TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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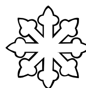

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TAX REFORM

WEDNESDAY, JUNE 8, 2005

U.S. 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 Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
June 08, 2005
No. FC–11

CONTACT: (202) 225–1721

Thomas Announces Hearing on Tax Reform

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on tax reform. **The hearing will take place on Wednesday, June 8, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include scholars from Columbia University, University of Michigan, University of California at Berkeley, and the Heritage Foundation. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 7, 2005, President Bush established the Advisory Panel on Federal Tax Reform. The Panel has been holding hearings throughout the country to solicit the opinions of leading experts, academics, and practitioners on reforming the tax code. Recognizing the burden imposed by the current Federal tax code in terms of compliance and growth incentives, the President's stated goal is to explore options to reform the tax code to make it simpler, fairer, and more pro-growth. The Panel shall report to the Secretary of the U.S. Department of the Treasury by July 31, 2005.

More than 14,000 changes have been made to the tax code since the last major reform effort in 1986. The tax code imposes economic distortions that cost the U.S. economy as much as 50 cents for every additional dollar raised, and causes taxpayers to waste 3.2 billion hours and as much as $100 billion complying with an increasingly complex system.

The 2005 Economic Report of the President noted: "The current Federal tax system is unnecessarily complex and distorts incentives for work, savings, and investment. As a result, it imposes large burdens on taxpayers and on the U.S. economy as a whole in the form of high compliance costs and distortions in economic decisions."

In announcing the hearing, Chairman Thomas stated, "In anticipation of recommendations from the Treasury Secretary on tax reform, this hearing will be the first of several to inform Congress on the need for and benefits of reforming the current tax code."

FOCUS OF THE HEARING:

The focus of the hearing will be on attaining a broad overview of the principle economic objectives of tax reform with a focus on fairness, simplicity, and impacts on growth. In particular, the hearing will explore: (1) ways to make compliance and understanding of the tax code simpler for American workers and businesses, (2) economic distortions and incentives imposed by the tax code, and (3) various measures of tax burdens.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Wednesday, June 22, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

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

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

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

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 THOMAS. I want to welcome you all to the Committee's first hearing on Federal tax reform since the President appointed an advisory panel on Federal tax reform to explore this important issue that is going to affect nearly every American household. I know some folks are wondering why we are holding hearings now on tax reform before the President's panel issues its recommendations. As the one Committee in the House that is charged with understanding and evaluating the product from the President's panel, the Chair thought it might be useful to begin an analysis of those kinds of criteria that would be useful in making choices based upon some of the panel's suggestions. The President

has appointed a highly qualified panel to examine the growing problem with our current Tax Code, and I would really like to thank especially the chairman and the vice chairman of this panel, former Senators Connie Mack and John Breaux for their service. It truly is a service. It will be a very difficult task in a relatively short period of time for them to pull together the alternatives as they have been asked to do. I do believe they will do it, but before the release of the advisory panel report and subsequently the U.S. Department of the Treasury Secretary's recommendation, as I said, this Committee as the tax writers in the House of Representatives really need to lay the groundwork and provide some degree of uniformity of comparison between approaches as we examine suggested changes in the Tax Code.

You will hear over and over again that there are three major priorities that we need to focus on. We have in front of us a distinguished panel of economists. Although they will do their best to try to sound as objective as they possibly can, to a certain degree, there is some subjectivity as you discuss the question for example, simplicity. We have seen significant changes since the last major restructuring of the Tax Code in 1986. One of our witnesses will mention in his testimony that the complexity of the current system has caused taxpayers to spend 3.2 billion hours preparing their taxes in 2000. Or we paid someone else to add to that 3.2 billion hours to prepare our taxes. I think most people can find a more productive use of their time. Of course the compliance cost is very expensive, estimated as high as $135 billion. If that is the truth, what we are saying is that it costs a dollar in compliance costs for every $7 in Federal income taxes paid.

A second priority that will be discussed is fairness. Clearly, from an objective versus subjective point of view, this is as much as any in the eye of the beholder. However, there are some metrics by which you can at least decide to judge the question of fairness. I think this panel can be very helpful in providing choices, even though you may choose from among those choices, at least we have a common knowledge base as we discuss what we mean by fairness. I guess a fundamental one would be that similarly situated taxpayers should bear similar tax burdens. Of course, the Code is limited, littered with preferences and disincentives, credits and deductions which make it difficult to truly compare in terms of fairness. All of us would agree, that it makes no sense to use taxes to fund the government raised in a way that discourages economic growth. There will be some discussion over whether or not certain types of taxes encourage economic growth, or, in fact, don't have much effect. I hope Members will listen to these discussions because once again, although some people feel very strongly about a particular approach, it may be that the difference between different approaches in terms of economic growth is not that much.

In some instances, I think there may be significant differences and we need to be aware of that as we take a look at something in the area of a trillion dollars that may be affected by particular options that we might choose that would be raised or not raised that would stimulate the economy or not stimulate the economy. The Chair is more than willing to accept applications by Members of the Committee for some degree of college credit for the discus-

sion that we may be engaged in, but frankly, we just have to have a particular understanding of economic terms and approaches so that we can share a common knowledge base as we begin to examine these various approaches. The Chair appreciates the attendance today, as always, and looks forward to Members' questions based upon the testimony provided by witnesses. With that, I would recognize the gentleman from New York for any opening statement he may make.

[The prepared statement of Chairman Thomas follows:]

Opening Statement of The Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good morning. Welcome to the Committee's first hearing on Federal tax reform since the President appointed an Advisory Panel on Federal Tax Reform to explore this important issue that affects nearly every American household.

The President has appointed a highly qualified panel to examine the growing problems with our current tax code and it has held many hearings across the country and will soon be reporting its recommendations to the U.S. Treasury Secretary. I'd like to thank the Members of this panel—particularly the Chairman and Vice-Chairman, former Senators Connie Mack and John Breaux—for their service, and I look forward to reviewing the Panel's recommendations.

But before the release of the Advisory Panel report, and subsequently the Treasury Secretary's recommendations, this Committee, as the tax writers in the Legislative Branch, intends to lay the groundwork and explore why we need to reform the tax code and the benefits of comprehensive reform.

Today's hearing will focus on the three major priorities that should be the driving force behind any tax reform we enact.

One priority should be simplicity. According to the President Advisory Panel, more than 14,000 changes have been made to the code since the last comprehensive overhaul in 1986. As one of our witnesses will mention in his testimony, the complexity of the current system caused taxpayers to spend 3.2 billion hours preparing their taxes in 2000. Clearly, there are more productive uses of Americans' time. The annual cost of complying with today's Federal tax system has been estimated to be $135 billion. In other words, it costs $1 in compliance costs for every $7 in Federal income taxes paid.

A second priority is the fairness of the current tax code. Some may suggest that "fairness" is simply in the "eye of the beholder" but as we will hear today, there are some metrics that everyone should agree with. For one, similarly situated taxpayers should bear similar tax burdens. The current tax code is littered with preferences and disincentives, credits and deductions so that tax burdens can vary widely even among taxpayers with equal incomes.

Finally, the tax code should not discourage economic growth, as many indicate that the current system does. Estimates of various tax reform options indicate that the stakes are large—roughly $1 trillion in present dollar terms, according to research done by one of today's witnesses—but also that it would take some time for these benefits to accrue.

The witnesses before us today will discuss these three priorities in more detail. Professor Joel Slemrod will talk about the complexity of our current tax code and how it could be simplified. Bill Beach will discuss the inequities in the current code and Professors Hubbard and Auerbach will address how the tax code distorts economic growth and how tax reform could alleviate these distortions.

I now recognize the gentleman from New York, Mr. Rangel, for any opening statement he may have.

Mr. RANGEL. Thank you, Mr. Chairman. The last time this Committee had hearings on tax simplification and reform was in 1995 where the distinguished gentleman from Texas, Chairman Archer led us into hearings. As a matter of fact, I tried to get invited on his buses to go around the country to pull up the Tax Code by the roots. Since that time, the Tax Code has doubled in terms of pages and complexities. It just seems to me, as I had thought with

Social Security, that when you are going to make changes with such complex legislation, that it just screams out for bipartisanship, because if we are going to have revenue neutrality in whatever we come up with, not that I truly believe we are going to come up with anything, but assuming that you and the President talk with each other and we are going to have a bill, it would seem to me that we should find some degree of agreement as to which deductions and which credits are going to be eliminated, how we have got to handle the dramatic differences in which we tax the very rich and how the middle class has got caught in a trillion dollar package of tax increases with the Alternative Minimum Tax (AMT).

