ironton, OH
Victor Ashe, Mayor—Knoxville, TN
Joe Carollo, Mayor—Miami, FL
Sharon Sayles Belton, Mayor—Minneapolis, MN
John DeStefano, Jr., Mayor—New Haven, CT
Paul D. Fraim, Mayor—Norfolk, VA
James W. Holley III, Mayor—Portsmouth, VA
Miguel A. Pulido, Mayor—Santa Ana, CA
Clarence Harmon, Mayor—St. Louis, MO
Gordon Bush, Mayor—East St. Louis, IL
Richard Borer, Mayor—West Haven, CT
Kim Steffield—Cordele, GA
Irvin Rustad—Fargo, ND
Herb Wounded Head—Pine Ridge, SD
John Thurman—Riverside County, CA
Lisa Thurston—Ullin, IL

Strategic Planning Communities—
Rick Mystrom, Mayor—Anchorage, AK
Richard Arrington, Jr., Mayor—Birmingham, AL
Peter Clavelle, Mayor—Burlington, VT Clyde M. Rabideau, Jr., Mayor—Plattsburgh, NY
Joseph P. Riley, Jr., Mayor—Charleston, SC
R. Keith Summey, Mayor—North Charleston, SC
Hardy Johnson, Jr., Mayor—Jackson, MS
Kay Barnes, Mayor—Kansas City, MO
Carol S. Marinovich, Mayor—Kansas City, KS
David L. Armstrong, Mayor—Louisville, KY
Jan Laverty Jones, Mayor—Las Vegas, NV
Michael Montandon, Mayor—North Las Vegas, NV

Jim Dailey, Mayor—Little Rock, AR
Patrick Henry Hays, Mayor—North Little Rock, AR
Marc Morial, Mayor—New Orleans, LA
Rudolph Giuliani, Mayor—New York/ Brooklyn, NY
Sharpe James, Mayor—Newark, NJ
Chris Bollwage, Mayor—Elizabeth, NJ
Vincent A. Cianci, Jr., Mayor—Providence, RI
Howard W. Peak, Mayor—San Antonio, TX
Brian Ebersole, Mayor—Tacoma/Lakewood, WA

Rural Enterprise Communities

Timothy Gilmartin, Mayor—Metlakatla Indian
Larry Rodgers—Four Corners
Zak Gonzalez—Orange Cove, Huron, Parlier, and Tule River Tribal Council
Barbara Cacchione—Empowerment Alliance of SW Florida
Karen M. Holt—Molokai
Lanny McIntosh—Austin
Sharla Krenzel—Wichita County
Charlotte Mathis—Bowling Green
John C. Bott—Lewiston
Tim Wolverton—Clare County
Melissa Buckles-Fort Peck Assiniboine and Sioux Tribe
John Strand—Deming
Billie J. Floyd—Tri-County Indian Nations
Debra Hanna—Fayette
Joe Vuknic—Allendale County ALIVE
Tom Mottern—Clinch-Powell
Leodoro Martinez—Middle Rio Grande
Martin Wold—Tri-County Rural
Gale Kruger—Northwoods Niijii
Ben Newhouse—Upper Kanawha Valley

Statement of Hon. Bill Thomas, a Representative in Congress from the State of California

Mr. Chairman, I appreciate having an opportunity to comment on provisions I believe should be included in the coming tax bill.

With respect to expiring provisions, I urge the inclusion of my bill to extend the Production Tax Credit (PTC) for wind power for an additional 5 years, H.R. 750. The bill has tremendous support in the House. One hundred and twenty-four members of the House, including 27 members of the Committee on Ways and Means, are cosponsors.

Wind offers one technology we can use to reduce climate-changing emissions. The America Wind Energy Association has estimated that under an extension of the PTC, working in conjunction with a set of policies aimed at further reducing costs, wind energy can achieve 30,000 megawatts of generating capacity in our country by 2010. Doing so would reduce CO_2 emissions by up to 100 million metric tons, about 18% of the reduction that the electric industry must achieve to reduce emissions back to 1990 emissions levels.

We should also give the embattled oil industry some help by including a five year carry back treatment to net operating losses resulting from the production of oil and gas as proposed in H.R. 423. Congress already extended a five year carry back to farmers and President Clinton has offered such a provision to the steel industry. My bill, which is supported by the Independent Producers Association of America and the California Independent Producers Association, aids the domestic oil industry in the same fashion.