However, I recognize that the chairman's style in leadership is to try to do this with just Republicans, as we find ourselves with the dilemma of Social Security and Central American trade agreement, the only problem I have is not even the Republicans on the Committee have the slightest idea as to where we are going. So, I can't complain about lack of bipartisanship there. It seems to me that this is such an important issue that if we are talking about flat taxes and value-added tax (VAT), that at some point the chairman may share with us whether or not we are going to take the Social Security reform bill and include that with a tax reform bill in order to get some incentives for the Social Security bill to have a new life. Now, I only know where you intend to take this from your press conferences and appearances on television. I do know that you want to expand Social Security beyond just retirement and disability and survival. But, it might be that we are going to have just one big reform package of Social Security and taxes.

So, I hope the witnesses are prepared to deal with private accounts and all those other things in Social Security, so at the end of the day, the American people and the Congress as a whole will have some idea where this august and powerful Committee intends to go. I want to thank the witnesses, in particular, for sharing their views with us. I only wish you were on this Committee so that could you give us at least a little more precise information as to where we should go. You are the only people we have had in 10 years to talk about reforming the Social Security system, and I hope and pray that we don't double the Tax Code in terms of size and volume as a result of this initiative. It is always interesting being on this Committee because there is no telling what might happen next. So, I thank the witnesses and we will see what happens. Thank you, Mr. Chairman.

Mr. LINDER. Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Mr. LINDER. Mr. Chairman, I ask unanimous consent to have a written statement as part of the record.

[The prepared statement of Mr. Linder follows:]

Opening Statement of The Honorable John Linder, a Representative in Congress from the State of Georgia

The President's Advisory Panel on Federal Tax Reform has been gathering testimony throughout the country and it is becoming clear to all—finally—that the current code is unfair, it undermines economic growth, and it places tremendous burdens on the American workers and businesses.

The current system is a nightmare of complexity that punishes work, saving, investment, risk-taking, and entrepreneurship. If there was a nationwide competition to come up with the most complex and unfair system that would be so indecipherable that even the agency that is tasked to oversee it cannot completely understand it—this would be the system that would be victorious.

Should we reform the tax system? Of course! Does it hinder economic growth? Of course! Can the United States meet its commitments under the current system? Of course not!

The GAO presented to this committee a study that shows that if we continue to tax at the current percent of GDP and continue our discretionary spending at its current percent of GDP, in just 35 years from today the entire Federal revenue stream will be insufficient to pay the interest on the debt.

We could, of course, raise taxes. Every tax increase in this nation's history has slowed economic growth. How is this helpful? We could cut discretionary spending. That has never garnered 218 votes in the last 50 years.

What to do?

A study commissioned in 1997 from Harvard argues that, on average, 22% of the price system represents the embedded cost of the current IRS system. You are paying the income tax costs, the payroll tax costs and the compliance costs of every business entity that has had a roll in delivering that good or service to you. In addition, the payroll tax, part of that embedded cost, is the largest hidden tax component in the prices of our goods and services and is the most regressive of the existing taxes.

Our exports also go abroad burdened by this hidden tax component. This makes us uncompetitive in the global economy and forces American businesses to build plants in nations with a lower tax on capital and labor. Those jobs are gone. America needs a tax system that is border-neutral that ensures that imports receive the same tax treatment at the checkout counter as domestically-produced goods.

The Tax Foundation produced a study that concludes that in 2004 we spent 6.6 billion hours filling out IRS paperwork costing Americans $203 billion. They predict that, due to complications passed in the last few years, the cost in 2007 will be $350 billion. Studies show that it costs the average small business $724 to collect, comply with the code and remit $100 to the Federal Government.

There is no way to estimate how much we spend calculating the tax implications of a business decision. The Director of the CBO tells me of a study that says we lose 18% of our economy to making "tax decisions" rather than "economic decisions." Add all of this up and it is costing us somewhere between $400 and $500 billion just to send in about $1.5 trillion in income taxes. That is not inefficient. That is stupid!

The IRS admits that the current code has driven at least $1.5 trillion into the underground economy. That is probably half of the real number. Those dollars are not paying for the government services that protect them.

Two recent studies have concluded that the amount of money held in Offshore Financial Centers in dollar denominated deposits now is between $9 and $11 trillion. Those are dollars that desire safety and secrecy. They exist offshore because of the IRS.

Nibbling at the margins of our current system will fix none of the above. Getting rid of the income tax, the payroll tax and the compliance costs will fix them all.

Why do we not want the underground economy to participate in our government? Why do we not want $10 trillion in our markets and banks? Why are we timid when we know that bold change will dramatically increase economic growth, investment, jobs and the values of our markets and thus solve the legacy costs of old manufacturing?

We must replace the current tax system that punishes entrepreneurship, success and thrift with a system that untaxes every citizen on the purchase of necessities and then treats everyone exactly the same.

America needs a tax system that is simple to understand and is not vulnerable to the continual alteration and amendment. Even when the current code is simplified, which was done in 1986 when many deductions were eliminated and tax rates were drastically lowered to only two levels, it is ultimately amended thousands of times. The end result is a system that is not simple and is not fair.

This can only be achieved by a pure consumption tax. A tax on the final purchase of new goods and services. With services becoming an increasing player in our economy they must be taxed just as goods are in 45 states today. Government ought to be neutral. It ought not pick winners and losers. I spent 14 years as a dentist in our legislature making a good living. It was never fair that I could make that living without ever taxing my source of income when all of my neighbors had to.

We owe it to our citizens to put in place a system that makes every taxpayer a voluntary taxpayer paying taxes when they choose, as much as they choose, by how they choose to spend. And we must give Americans the privilege that a free society owes to its citizens. The privilege of anonymity. No government agency should know more about us than we are willing to tell to our family.

America needs a tax system that is fair and simple, protecting the poor, treating all Americans the same, and is easy to understand. This new system must be voluntary, not coercive or intrusive. It must be transparent, eliminating hidden taxes and ensuring that all Americans know what the government costs. Our reform efforts must also be border-neutral so that our exports are free of the burden of the tax code and can become competitive around the world. Finally, fundamental reform must stop picking winners and losers through the tax code and ensure the long-term solvency of Social Security and Medicare.

With today's hearing, our Committee hopefully will begin the process of advancing such a tax code.

Chairman THOMAS. Without objection. Other Members who have a written statement can certainly make it a part of the record. Just respond briefly to the gentleman. I have written letters to Members in the past and I have written them recently, every Member, and have requested input as to where they might like the Committee to go. Those letters are never answered. They are, in fact, sent to you and you then send me a letter. I continue to invite comments by Members as to where we might go. If Members choose not to respond to the chairman, that is, of course their privilege, but the accusation that there hasn't been an attempt to reach out simply is not true. Let me also say that at this point, one of the reasons we have such a distinguished panel of economists in front of us, prior to the President's panel presenting their options for tax reform, is to begin a dialog among ourselves and with experts about fundamental concepts of taxation before we look at particular proposals so that we can have an opportunity to carry on a dialog among ourselves.

The Chair will, as he has done consistently, reach out to Members to participate in that. If Members choose not to do that, that is the Members' choice, not that they have been refused participation, but they choose on their own not to participate. So, sometimes, notwithstanding the belief that there is some preconceived notion, the Chair firmly believes that the going is the goal, and that as you begin the process, you begin to see options available to you that may not be able at the beginning of the process. This hearing is primarily to provide us with the tools to recognize and perhaps understand a level of conceptual and communicative ability to discuss the relative aspects of different approaches, weigh choices and understand the outcome of those choices prior to making them.

With that, the Chair thanks you, given the very important and diverse lives that you have, for your willingness to come before the Committee for a period of time. Your written statement will be made a part of the record and the Chair invites you to address the Committee in any way that you see fit over your prepared statement, but that the Chair hopes that questions by the Members will stimulate some discussion among the panel because once you read your testimony I find quite interesting that a number of you have paired up on various monographs and you certainly footnote each other, if you didn't footnote yourself occasionally. It means you are

very conversant with each others' work. I thank you very much for your time, as I said.

Chairman THOMAS. Starting with Dr. Auerbach and moving across the panel.

STATEMENT OF ALAN J. AUERBACH, ROBERT D. BURCH PROFESSOR OF ECONOMICS AND LAW, UNIVERSITY OF CALIFORNIA AT BERKELEY, AND DIRECTOR, BURCH CENTER FOR TAX POLICY AND PUBLIC FINANCE, BERKELEY, CALIFORNIA

Mr. AUERBACH. Thank you very much Mr. Chairman. It is a great pleasure to be here again to talk about, again, about tax reform. In my written comments I focus on the effect of tax reform on competitiveness and economic growth. In particular, I also highlight one popular objective that sometimes is associated with what tax reform can do that I think is probably misdirected. In the end, after I go through various issues, I come up with what I hope are a useful list of recommendations for how to think about tax reform as opposed to supporting any particular proposal. If one starts talking about competitiveness, and that is obviously a major concern, given that the United States has been experiencing really massive trade deficits, close to 6 percent of gross domestic product (GDP) in the first quarter of this year. The first question one has to address is exactly how we measure competitiveness. I mean, we commonly think about competitiveness by looking at our cost relative to the cost of foreign producers, but that is actually a hard thing to do because exchange rates move around.

Of course, there has been a lot of discussion about exchange rates, for example the exchange rate with China recently. Given that exchange rates move around, it is not a very stable measure of competitiveness, and I argue in my testimony that a better approach to measuring competitiveness is measuring our productivity, because the more we can produce ultimately the higher standard of living we can have. We can't consume more than we produce in the long run, although in recent years we have come close to doing that. So, our objective as a society in thinking about competitiveness should be to have as high a level of productivity and a rising level of productivity. When we focus on international trade, we would should simply see that as a means for achieving a higher level of productivity and a higher standard of living, rather than an end in itself. That is, we shouldn't take a mercantilist approach of trying to have trade surpluses or strong exports as an end in themselves but simply as a goal toward achieving a higher standard of living and a higher degree of productivity.

Now, productivity is caused by several factors, many of which are influenced by the tax system in important ways. The condiments generally emphasize three types of capital accumulation as augmenting simple labor and the production of higher levels of GDP: tangible capital, plant and equipment of course, but also intangible capital, ideas, and further, human capital, the education and training that makes workers more skilled. We should focus on all three because all three are important components of achieving higher productivity. Sometimes we focus just on tangible capital, and I think that is probably a mistake. Certainly if you look within any

category and across categories you can see that our tax system does not treat the different forms of capital accumulation in a uniform manner. That leads to a number of distortion of the choices and makes our tax system less effective. Now, I focus, although I discuss all three types of capital, I focus most on tangible capital. I point out there that there are four dimensions in particular. You can think of the types of effects that the tax system has as four dimensions in which they vary. First whether they are broad or targeted, second whether they are temporary or permanent, third whether they are aimed at savers or investors, and fourth, and perhaps the one I emphasize the most, whether they apply to capital assets already in place as opposed to prospective investments.

There is sort of a loose sense that things that are good for capital are good for investment. We should really think about these things separately. Some provisions, provisions if you want to encourage investment and saving, then you want provisions that are targeted toward investment and saving. Sometimes you also have to give subsidies to existing assets as well. That is not really something that helps you accomplish additional capital formation and productivity. I also talk about one thing that tax reform cannot do, and the reason I single this out is it comes up over and over again in the tax reform debate. There is a sense that some consumption tax proposals, like a value-added tax or retail sales tax that provide border adjustments, that is, don't tax exports and do tax imports, that those systems somehow, by that provision, help the trade balance. I, in my comments, in my written comments I go through why that really isn't right. I think it is generally accepted by economists that that is not an important reason or an important way in which a consumption tax proposal or other proposal will affect the trade balance. There are other indirect ways, but not that. Then finally at the end, and perhaps if I have time in a question and answer session, I will go through the recommendations that I have. They are listed at the end of my testimony. Thank you, Mr. Chairman.

[The prepared statement of Mr. Auerbach follows:]

Statement of Alan J. Auerbach, Robert D. Burch Professor of Economics and Law, Director, Burch Center for Tax Policy and Public Finance, University of California at Berkeley, Berkeley, California

I am pleased to have this opportunity to offer my views on the effects of the tax system on economic growth and international competitiveness and the role that tax reform can play in promoting both. Today, I will discuss the design of effective tax incentives and how the current tax system measures up. I will also highlight one potential goal that tax policy cannot achieve. Finally, I will draw some conclusions regarding the design of fundamental tax reform and how potential reform plans should be evaluated.

What is Competitiveness?

The United States has experienced massive trade deficits in recent years, with net imports in the first quarter of 2005 approaching 6 percent of GDP. This has led to concerns that U.S. producers may be losing their ability to compete in the global marketplace. But how should one define competitiveness?

The simplest definition of competitiveness, perhaps, involves a comparison of domestic and foreign costs of production; U.S. producers are "competitive" if their costs of production are lower. But this measure of competitiveness suffers from two logical problems. First, the costs of foreign producers, measured in U.S. dollars, depend on the exchange rates between the dollar and the respective foreign currencies. A low enough dollar would make all U.S producers competitive according to this definition, even with no changes in domestic or foreign production techniques or local labor

costs. Thus, U.S. producers could be competitive even in our weakest industries or, at a different configuration of exchange rates, not competitive even in our strongest. Second, the most fundamental economic concept of international trade—Ricardo's principle of *comparative advantage*—dictates that a country will export the goods and services in which it is *relatively* competitive, and import the goods and services in which it is not—even if it is extremely efficient at producing goods and services in the latter category. By definition, a country cannot have a comparative advantage in producing everything, and thus it cannot have a uniform cost advantage. Thus, a comparison of domestic and foreign costs, though perhaps intuitively appealing, is not a useful measure of competitiveness.

A better approach to measuring competitiveness relies on a comparison of productivity, the amount of goods and services produced per worker hour. Higher productivity means a higher attainable standard of living, for over the long term a society cannot consume more than it produces. Our objective, as a society, should be a high and rising standard of living. International trade is only a means to achieving this ultimate objective; strong exports or a trade surplus are not ends in themselves.

The Determinants of Productivity

Productivity per worker hour depends on a range of factors, many of which are influenced by taxation. We should consider the impact of taxation on human capital, tangible capital, and intangible capital—the three types of capital that increase productivity by augmenting basic, unskilled labor. All three types of capital are important determinants of productivity and policies to foster capital accumulation should be designed with all three types in mind (not just tangible capital). Our present tax system does not treat the different types of capital uniformly, thereby creating uneven incentives for capital accumulation.

Tax Policy and Human Capital

The costs of accumulating human capital through education, on-the-job training and workplace experience receive relatively favorable treatment under current law. A primary cost of education and training is forgone earnings—the earnings given up by staying in school or by accepting a lower current salary in order to gain valuable job experience—and this cost is effectively tax-deductible, because income and payroll taxes are avoided when earnings are forgone. The progressivity of the tax rate schedule offsets the benefit of being able to expense costs immediately, for those who accumulate human capital will have higher future incomes and thus face higher marginal tax rates. But there is another aspect of the "success" tax that is often ignored, that a progressive rate structure also provides insurance against income uncertainty. Success may be the result of education and hard work, but it also depends on luck: by choosing the right field of study, working for a successful employer, or avoiding debilitating illness. Indeed, recent research suggests that moving to a less progressive rate structure might be undesirable, if one takes the reduction in this insurance function into account.[1]

The marginal tax rate reductions of recent legislation, then, have offsetting effects on incentives for human capital accumulation, increasing after-tax investment returns, but also increasing the uncertainty of these returns. However, there is another important aspect of recent policy that discourages human capital investment—the fact that we are on an unsustainable fiscal path. That is, there is a significant risk of large future tax increases. The decision to invest in human capital relies on a very long time horizon, since the returns to education and training may be realized only after several years. The prospect of higher future taxes *and* the uncertainty regarding the form and level of these taxes each discourage human capital investment. A tax system's instability, in itself, discourages human capital investment (and indeed, other types of investment as well), and it is difficult to maintain a stable tax system when there is a large and growing imbalance between taxes and spending.

Tax Policy and Intangible Capital

Intangible capital investments generally face more favorable tax incentives than do investments in human capital. Not only can investors write off such investments immediately, but qualifying investments are eligible for the Research and Experimentation credit. Because the immediate write-off, by itself, effectively eliminates the tax on new investments, the combination of immediate write-off and the R&E credit delivers an outright subsidy to investments in intangible capital. Does such

[1] Shinichi Nishiyama and Kent Smetters, "Consumption Taxes and Economic Efficiency in a Stochastic OLG Economy," National Bureau of Economic Research Working Paper No. 9492, February 2003.

favorable treatment have any justification? The answer is yes, because many intangible investments have the capacity to convey positive "spillovers" to others in society. Put another way, if investors cannot capture all the benefits of their investments, they need some sort of compensation from the rest of society—those who also gain from these investments—and a tax subsidy is therefore fair. The right level and scope of the subsidy are difficult to determine, however, for it is hard to identify the social payoffs to different types of investments in intangible capital.

It should also be remembered that intangible capital depends on more than research and development investment, and is influenced substantially by government policy beyond the realm of taxation. Our ability to achieve high levels of production relies on the clarity and force of our legal system, the rationality of our regulations, the flexibility of our employment relationships, and so forth. We should view tax policy toward intangible capital as but one component of a portfolio of policy tools.

Tax Policy and Tangible Capital

Incentives to invest in tangible capital, primarily plant and equipment, are affected by myriad tax provisions. In thinking about the nature of the provisions, it is useful to distinguish four dimensions in which tax provisions may vary:

1. Are they broad or targeted?
2. Are they temporary or permanent?
3. Are they aimed at savers—those who supply the funds for investment—or at the companies that actually spend the funds?
4. How do they apply to capital assets already in place, as opposed to prospective investments?