The recent increase in crude oil prices hardly means that H.R. 423 is no longer needed. Prices of late have risen on speculation that OPEC will maintain price discipline, hardly something on which we can count. H.R. 423 can serve as an insurance policy against further loss of jobs and production, both of which are valuable in this economy.

H.R. 607 will remove barriers to mutual fund investment in publicly-traded partnerships (PTPs). PTP shares are subject to federal regulations on reporting data to the market. The shares are openly traded on public exchanges. In spite of these similarities to stocks and bonds, PTP shares are avoided by mutual funds managers because of outdated Internal Revenue Code standards.

Under the Code, mutual funds can lose their pass-through status if more than 10% of their income comes from investments which are not listed in the statute. As PTP shares are not among the listed investments, fund managers avoid PTP shares due to the risk of earning too much income from them. H.R. 607 provides a simple solution to this anomaly by including PTP shares in the list of assets generating income a mutual fund can count to its legal requirements.

H.R. 1713 resolves long-standing problems for companies trying to manage risk with respect to vital supplies and working capital. Increasingly, businesses are relying on hedging and financial derivatives to manage their exposure to the risk of input price changes and capital costs.

For taxpayers, the lack of clarity means continued uncertainty as to whether or not instruments will be treated as capital assets for tax purposes. Unless gain and loss are treated the same way, taxpayers' ability to manage risk will remain limited by the tax code.

H.R. 1713 resolves the issue by defining hedge transactions as those in which risk is being managed. The language of the bill has been developed with Treasury and the resulting bill will actually raise federal revenue.

I also strongly recommend the inclusion of H.R. 1616, the Real Estate Investment Trust Modification Act of 1999, in the coming bill. This bill, which Congressman Cardin and I coauthored, will resolve outstanding problems in the tax treatment of Real Estate Investment Trusts (REITs). H.R. 1616 incorporates the Administration's REIT proposals but goes beyond them to make critical improvements in three areas of the law: services, the treatment of hotels, and handling bankrupt or foreclosed health care properties.

The bill allows REITs to offer tenants services through Taxable REIT Subsidiaries. These subsidiaries will pay tax on income they earn. Severe penalties will apply to excessive changes used to shift subsidiary income back to the parent company, reducing the risk of "earnings stripping" schemes. The creation of these subsidiaries is vital to modernizing the role of REITs in offering resources to their tenants.

Services are an increasingly important part of the real estate trade. While corporations and partnerships can offer potential tenants internet connections and other services, a REIT can only offer such services after the IRS deems them "customary" in the trade. Until services are deemed customary, the income they generate puts a REIT at risk of losing its pass-through status. Today's law therefore makes REITs inherently less competitive than other rentors in the market.

The bill also corrects an anomaly in the treatment of hotel REITs. Today, the law forces a REIT to have an independent third party lease the REITs' properties to a hotel operator. This rule diverts rental profits from the REIT shareholders to a third party. The bill's TRS requirement allows hotel REITs to use Taxable REIT Subsidiaries to conduct these activities.

The final significant adjustment is in the treatment of health care properties subject to foreclosure proceedings or abandoned by lessees. Present law requires a REIT to find a new tenant within an unreasonably short period of time. Failure to meet this requirement means income from the property cannot be treated as rental income of the sort needed to remain a REIT. H.R. 1616 gives REITs in this difficult position up to two years in which to find a new tenants.

For additional environmental benefits in reducing greenhouse gases, I urge the inclusion of H.R. 1358 in the coming tax bill. H.R. 1358 creates tax incentives to raise the energy efficiency of both new and existing homes. In the case of new homes, 30% more efficient than model code standards, a builder would receive a $2,000 credit. Homeowners would get a $2,000 credits for making improvements to existing housing stock.

Incentives to improve homes are a good way to achieve voluntary greenhouse gas reductions. The average home today is responsible for about 12 tons of carbon dioxide in the atmosphere. H.R. 1358 gives builders and homeowners a substantial incentive to cut those emissions without forcing them to take prescribed steps.

The Alliance to Save Energy has estimated the new home credit in H.R. 1358 would reduce the carbon dioxide emissions by up to 200,000 tons per year, nearly seven times the reduction expected from the Administration's proposal in this year's budget. Further, H.R. 1358 provides incentives to improve older homes as well. While older housing is far less efficient in its use of energy and substantial gains could be made there, the Administration's budget ignores this vital area.