Broad versus Targeted

One of the key principles of tax design is that taxes should have as broad a base as possible, so as to permit the lowest possible tax rate for a given revenue requirement. A broad-based, low-rate system promotes efficiency by limiting the distortions of economic decisions, and may also be simpler and easier to administer than alternative systems.

Why deviate from this appealing norm? For example, why implement an investment tax credit for investment in equipment, as we did prior to 1986? One argument is that the favored investment provides significant social spillovers, basically the same rationale as for the favorable treatment of investments in intangible capital. But there is no convincing empirical support for the argument that certain types of equipment investment generate such positive spillovers, so this argument is weak. A second defense of targeted provisions is that they offset existing benefits available to other investments. For example, prior to the changes introduced by the Tax Reform Act of 1986, some argued that real estate investment enjoyed a variety of tax benefits, so that the investment credit simply leveled the playing field. While such an argument may have had merit, at least before 1986, it is extremely difficult to get such offsets right, as the tax provisions one must weigh in seeking balance are typically quite different.

Temporary versus Permanent

No tax provision is truly permanent, because each year brings the possibility of new tax legislation. But some provisions are explicitly temporary. The bonus depreciation provisions introduced in 2002 and enhanced and slightly extended in 2003 had this characteristic; indeed, bonus depreciation has now expired.

Why adopt temporary provisions? The strongest potential justification is as a stabilization device, to dampen swings in the economy. For example, bonus depreciation was introduced while the economy was still recovering from the 2001 recession, which had been characterized by a steep drop in equipment investment. Historically, adjustments of the investment tax credit were often motivated by similar concerns. There is plenty of evidence that fluctuations in investment incentives altered the path of investment, but no evidence that such effects served the purpose of stabilization.[2] Very short-lived provisions, such as the bonus depreciation scheme, are especially tricky to implement because they provide more powerful incentives for longer-lived assets, allowing investors to lock in "cheap" capital for a long time. The variations in incentives across assets depend on how temporary the provisions are, making the tailoring of provisions to provide uniform incentives extremely difficult in a dynamic tax environment.

[2] Alan J. Auerbach and Kevin Hassett, "Tax Policy and Business Fixed Investment in the United States," *Journal of Public Economics* 47(2), March 1992, pp. 141–170.

Saving versus Investment

With the existence of international capital flows, saving and investment can occur in different countries. That is, savers in the United States can supply funds for foreign investment, and businesses in the United States can attract funds for their investment from abroad. If U.S. capital accumulation is our goal, is it U.S. saving or U.S. investment we should be encouraging?

The argument for encouraging U.S. saving is straightforward, for increasing saving expands national wealth, whether this wealth is invested abroad or at home. An increase in U.S. saving would also contribute to a reduction in our trade and current account imbalances, for, as discussed further below, the share of our domestic production not claimed by domestic investment or government and private consumption is available for export.

The argument for encouraging U.S investment, as opposed to U.S. saving, is less obvious, unless one subscribes to the view that such investment generates large social spillovers, a view that I have already dismissed. In the end, though, there is less distinction than there may appear to be between policies that encourage saving and policies that encourage investment, because investment and saving tend to move together.[3] Thus, policies that encourage saving encourage investment, and policies that encourage investment encourage saving.

New Capital versus Old Capital

Some people seem to believe that provisions that benefit capital necessarily benefit investment, but capital and investment are distinct. Provisions may reduce the tax burden on existing capital more or less than they reduce the tax burden on new investment. If stimulating investment is our aim, then we should seek to reduce the tax burden on investment. Although reducing the tax burden on existing capital at the same time may be unavoidable, doing so may actually *discourage* saving and investment, for example, by increasing asset values and stimulating the consumption of goods and services.

Historically, proposals and actual policies have varied considerably in their relative treatment of old and new capital. The following diagram illustrates this variation, with provisions favoring old capital more toward the left, and those favoring new capital more toward the right.

A reduction in the corporate tax rate lowers the tax burden on both new and old capital, though it may help old capital more to the extent that depreciation deductions are more favorable for new assets and shield more of their income from taxation. An investment tax credit, on the other hand, provides no benefit at all to existing capital. Moving in the other direction, a reduction in the capital gains tax rate favors old capital substantially more than new capital. A cut in the capital gains tax rate reduces the tax burden not only on future income from existing assets but also on these assets' past income—gains that have already accrued but have yet to be realized.

Focusing tax provisions on new capital makes the provisions more efficient at achieving their goal, but there are limits to the feasibility of doing this. For example, an incremental investment tax credit, applicable to investment in excess of some base level, would be an even more cost-effective way of encouraging investment. But though the incremental ITC has occasionally been proposed, the determination of its base investment level is complex and involves potentially perverse side effects of the type that have plagued the R&E credit over the years.

The way a tax provision is implemented also affects the extent to which it favors old or new capital. For example, phasing in a reduction in the corporate tax rate rather than adopting the reduction immediately concentrates more of the overall benefit on new capital. Because investment decisions are forward looking, a prospective corporate tax cut may be almost as effective at stimulating investment as an immediate one. But the phase-in procedure will save revenue and limit windfalls to capital already in place, the source of current income. By this logic, the dividend and capital gains tax reductions of 2003 get things almost exactly backward. If in-

[3] Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *The Economic Journal* 90(358), June 1980, pp. 314–329.

vestors believe that the scheduled sunset after 2008 will occur, then the tax reductions will have almost no impact on the incentive to invest while still providing substantial tax benefits to the owners of existing assets.

Finally, it is important to look at substance rather than form in estimating the extent to which a tax provision favors new or existing capital. Provisions labeled "savings incentives" appear aimed at the generation of new savings, and hence targeted at new capital. Any provision that provided a tax benefit only for new saving would indeed be an incentive to save. But many tax incentives for "saving" are available to individuals who simply transfer existing assets into a qualifying account. Such asset transfers do not constitute new saving, and the associated tax benefits represent windfalls to existing assets. Legislators should keep this caveat in mind when considering the expansion of such schemes.

Measuring the "Bang for the Buck"

As just discussed, capital income tax provisions vary in the extent to which they provide windfalls to existing capital rather than incentives for new investment. For a given investment incentive, a provision that limits windfalls will have a lower revenue cost and hence a higher "bang for the buck"—a greater investment stimulus per dollar of lost revenue. But comparing the revenue lost by different provisions is tricky because the provisions may vary in their timing. Provisions that provide "front-loaded" incentives may appear more costly over a short revenue window than comparable provisions that are "back-loaded." A familiar recent example is the comparison between traditional IRAs and Roth IRAs. The two types of accounts offer similar tax benefits to depositors when calculated over the long term, but the tax benefits of the Roth IRAs are received by a depositor over time (through the exemption of earnings from tax), while the traditional IRA delivers its benefits through an immediate tax deduction. Thus, over a short period, say a ten-year budget window, the Roth IRA will *appear* less expensive and seem to have a bigger bang for the buck than the traditional IRA even though this is not the case.

Another example comes from the Tax Reform Act of 1986, which reduced the corporate tax rate while repealing the investment tax credit. As discussed above, the investment tax credit is focused more on new capital than is a corporate tax rate reduction, so trading in the ITC for a tax rate cut seems like a move in the wrong direction, at least in terms of potential bang for the buck. But the ITC is a front-loaded incentive, which makes it appear more expensive over a short time period than a corporate tax rate reduction with a similar impact on the incentive to invest. As the 1986 reform aimed at short-term revenue neutrality, the process was biased against the ITC.[4]

What Tax Reform Cannot Do

There are, of course, many things that tax reform cannot accomplish, but there is one objective so closely tied to tax reform in the minds of some that it deserves explicit attention, lest reform efforts be misdirected. Tax reform cannot reduce the trade deficit, at least not through the tax treatment of exports and imports.

The trade deficit, by definition, equals the amount by which domestic investment spending plus non-investment purchases by government and households exceed domestic production, i.e., GDP; we must import the excess of what we spend over what we produce domestically. Unless we reduce domestic investment spending—clearly not an objective of tax reform—the only ways to reduce the trade deficit are to increase domestic production or to reduce spending by government and households. Either one of these changes—increasing production or reducing non-investment spending—amounts to an increase in U.S. national saving, so reducing the trade deficit (assuming we don't sacrifice domestic investment) requires an increase in national saving. Thus, tax reform must increase national saving in order to reduce the trade deficit.

Tax reform can increase national saving by expanding the economy's productivity, and hence the size of potential GDP, as well as by encouraging saving directly, encouraging households to spend less and save more of their current income. (Other government policies, too, can reduce the trade deficit, notably deficit reduction policies that reduce government spending and, through tax increases that reduce household disposable income, reduce household spending.) But tax reform cannot increase national saving simply by its treatment of exports and imports.

Some consumption tax proposals, such a value added tax or a retail sales tax, incorporate border adjustments—they are not imposed on exports, but are imposed on

[4] Indeed, the one-year revenue effects of these two tax provisions were roughly offsetting. See Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986, *Journal of Economic Literature* 35(2), June 1997, pp. 589–632.

imports. Other proposals do not include border adjustments; they do not relieve the tax on exports and do not tax imports. In comparing the approaches with and without border adjustments, some have argued that inclusion of border adjustments would reduce the trade deficit by making our exports cheaper abroad and our imports more expensive at home. But, with no other differences in economic fundamentals in the United States or abroad, border adjustments will simply strengthen the dollar, putting importers and exporters in the same competitive positions no matter which approach is adopted.[5] Ironically, the stronger dollar that border adjustments would induce would also provide windfalls to foreigners holding dollar-denominated assets—the very ones who have financed our recent trade deficits.

In summary, tax reform can help the trade balance, but only indirectly, through its impact on national saving. The decision whether to include border adjustments as part of a tax reform package should hinge primarily on other factors, such as simplicity, compliance costs and ease of administration.

Implications for Fundamental Tax Reform

On the basis of the preceding discussion, I offer the following guidelines for tax reform design.

1. In thinking about the sources of productivity, keep all forms of capital, not just tangible capital, in mind.
2. With few exceptions, avoid narrowly targeted tax provisions. Such measures may be justified in exceptional cases, but more often are a source of complexity and distortion.
3. Focus on incentives. Provisions formally associated with "capital" or "saving" do not necessarily encourage capital accumulation very much. Providing windfalls to existing assets does not stimulate investment or saving.
4. Take future revenue consequences into account. Proposals can be tailored to minimize short-run revenue costs or maximize short-run revenue gains with little impact on the proposals' economic effects or long-run revenue consequences. The attractiveness of these proposals should not hinge on such cosmetic alterations.
5. Pay close attention to the design of transition provisions. Phase-in provisions can be an effective method of focusing tax benefits on investment rather than on existing assets. But the piecemeal application of tax incentives can also introduce opportunities for tax arbitrage, where individuals receive tax benefits simply by transferring existing assets to achieve tax-favored status.
6. Do not conceive of tax reform as providing simple solutions to the U.S. trade deficit.
7. Remember that the objectives of tax reform will be undercut if the overall fiscal system is unstable. Tax reform and broader fiscal reform are complementary.

Chairman THOMAS. I thank you very much, Dr. Auerbach. Mr. Beach.

STATEMENT OF WILLIAM BEACH, DIRECTOR OF CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. BEACH. Thank you very much, Mr. Chairman. My name is William Beach, and I am from the Heritage Foundation. I do appreciate the decision by your staff to assign me the one topic which is only true if it is the eye of the beholder that is making the decision. I think there are some rules, though, that we can apply to the whole business of justice. Attaining a simple fair and pro-growth tax system involves disciplined thinking of by policy makers about a number of important changes to current law. I would like to draw your attention to some of the considerations you should make when thinking about fairness. If you lived in a simple political and tax world, which none of us do, then every change to the Nation's tax law would have to pass the test. Does the change treat equals equally? Does it reinforce vertical proportionality of the tax system?

[5] See Alan J. Auerbach, "The Future of Fundamental Tax Reform," *American Economic Review* 87(2), May 1997, pp. 143–146.

That is as your income rises do you pay more tax? Does the change to tax policy disturb the peaceful and lawful work of taxpayers toward their economic and social goals? Unfortunately, we do not live in this perfect world even though this model is a key to the survival of good policy in a political environment awash with conflicting interests. Also, unfortunately, the analytical tools you have at your disposal for evaluating the equity elements of proposed changes are rather crude, unfortunately, easily abused and not well suited for answering many of these key equity questions. Nearly every tax bill is challenged to prove that it is fair. Fairness, however can and probably does mean something different to each person who thinks about it. I imagine that there are differences on this subject even on this Committee.

Chairman THOMAS. Mr. Beach, There are some people who are not able to hear you clearly. If you will, pull that mike down closer to your mouth. Thank you very much.

Mr. BEACH. Thank you very much. I imagine that there are differences on this subject, even on this Committee. Since you cannot entertain an infinite number of different definitions of fairness but must instead be governed by a definition that enjoys wide support and also allows you to make decisions on fairness, it is appropriate to start with the question of what is tax fairness. In a moment or two, I am going to try to answer that. I think we can all agree that tax fairness at least means that everyone pays their fair share. That is the total amount of taxes a person pays is proportional to their economic ability to pay taxes. Thus taxes paid are proportional to income or consumption or to some other measurement of our use of government. Tax fairness also should mean, and I think generally does mean the tax policy enacted today will act on each person's taxable income so as to disadvantage no type of taxpayer over another achieving their economic ends. This forward equity of the Tax Code is crucial but seldom noted fairness consideration. Vertical equity, horizontal equity and forward equity are crucial. Three elements of equity. For example, do tax changes made today raise barriers to women reentering the work force years from now after raising a family, or to immigrants starting micro businesses or to retirees pursuing part time work? Do policy changes make it more or less difficult for young people to achieve their goals?

Now economists, and many on this panel, have developed techniques for analyzing how tax policy changes effect taxpayers and non taxpayers. This family of techniques is known as distribution analysis, and provides policy makers with crude but sometimes effective tools for determining whether their policy changes meet the test of vertical horizontal and forward equity. I would suspect that in the course of your deliberations over the next several months, maybe even over the next year you will have presented to you tables that show the distribution of proposed changes. There are many things that the Members need to keep in mind when looking at those tables. First off, against which kind of a concept is the tax policy change distributed? Most often it is income. So, you will see tables that will have on the vertical axis income, and it will be broken up into 20 percentiles or deciles or some sort of measurement. Ask yourself what income is being looked at here? Does it include, for example, only income in the year that the analysis is made, sal-

ary and wages, or does it include net worth or does it include the imputed value of your house? Crucial because one group will tell you, here is what this tax policy change will mean. They may use a different definition of income than another group. So, it is crucial that the Committee think what is the definition of income that we want to look at consistently from policy change to policy change.

Second, some people will say, oh, it is not appropriate to use income since it is so difficult to define. Let us use consumption. Well, consumption is, after all, a fairly public thing. We consume things at a grocery store. We all observe other people consuming it. Surely this must be more fair than income. Yet, if you think about consumption, our big consumption happens when we are young, when we are buying houses, when we are paying off education, when we are raising families. When we reach middle age like myself, family's gone and I am now building net worth. My consumption falls. As I retire, I use up my savings. So, there is even a question, does consumption measure what we are trying to look at when we look at tax policy changes. This whole business of fairness, and I will conclude with this, needs to be governed by principles. First off, look at vertical, horizontal and what I call forward equity. I think that is crucial. Then you need determine how are you going to measure from one proposal to the next proposal, what happens to the distribution of income or the distribution of tax burden or the incidence of tax burden. That means you have to do some things behind closed doors, and that is, decide the metric you are going to use to evaluate the policy changes that will be presented to you by many, many people in this town. Thank you very much.

[The prepared statement of Mr. Beach follows:]

Statement of William Beach, Director of Center for Data Analysis, The Heritage Foundation

The President's call for fundamental tax reform combined with this committee's continued interest in repairing and improving our tax code provides an enormous opportunity for expanding the social and economic well-being of all Americans. Attaining a simple, fair, and pro-growth tax system, however, involves disciplined thinking by policy makers about a number of important changes to current law. I would like to draw your attention to some of the considerations you should make when thinking about fairness.

Let me ask you to hold a mental construction in mind for the next few minutes. It is this: in a perfect tax world, every taxpayer at each income level would be treated equally and the more people made in taxable income the more tax they would pay. In this world, as well, the taxes levied to raise the necessary revenues for needed government would not interfere with the equal right of all taxpayers to use their labor and capital in such a way as to achieve their economic and social goals.

That simple mental construction is crucial to the work you do day in and day out and especially to the product we all hope will flow from this committee once the President's Advisory Panel on Federal Tax Reform completes its work. You need to have a model against which you can evaluate the horizontal, vertical, and forward equity of changes to our current tax code.

If you lived in this simple tax world, then every change to the nation's tax law would have to pass the test: does the change treat equals equally, does it re-enforce vertical proportionality of our tax system, and does the change disturb the peaceful and lawful work of taxpayers toward their economic and social goals.

Unfortunately, we do not live in this perfect world, even though this model is a key to the survival of good policy in a political environment awash with conflicting interests. Also unfortunately, the analytical tools you have at your disposal for evaluating the equity elements of proposed changes are rather crude, easily abused, and not well suited for answering these key equity questions.