Finally, I have introduced H.R. 1914 to correct a flaw in the "dividend allocation" rule applicable to farmer cooperatives. Generally, a cooperative can deduct dividends paid to farmers which are based on cooperative earnings from business done for those farmer patrons. Earnings from other "nonpatronage sources" are taxed when received by the coop as well as in the farmers' hands. Over the years, a "dividend allocation rule" has developed out of Treasury and court decisions that now creates problems for coops using sales of stock to raise capital.

Coops are increasingly interested in raising funds through stock sales because many are reaching the limits of raising capital through debt. If dividends are paid on stock, the allocation rule taxes some income three times because the rule makes the coop reduce its dividends paid deduction based on the amount paid out on stock.

H.R. 1914 puts an end to the third level of tax by allocating dividends paid on stock to nonpatronage sources of income and retained earnings first. Adoption of this rule will allow farmer cooperatives to continue serving agriculture in today's sophisticated markets.

Statement of U.S. Securities Markets Coalition

This statement is submitted by the U.S. Securities Markets Coalition. The members of the Coalition are The American Stock Exchange, The Boston Stock Exchange, The Chicago Board Options Exchange, The Chicago Stock Exchange, The Cincinnati Stock Exchange, The NASDAQ Stock Market, The National Securities Clearing Corporation, The Options Clearing Corporation, The Pacific Stock Exchange, and The Philadelphia Stock Exchange. The statement sets forth two recommendations for improving the accuracy and fairness of the "tax straddle" rules. The proposals, which are relatively modest, will result in more equitable treatment of investors seeking to hedge risk associated with appreciated securities by tailoring the tax straddle rules to more precisely implement their underlying purposes. The statement also urges the Committee to proceed cautiously in considering certain aspects of the Administration's proposal to repeal the special rules for stock under section 1092(d)(3).

OVERVIEW

The significant increases in the value of equity securities in recent years have led many investors to seek to hedge their appreciated stock positions against possible declines in value. While the options exchanges provide an efficient means for investors to hedge such risks,[1] certain aspects of the "loss deferral" rule of section 1092, relating to tax straddles, impose what amounts to a tax penalty on legitimate hedges of appreciated stock with options and other financial instruments.

The Administration has previously recognized the "punitive" nature of the loss deferral rule,[2] and in 1997 and 1998 the Administration proposed legislation to make certain aspects of the rule more equitable.[3] In both instances, the Administration's proposal was coupled with certain proposals to expand and clarify the tax straddle rules of section 1092 and to clarify the treatment of ordinary business hedges. Although the Administration's Year 2000 Budget includes these latter proposals, the Administration inexplicably did not renew its prior proposal to ameliorate the harsh effects of the loss deferral rule.

The Coalition urges the Committee to improve the fairness and accuracy of the loss deferral rule in order that taxpayers who enter into legitimate hedges of appreciated stock positions will not receive inappropriately harsh tax treatment. Specifically, the Coalition recommends that section 1092 be amended to provide that (i) gain that has economically accrued before a straddle is created will not be taken into account for purposes of applying the loss deferral rule, and (ii) losses that have been deferred under the rule will be "freed up" on a proportionate basis as gains on offsetting positions are recognized.

The Coalition also recommends that the Committee exercise considerable caution in evaluating the Administration's proposal to eliminate the special treatment of stock under the tax straddle rules. If the proposal is broadly implemented, it will have significant consequences that need to be carefully examined.

DISCUSSION

1. *The "loss deferral" rule and its origins*. Under Code section 1092(a)(1), a recognized loss with respect to a position in a straddle is taken into account only to the extent that it exceeds unrecognized gain with respect to one or more positions that were offsetting positions with respect to the position from which the loss arose. This rule (the "loss deferral" rule) is applied at the end of the year in which the loss is

[1] Trading volume on the options exchanges has increased significantly in recent years. For example, the total volume on the options exchanges has increased from 295,000,000 contracts in 1996 to 406,000,000 contracts in 1998, with each contact representing an option on 100 shares of stock.

[2] *See* "Report on Tax Simplification Proposals," U.S. Treasury Department (April 16, 1997) ("[T]he loss deferral provision under the straddle rules is punitive and sometimes results in a total disallowance of losses."); "General Explanations of the Administration's Revenue Proposals," U.S. Treasury Department (February 1998) at pp. 52–53 ("[T]he loss deferral provision under the straddle rules can be punitive and sometimes results in a total disallowance of losses.").

[3] *See id.*

recognized. Any loss that is deferred under this rule is treated as sustained in the following year, when the loss is again subjected to the same rule (*i.e.*, it is to be taken into account only to the extent it exceeds the unrecognized gain in positions that were offsetting positions).

The loss deferral rule was enacted in 1981 along with the other "anti-straddle rules" of section 1092. The specific transactions that Congress had in mind were straddles in commodities and commodities futures, which had become widely touted as transactions that could be used to create artificial losses to defer tax on unrelated gains.[4] For example, a taxpayer seeking to shelter a capital gain would simultaneously enter into both long and short futures contracts with different delivery months in the following year. Whichever way the price of the underlying asset moved, the value of one contract would go up while the value of the other contract would go down. The taxpayer would then close out the loss contract and replace it with a similar contract with a slightly different delivery month. The taxpayer would use the loss to offset unrelated capital gain. In the following year, the taxpayer would close out both of the remaining contracts, in effect deferring gain from one year to the next.[5] The loss deferral rule prevents this result by denying the taxpayer the ability to claim the loss on the straddle position to the extent there is unrecognized gain in the offsetting position at year-end.

As part of the 1981 anti-straddle legislation, Congress also adopted section 1256, which marks all regulated futures contracts to market at year-end. This mark-to-market regime, which treats all regulated futures contracts (and certain other contracts) as sold at the end of the year, prevents taxpayers from using straddles consisting solely of these contracts to create artificial losses.

In 1984, the straddle provisions, including the loss deferral rule, were extended to cover (i) straddles consisting of options on stock, (ii) straddles consisting of stock and an option (or options) with respect to substantially identical stock or securities, and (iii) under regulations, straddles consisting of stock and positions with respect to substantially similar or related property (other than stock). *See* Code § 1092(d)(3).

2. *Gain that arises before a straddle is created should not be taken into account under the loss deferral rule*.—A loss on a position that was part of a straddle is deferred to the extent of any unrecognized gain remaining with respect to a position that was offsetting to the loss position. Current law does not distinguish between unrecognized gain that arose during the period of the straddle and unrecognized gain that arose before the straddle was entered into.

The failure to make this distinction is understandable in light of the types of transactions that Congress had in mind when the straddle provisions were adopted in 1981. These transactions typically entailed simultaneously entering into long and short commodities futures contracts. When both "legs" of a straddle are entered into at the same time, there can be no preexisting gain associated with either position, and any loss from a position is properly viewed as "artificial" to the extent that the taxpayer has economic gain on an offsetting position. As the Treasury Department has previously explained, straddle transactions are "transactions having multiple components in which the same market movement simultaneously produces a loss and a gain."[6]

The enactment of section 1092 (as well as section 1256) put a stop to the types of transactions Congress was concerned about in 1981. In today's world, the straddle rules most commonly operate with respect to transactions in which a taxpayer has held a position (such as stock) for some period of time before entering into another position (such as an option on the stock) to hedge some of the risk associated with the first position. If the taxpayer hedges appreciated stock, say, by purchasing a put option on that stock, any loss with respect to the put option will generally be deferred under the loss deferral rule without regard to whether the stock increases in value during the time the put option is outstanding.

Example:

> Assume that an investor bought 1,000 shares of Amazon.com at $5 a share and that it is currently trading at $150 a share. The investor buys a put option on all 1,000 shares with an exercise price of $140 a share, for which the investor pays $5,000. The put protects the investor if the stock price drops below $140. On the put's expiration date, Amazon.com is trading at $145, so the put expires unexercised. The taxpayer has a loss of

[4] *See* S. Rep. No. 97–144, 97th Cong. 1st Sess. 145–146 (1981).

[5] *See* S. Rep. No. 97–144, *supra*, at 146. For a more detailed description of a classic commodities straddle, *see* Rev. Rul. 77–185, 1977–1 C.B. 48 (describing a straddle transaction in silver futures contracts).

[6] *See* Statement of John E. Chapoton, Assistant Secretary of the Treasury Department for Tax Policy, Before the Ways and Means Committee on November 2, 1983 at page 21.