As I observed, nearly every major tax bill is challenged to prove that it is fair. Fairness, however, can (and probably does) mean something different to each person

who thinks about it. I imagine there are differences on this subject even on this committee. Since you cannot entertain an infinite number of different definitions of fairness but must instead be governed by a definition that enjoys wide support and also allows you to make decisions on fairness, it is appropriate to start with the question: What is tax fairness?

I think we all can agree that "tax fairness" at least means that everyone pays their fair share. That is, the total amount of taxes a person pays is proportional to their economic ability to pay taxes. Thus, taxes paid are proportional to income or to consumption or to some other measure of our use of government.

"Tax fairness" also should mean (and I think generally does mean) that tax policy enacted today will act on each person's taxable income so as to disadvantage no type of taxpayer over another in achieving their economic ends. This forward equity of the tax code is a crucial but seldom-noted fairness consideration. Lawmakers should consider whether policy change facilitates individual economic, social, and personal choices that set in motion a sequence of activities that lead to goals a person sets for him or herself. For example, do tax policy changes made today raise barriers to women re-entering the workforce years from now after raising a family, or to immigrants starting micro-businesses, or to retiree pursuing part-time work? Do policy changes make it more or less difficult for young people to achieve their goals?

Economists have developed techniques for analyzing how tax policy changes affect taxpayers and non-taxpayers. This family of techniques, known as distribution analysis, provides policy makers with crude but sometimes effective tools for determining whether their policy changes meet the tests of vertical, horizontal, and forward equity.

Distribution analysis, however, often flounders on two, central problems: 1) what should we use to measure tax incidence against and 2) how does the passage of time affect the distribution of taxes.

What policy makers frequently want to know is simply enough stated (how will tax policy change affect the economic well-being of taxpayers), but just as frequently is hard to answer. How do you measure the relationship between tax policy and economic well-being? Because we cannot measure all of the things that affect a taxpayer's well-being, economists often settle on proxies for those data we cannot obtain or activities we cannot observe. Certainly, the most common of such proxies is income.

However, what is income? Most people think of income as the total amount of money they make each year. But, does that amount count the income from previously taxed income, like interest on a savings account or dividends from an investment? Is "income" the total amount that is spent on all goods and services and leisure? Does it include net worth? Do we count non-cash compensation when distributing the effects of a tax policy change?

Even if we could settle on an income concept that most analysts would accept, how good are the income data that we would use to create distribution tables. For example, the U.S. Census Bureau obtains a pretty good idea about household and individual income at each decennial census. During the intervening decade, Census regularly surveys the population and produces updates to its decennial estimate of income (most notably the March supplement each year) that form the basis for so much of our economic work on taxes.

This important dataset, however, is composed of only 60,000 households out of total population of over 110,000,000 households. While that survey size assures statistical significance on most demographic concepts, it produces at best a crude representation of the types and ranges of income, particularly among high-income households.

What about distributing tax policy changes by consumption? Consumption generally is a public act, and the very fact that consumption leaves highly visible footprints means that using it for distributional purposes avoids many of the definitional problems surrounding "income." If we were to use consumption as the metric against which to measure the fairness of a tax system, we would assume that levels of tax payments would follow levels of consumption.

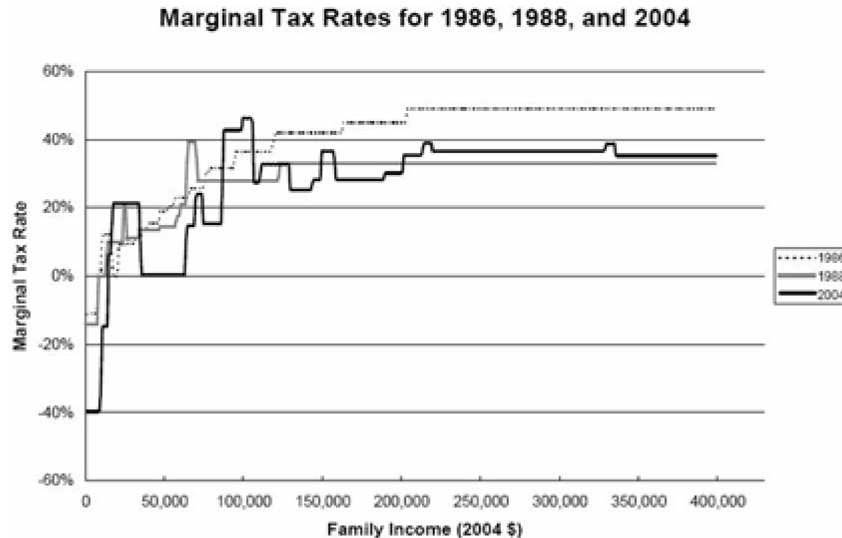
Simple enough, but what do you do with young taxpayers? They are consuming very expensive education that they pay off over time, buying homes to start a family that are paid through mortgages, buying their first car, their furniture, and raising children (by itself an expensive proposition). Short-term and long-term consumption get mixed together in real life, which raises problems for distributional analysts.

Anyway, consumption patterns tend to follow the cycle of life: high consumption and debt early on, followed by increases in net worth and less consumption in middle life, which ends with low consumption and depletion of savings over retirement. If a tax system followed that pattern of consumption, would it be fair? Probably not.

Finally, some analysts argue that we can learn a great deal about the fairness of a tax system by studying the actual marginal tax rates faced by taxpayers across income. If a tax system meets the vertical and horizontal tests for fairness, then marginal tax rates will be roughly the same for all taxpayers in each income class.

However, our current tax policy is, if anything, one of targets, not of equal treatment. That is, Congress has decided to use the tax system to achieve specific social and economic goals, which has resulted in a significant decay in vertical equity. To illustrate this point, I have provided in my full testimony a wonderful graph prepared by Kevin Hassett of the American Enterprise Institute, a tax economist well known to this committee. Dr. Hassett compares the current tax code to tax law in 1986 and 1988 and how tax policy has affected the marginal income tax rates faced by a family of four. While this graphic shows many things, its single most important message is how targeting tax relief has produced significant equity distortions in the code.

As Dr. Hassett's chart shows, drifting away from a tax system governed by principles has led to tax law that is less just. Achieving a significantly better tax code obviously involves major legislative efforts. Having guiding principles before the members of the House and the Senate should help them extract our tax code from the dramatic difficulties into which it has fallen.



Chairman THOMAS. Thank you very much, Mr. Beach. Dr. Burman.

STATEMENT OF LEONARD E. BURMAN, CO-DIRECTOR OF TAX POLICY CENTER AND SENIOR FELLOW, URBAN INSTITUTE

Mr. BURMAN. Chairman Thomas, Ranking Member Rangel and distinguished Members of the Committee, thank you for inviting me to testify on the principles that should guide reform of the tax system. I applaud the Committee for taking on this crucially important subject. I came to Washington 20 years ago to work at the Treasury Department on what became the Tax Reform Act 1986 (P.L. 99–514). Although it was far from perfect, that reform was guided by the bedrock principles of fairness, simplicity and economic efficiency. Although some parts of the final bill weren't simple, it clearly made the tax system fairer and more efficient. I

would be delighted to see if we would could repeat the trick again today while also make the tax system simpler. In my testimony, I focus on how the income tax system affects low and middle-income taxpayers and the potential effects of tax reform on those populations. Low-income families depend heavily on the income tax system. Although they don't benefit from traditional deductions and credits, most do benefit from refundable tax credits which are available even if a tax filer doesn't owe income tax.

In fact, the refundable Earned-Income Tax Credit (EITC) is the largest source of cash assistance for low income families bigger in the aggregate than Temporary Assistance for Needy Families (TANF) or food stamps. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107–16) also substantially increased the refundable child tax credit. Both of these credits encourage work and help families with children meet basic needs. Since the EITC and the child tax credit phase in with earnings they encourage labor force participation among low income single parents. These two refundable tax credits now represent a very large portion of income for low income households with children. The typical household with one eligible child and income between $10,000 and $15,000 receives tax credits worth $2,523 or almost 23 percent of income in 2005. A household with 2 children and the same income would receive $3,764 or almost 35 percent of income in those credits. Even at incomes of $25,000 to $30,000 the EITC and child tax credit boost income by more than 15 percent for families with two or more children.

The great value of these credits also poses a risk for tax reform. Any new tax reform that eliminated or reduced these credits would devastate low income households unless new spending programs were created to provide cash assistance. For middle income families, a complex hodgepodge of tax benefits, all with separate eligibility rules and income tests, creates enormous variation in effective tax rates. As documented in my written testimony, similar families can receive very dissimilar tax treatment. Income phaseouts for credits and reductions in the AMT create hidden taxes and needless complexity. The best thing the tax reform could do for these families would be to consolidate income support programs and simplify eligibility. To the extent possible, the hidden rates created by phase-outs in the AMT should be replaced by explicit adjustments to the tax rates schedules or financed by closing loopholes. For example the phase-out of the child tax credit of incomes over $110,000 adds 5 percentage points to marginal tax rates in that income range. A better and equally progressive option would be to eliminate the phase-out and raise statutory tax rates slightly starting at the same income level.