$5,000 on the put (as well as an economic loss on Amazon.com during the period of the straddle).

Under current law, the taxpayer cannot claim the $5,000 loss on the put because he continues to hold the Amazon.com stock with unrecognized gain that is greater than the amount of that loss. This is true even though (i) all of the gain accrued economically before the straddle was entered into, and (ii) the value of Amazon.com actually declined during the period of the straddle.

There is no policy rationale to support the result under current law. The loss on the put in the example is a real economic loss (as opposed to the "artificial losses" that Congress sought to preclude by enacting section 1092). The gain that current law takes into account all arose before the straddle was entered into and cannot properly be viewed as offsetting the loss on the put.

The Coalition recommends that the loss deferral rule of section 1092(a)(1) be amended so that gain accruing before the straddle is entered into is not taken into account in determining the amount of any loss to be deferred as a result of the straddle transaction. This change will both reduce the unfairness inherent in present law and more precisely implement the original purpose of the straddle rules, which was to prevent taxpayers from creating economically offsetting gains and losses through straddle transactions and using the losses to defer tax on unrelated gains.

As a corollary of this change, any economic loss on a position that arises before a straddle transition is entered into would also be disregarded in determining the amount of unrecognized gain on that position for purposes of applying the loss deferral rule. This change will prevent taxpayers from exploiting the lack of precision in the current rules by entering into straddles with respect to positions with "built-in losses." [7]

The Coalition's proposal can be readily implemented by limiting the amount of loss subject to the loss deferral rule to the amount of unrecognized gain in the retained offsetting position(s) that arose after the time the straddle was created. Because application of the straddle rules is limited to positions with respect to actively traded personal property, it should generally not be difficult to determine the market value of the position at the time the straddle is created (*i.e.*, when the offsetting position is entered into). Current law already depends on determining the market value of the position as of the end of the year.

The application of the Coalition's proposal can be illustrated by the following example.

Example:

Investor X holds 1,000 shares of stock with a basis of $10,000 ($10 per share) and a value of $60,000 ($60 per share). X buys a put option with an exercise price of $60 on all 1,000 shares, paying a premium of $7,000. At the expiration of the put, the stock is trading at $62 per share, and the put expires worthless. X continues to hold the stock, which is trading at $62 at year-end.

Under current law, X cannot deduct any portion of the $7,000 loss on the put because the unrecognized gain in the stock exceeds that amount. This is true even though the $7,000 loss on the put was offset by only a $2,000 gain in the stock during the period the straddle was in place. Under the proposal, X would be allowed to deduct $5,000, which represents the real economic loss to X during the time the straddle is in place. The remaining $2,000 of loss, which was offset by gain on the stock, would be deferred as under current law. The only additional change would be that the unrecognized gain taken into account at year-end would be limited to the excess over $60 per share (the value of the stock at the time the straddle was entered into).[8]

[7] A taxpayer who holds a depreciated stock or security may be able to generate artificial losses through straddle transactions and avoid application of the loss deferral rule. Assume a taxpayer holds stock with a basis of $10,00 and a value of $8,000. The taxpayer enters into a straddle transaction that results in a $2,000 loss on the offsetting position and a $2,000 increase in the value of the stock during the straddle. Because there is no overall gain in the stock, the loss deferral rule will not defer the deduction of the $2,000 loss (even though it was economically offset by $2,000 of gain on the stock during the time the straddle was in place).

[8] The Coalition's proposal to segregate gain (or loss) that arises before a straddle is created for purposes of the loss deferral rule is consistent with approaches taken by Congress in other areas. For example, under Code section 475(b)(3), if a securities dealer holds property for investment and then converts it to dealer property, the property becomes subject to the mark-to-

Continued

In light of the substantial appreciation of equities over the last several years, and the desire of investors to hedge risks associated with their appreciated investments, this is an appropriate time for the Committee to correct an obvious inequity in the straddle rules. The loss deferral rule of current law is unnecessarily crude and imprecise. The Coalition urges the Committee to report legislation that will make the loss deferral rule both more equitable and more accurate in light of its intended purpose.

3. *Permit deferred losses to be deducted proportionately as offsetting gains are recognized.*—Under current law, a loss on a position that was part of a straddle apparently has to be deferred to the extent of any unrecognized gain with respect to one or more positions that were offsetting to the loss position. *See* Code § 1092(a)(1)(A). This rule applies even if the taxpayer has recognized a substantial portion of the gain associated with such offsetting positions.