Many tax reform proposals which shift away from a tax based on income to a tax based on consumption. Although these proposals are often motivated by concerns about complexity and efficiency, they would almost inevitably shift tax burdens on to middle and/or lower income groups. Consumption is a much larger share of income for lower- and middle-income households than for those with high incomes. Families earning less than $30,000 spend virtually all of their income, while those with incomes over $200,000 spend less than 40 percent. Compared with the comprehensive income

tax, the consumption tax would exclude two-thirds of income from the tax base for the highest income households. Thus, a consumption tax rate would have to be three times as large an income tax rate to keep the same tax burden on those families. Otherwise the tax burden would inevitably shift on to lower and middle income households. Despite the concerns about equity, a consumption tax might still be worthwhile if there were huge economic benefits. There aren't likely to be. Most of the claimed benefits of switching to a consumption tax come from base broadening and the large tax imposed on existing capital during the transition period to a new tax. Base broadening could just as well be done under the income tax and the lump sum tax on old capital that excites economists, that is a big tax on senior citizens doesn't seem like it is going to happen from my perspective.

Beyond that, it is not a given that a consumption tax would raise economic efficiency more than a similarly comprehensive income tax would. Exempting capital income from tax necessarily means that you have to raise the tax burden on labor, so you are reducing distortion on one margin, the discouragement of savings, but you are increasing it on another by discouraging work. The economic evidence suggests that those things about balance out. The overall efficiency gains are likely to be very small. One last point, just that a surprising effect of switching to a consumption tax in the real world is that it might not even encourage saving, and that is because currently, certain kinds of savings accounts, retirement savings accounts receive special tax breaks, 401(k)s, pensions. If you eliminated those tax breaks and said everything was tax free, everything received the same tax treatment, it is possible that workers would end up saving less than they do currently. There is more in my written testimony but I would be happy to answer your questions in the questions and answers.

[The prepared statement of Mr. Burman follows:]

Statement of Leonard E. Burman, Co-Director of Tax Policy Center and Senior Fellow, Urban Institute

Chairman Thomas, Ranking Member Rangel, and distinguished members of the Committee. Thank you for inviting me to testify on the principles that should guide efforts to reform the tax system.

I applaud the committee on taking on this crucially important subject. I came to Washington 20 years ago to work for the Treasury Department on what became the Tax Reform Act of 1986. Although far from perfect, that reform was guided from the start by the bedrock tax policy principles of fairness, simplicity, and economic efficiency. Although some parts of the final bill were simple and some weren't, it clearly made the tax system fairer and more efficient. I would be delighted if we could repeat the trick again today, while also making the tax system simpler.

Although I think people exaggerate when they claim that the 1986 Tax Reform has been fully undone in the intervening two decades, the tax code is once again in need of reform. It is needlessly complex. It is riddled with loopholes. It imposes vastly different tax burdens on people with similar abilities to pay. And it does not raise enough revenue to finance current government operations, much less the growing costs of the retirement of the baby boom generation.

In my testimony, I will focus on how the income tax system affects low- and middle-income taxpayers and the potential effects of tax reform on those populations. I have six main conclusions:

- First, despite its flaws and some recent erosion, the income tax is highly progressive. In other words, low- and middle-income families bear much smaller proportional tax burdens than those with high incomes. This mitigates the effects of other regressive taxes, such as federal payroll and excise taxes and state and local sales taxes.

- Second, the income tax code is an important source of income support for low-income households.
- Third, tax reform could help low- and middle-income households by reducing their tax burdens further—both by lowering their rates and by simplifying and consolidating tax benefits to which they are entitled.
- Fourth, some so-called fundamental tax reform proposals could shift the tax burden away from those most able to pay to those least able.
- Fifth, the claimed economic gains from such proposals are speculative at best, based solely on theoretical models that have little relationship to economic reality.
- And, last, systemic tax reform presents the ideal opportunity to bring our fiscal system back into balance. If it closed loopholes under the income tax and used the revenues to reduce the budget deficit, such reform would spur economic growth by making the tax system more neutral, increasing national savings, and lightening tax burdens on future generations.

I. Current Situation

The President's executive order establishing the Advisory Panel on Tax Reform called for revenue-neutral tax reform that would advance these objectives: "(a) simplify Federal tax laws . . . (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner . . . and (c) promote long-run economic growth." Although I think revenue neutrality is a misplaced priority given our current fiscal situation, the President's objectives stand on the bedrock principles of public finance—simplicity, fairness, and economic efficiency.

Let's first consider the President's all-important desire to share the burden progressively and look at how the current Federal tax code affects low- and middle-income Americans. Its glaring flaws notwithstanding, the current income tax does have many strengths. To start, it is highly progressive. In 2005, the Tax Policy Center estimates that 87 percent of the individual income tax will be paid by the highest-income 20 percent of households ranked in terms of cash income. (Table 1.) Almost 61 percent will be paid by the top 5 percent. By comparison, the bottom 40 percent of households receives more in refundable tax credits than they pay in taxes on average. Collectively, the bottom fifth receives net tax credits worth 5.5 percent of income; the top 1 percent pays taxes averaging 20.1 percent of income.

Although the estate tax and the corporate income tax are also quite progressive, federal payroll taxes are regressive, consuming a much larger share of income for low- and middle-income households than for those at the top.[1] And here's the rub: since payroll taxes are the second largest share of revenue after the individual income tax, and much larger than the other federal taxes, the overall tax system is less progressive than the income tax. Including state and local taxes—which rely much more heavily on regressive sales taxes—some analysts conclude that the overall tax system is not progressive at all.[2]

Recent federal tax changes have provided important benefits to lower-income households. The Economic Growth and Taxpayer Relief Act of 2001 (EGTRRA) increased the child tax credit (CTC) and made it partially refundable, expanded the earned income tax credit (EITC), increased the standard deduction for married couples, and created a new 10-percent tax bracket.[3] Legislation enacted in 2003 and 2004 sped up the effective date for some of these provisions. Nonetheless, by cutting top individual income tax rates, phasing out the estate tax, cutting the corporate income tax, and expanding opportunities for tax-free saving, the 2001–2004 tax cuts on balance made the tax system less progressive. Measured as a share of income, the top tenth of one percent of taxpayers—that's one in one thousand—got tax cuts 18 times as large as the bottom fifth got. (Table 2.)

Table 2 also shows that households in every income class benefited from the tax cuts, but that view is misleading. Since none of the tax cuts were offset by tax increases or spending cuts elsewhere, it is impossible to say who the winners and los-

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[1] The progressivity of the estate tax is understated somewhat in the table because it is distributed in terms of cash income. Some people who are quite wealthy can have very modest cash incomes—for example, because most of their income is in the form of unrealized capital gains. If households are ranked in terms of economic income (including the imputed income generated by unrealized assets), then 98 percent of the estate tax falls on the highest-income 5 percent of households.

[2] See McIntyre, Bob. 2004. "Overall Tax Rates Have Flattened Sharply Under Bush: Total Federal, State & Local Rate on Richest Now Only Slightly Higher than on Middle Ranges," Citizens for Tax Justice, April 12. Available at http://www.ctj.org/pdf/fsl2004.pdf.

[3] See Leonard E. Burman, Elaine Maag, and Jeff Rohaly, 2002, "The Effect of the 2001 Tax Cut on Low- and Middle-Income Families and Children," available at: http://www.taxpolicycenter.org/publications/template.cfm?PubID=410465.

ers are. If the resulting budget deficits lead to cuts in programs mostly benefiting middle- and lower-income households, then they and their children will be the big losers. If burgeoning debt starves businesses of capital, tomorrow's families may bear the brunt. If instead middle-class benefits are politically too popular to curtail and Congress can't or won't cut spending, then high-income people may end up worse off than they would have been without the tax cuts.

The bottom line is that it is impossible to assess the winners and losers from tax changes that are not revenue neutral: we cannot gauge the effects of the 2001 to 2004 tax cuts until we see how Congress ultimately finances them.[4]

A. How the income tax affects low- and middle-income households

The tax system is a mixed bag for low- and middle-income households. On the one hand, it is overly complex. Tax filers must fill out numerous worksheets and forms to claim tax credits for working, children, child care, education, and many other activities. On the other hand, these programs provide significant income support for households that are struggling to meet essential needs. A better tax system would not make families jump through so many hoops to get this support, but tax reform that just swept all of these subsidies away to help broaden the tax base would eviscerate income support for low- and middle-income households.

1. Refundable tax credits for low-income families

Low-income families rely particularly heavily on the income tax system. Although they do not benefit from traditional deductions and credits because most do not owe income tax, they do benefit from refundable tax credits, which are available even if a tax filer does not owe income tax.