Example:

> Investor B buys 1,000 shares of Selectron at $50 share and buys a put option on all 1,000 shares with a strike price of $45 at a cost of $2,000. Assume that the stock goes up to $70 per share and the puts expire worthless. B then sells 900 shares of the stock, thereby recognizing $18,000 of gain ($63,000 of proceeds less basis of $45,000). Under current law it appears that B cannot deduct any portion of the $2,000 loss on the puts because he still has $2,000 of unrecognized gain in his 100 remaining shares of stock. This is true even though B sold—and recognized gain on—90% of the stock position that was offsetting to the puts.

This aspect of current law is unnecessarily harsh and should be corrected. Section 1092 should be amended to provide that a taxpayer is permitted to deduct a portion of any loss from a position that was part of a straddle to the extent that he or she has recognized a similar portion of gain associated with offsetting positions in the straddle. Thus, in the above example, B would be permitted to deduct 90% of his loss on the puts ($1,800) because he recognized the gain associated with 90% of his stock position.

This proposal is consistent with the hedge timing rules of Treasury Regulation section 1.446–4. It appropriately matches the timing of the loss on the hedging position to the timing of the gain on the hedged position. As with the proposal set forth above, it would both improve the accuracy of the tax straddle rules and ameliorate unnecessarily harsh consequences under current law.

4. *The Administration's proposal to eliminate the special rules for stock.*—The Administration's Year 2000 Budget includes a proposal to repeal the special rules for stock under section 1092(d)(3). These rules generally limit application of the straddle rules, in the case of stock, to (i) straddles consisting of stock and options with respect to substantially identical stock or securities, and (ii) to the extent provided by regulations, straddles consisting of stock and positions with respect to substantially similar or related property (other than stock).

In 1995 Treasury exercised its regulatory authority to apply the straddle rules to straddles consisting of stock and positions with respect to substantially similar or related property (other than stock). *See* Treas. Reg. § 1.1092(d)–2. This regulation provides guidance on the meaning of the phrase "substantially similar or related property" by cross-referencing Treas. Reg. § 1.246–5, which was adopted at the same time and which provides guidance on the meaning of the same phrase for purposes of section 246(c). The IRS has also issued a proposed regulation that would amend Treas. Reg. § 1.1092(d)–2 to make clear that the regulation applies to a straddle consisting of stock and an equity swap.

It is our understanding that Treasury's main reason for making the legislative proposal to eliminate the special rules for stock is to eliminate any uncertainty regarding its authority under current law to apply the straddle rules to stock offset by an equity swap. However, the proposal, as stated, would have much broader consequences, some of which are difficult to gauge.

There are two areas that we believe need careful study if the special rules for stock are to be repealed. First, long stock and short stock positions (*i.e.*, short sales),

---

market rules of that section However, only gains and losses arising after the date of conversion are marked to market. Any unrealized gain or loss existing at the date of conversion remains suspended until the property is sold.

Another analogous provision is former section 851(g), which provided that gains and losses of regulated investment companies during the period of any "designated hedging transaction" would be netted for purposes of the "short-short test" of former section 851(b)(3). Thus, any gain or loss arising before such a hedging transaction was entered into was segregated from the calculation of the net gain or loss during the period the hedging transaction was in place.

which have long been governed by section 1233, would become straddles subject to section 1092. At a minimum, the proposed change would appear to make the rules of section 1233 redundant as applied to publicly traded stock. Whether there may also be some unintended consequences is a subject that should be carefully studied.

Perhaps of greater importance, and creating greater uncertainty, would be the elimination of the "substantially similar or related property" standard (which is part of the special rules for stock in section 1092(d)(3)). As noted above, Treasury has issued guidance on the meaning of that standard under section 246(c) and has incorporated that guidance by reference for purposes of section 1092(d). While that guidance is not without its problems, it does provide a body of law that taxpayers (and the government) can refer to and rely upon. Simply eliminating that standard under section 1092 would raise substantial uncertainties as to the potential scope of the application of the straddle rules to stock. Unless there is some compelling reason to eliminate this standard, the Coalition would urge the Committee not to do so. At the very least, careful study must be given to the types of transactions that could conceivably cause stock to be part of a straddle if the standard is eliminated.

○