In fact, the refundable EITC is the largest source of cash assistance for low-income families—bigger in the aggregate than temporary assistance for needy families (TANF) or food stamps. EGTRRA also substantially increased the refundable child tax credit in 2001. In 2005, families could claim a refundable child tax credit up to 15 percent of earnings over $10,800.[5]

Both of these credits encourage work and help families with children meet basic needs. Since the EITC and CTC phase in with earnings, they encourage labor force participation among low-income single parents. The phase-out of the EITC can discourage a spouse from working, but since most EITC recipients are single heads of household this isn't a major concern.[6] Research suggests that, on balance, the EITC encourages work among recipient households.[7]

These two refundable tax credits now represent a very large portion of income for low-income households with children. The typical household with one eligible child and income between $10,000 and $15,000 receives tax credits worth $2,523, or 22.9 percent of income, in 2005. (Table 3.) A household with two children and the same income receives $3,764, or 34.5 percent of income, in refundable child tax credits and EITC. For the average household with three or more children, the credits are worth almost $4,000, or 36 percent of income. Families with incomes between $15,000 and $20,000 receive even larger tax benefits, though they amount to a smaller share of income. Even at incomes of $25,000 to $30,000, the EITC and CTC boost income by more than 15 percent for families with two or more children.[8]

A very large percentage of households with children receive these benefits. Almost 74 percent of one-child households and 83 percent or more of households with two or more children benefit from the CTC or the EITC or both. Participation is lower for very low-income households because more of them do not have earnings, and for higher income households because more of them have incomes above the phase-out thresholds for the credits. But, among eligible households, participation is very high.[9]

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[4] See William G. Gale, Peter Orszag, and Isaac Shapiro, 2004, "Distribution of the 2001 and 2003 Tax Cuts and Their Financing," *Tax Notes,* June 21, pp. 1539–1548.

[5] The threshold is indexed for inflation.

[6] See Nada Eissa and Hilary W. Hoynes, 2004, "Taxes and the Labor Market Participation of Married Couples: The Earned Income Tax Credit," *Journal of Public Economics,* Vol. 88, pp. 1931–1958.

[7] See Nada Eissa and J. Liebman, 1996, "Labor Supply Responses to the Earned Income Tax Credit," *Quarterly Journal of Economics,* Vol. 111, pp. 605–637; and B. Meyer and D. Rosenbaum, 2001, "Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers," *Quarterly Journal of Economics,* Vol. 116, pp. 1063–1114.

[8] Very low-income households without children qualify for a small EITC, but not the CTC. It is worth an average of $229 for recipient households; only 3 percent of childless households qualify.

[9] See Leonard E. Burman and Deborah Kobes, 2003, "EITC Reaches More Eligible Families Than TANF, Food Stamps," *Tax Notes,* March 17, p. 1769.

The great value of these credits also poses a risk for tax reform. Any tax reform that eliminated or reduced these credits would devastate low-income households, unless new spending programs were created to provide cash assistance. In fact, although many tax incentives are probably less effective than comparable spending programs, the EITC and CTC have a lot to recommend them. Despite being overly complex, the EITC is a very efficient way to provide cash support for low-income households.[10] Most recipients of the tax credits would be filing returns anyway to get refunds of withheld income taxes, and much of the information about income eligibility is already reported on tax returns. The refundable credits also avoid the stigma associated with traditional welfare programs. And, despite the complexity, filing a tax return is often easier for low-income working families than waiting in line at a welfare office during working hours.[11]

2. Tax subsidies for middle-income families

Middle-income families benefit from an ever-growing panoply of social programs that have been injected into the tax code. Among them are credits for childcare expenses, credits and deductions for education, a tax credit for adoption expenses, and itemized deductions for mortgage interest, charitable contributions, state and local income, sales, and property taxes, and exclusions from income for such employer-provided fringe benefits as pensions and health insurance. The nonrefundable tax credits are often of limited value to lower-middle-income taxpayers because they have limited tax liability, and the deductions and exclusions are worth the most to those with the highest incomes. The value of a deduction is equal to the deduction amount multiplied by the marginal tax rate for those who itemize deductions. Since higher income households tend to have more and larger deductions and also the highest marginal tax rates, they get the largest benefits from deductions and exclusions.

The consequences of this hodge-podge of targeted tax benefits are complexity and inequity. Households with similar ability to pay tax can end up owing much different amounts, depending on how many hoops they jump through to qualify for credits and deductions. Table 4 shows that there can be considerable variation in average tax rates for similar families with comparable incomes. The variation arises from differences in use of credits and deductions and whether households are eligible for benefits (for example, based on the age of children). A homeowner in a high-tax state can pay much less tax than a renter in a low-tax state, for example. Variations among lower-income families with children can be enormous, depending on whether they qualify for the EITC and CTC.

Table 5 shows that there is even more variation in effective marginal tax rates—that is, the amount of additional tax paid on a dollar of additional income.[12] The negative tax rates for lower-income families and individuals arise from the phase-in of eligibility for the EITC and CTC. The positive tax rates arise from the statutory tax brackets, the phase-out of eligibility for benefits, and the individual alternative minimum tax, which raises effective marginal tax rates for most taxpayers who must pay it.[13]

A major source of variation arises from the notion that every tax incentive must be progressive: the EITC, CTC, education tax incentives, and many other provisions phase out at certain income levels. A major reason why ever more taxpayers must pay the AMT is the phase-out of the exemption allowed to calculate taxable income

[10] Most EITC recipients use paid preparers to file their tax returns. See Elaine Maag, 2004, "Tax Preparation for Low-Income Households, Knowledge of the EITC," *Tax Notes,* August 2, p. 555. This is in part a function of the complexity of the EITC relative to the functional capacity of some recipients and partly due to the popularity of refund anticipation loans offered by some tax return preparers.

[11] Janet Holtzblatt and Janet McCubbin, 2004, "Issues Affecting Low-Income Filers," in Henry J. Aaron and Joel Slemrod, eds., *The Crisis in Tax Administration* (Washington, DC: The Brookings Institution Press): 148–188.

[12] For a discussion, see Leonard E. Burman and Mohammed Adeel Saleem, 2004, "Income Tax Statistics for Sample Taxpayers, 2003," *Tax Notes,* January 19, pp. 413–418. The Table shows the marginal tax rate on earnings. Marginal tax rates on other forms of income would often be different. Marginal tax rates are calculated by increasing income by a small amount and calculating the increment in tax liabilities after credits per dollar of additional income. The marginal increase in income is the maximum of $100 and the minimum of one percent of AGI and $1,000. This is done to smooth out some kinks in explicit and implicit tax rate schedules. The effective marginal tax rates might not add up exactly because of rounding or because the formulae for them are not exactly continuous.

[13] See Leonard E. Burman, 2005, "The Expanding Reach of the Individual Alternative Minimum Tax: Testimony submitted to the United States Senate Subcommittee on Taxation and IRS Oversight of the Committee on Finance," May 23, available at http://www.urban.org/UploadedPDF/900812_Burman_052305.pdf.

for AMT purposes, which raises effective marginal tax rates by 25 percent. Although phase-outs reduce the revenue losses from each provision, they also add complexity and make it hard for some families to know in advance whether they will be eligible for a subsidy and. if so, how much. As noted, these phase-outs create hidden tax surcharges that are tantamount to higher statutory tax rates.

To return to the AMT for a moment, a special problem is that it will affect more and more middle-income households in coming years. By 2010, almost all married taxpayers with incomes between $75,000 and $100,000 and with two or more children will be subject to this pointlessly complicated tax. Its effect, like that of the phase-outs, is to raise marginal tax rates on most families subject to the tax.

The best thing that tax reform could do for low- and middle-income families would be to consolidate income-support programs and simplify eligibility. To the extent possible, the hidden taxes created by phase-outs and the AMT should be replaced by explicit adjustments to the tax rate schedules or financed by closing loopholes. For example, the phase-out of the CTC at incomes over $110,000 adds 5 percentage points to marginal tax rates in that income range. A better and equally progressive option would be to eliminate the phase-out and raise statutory tax rates slightly starting at the same income level.

II. Effects of tax reform

The consequence of moving so much economic support into the tax system is that "tax reform" could lead to a massive cut in income support for low- and middle-income families. Base broadening is equivalent to slashing cash transfers.

Base broadening is a good idea, but policymakers would need to adjust refundable credits and tax rates to hold low- and middle-income households harmless, on average. Even then, there would be many winners and losers.[14] Arguably, it might make sense to consolidate cash assistance programs in the tax code into a couple of refundable credits. For example, a 20-percent work tax credit for the first $10,000 of wages for each nondependent, non-student, adult worker, and a $1,500 per child fully refundable child tax credit would provide about the same amount of assistance to a single mother with two children and $20,000 of earnings as current law. If eligibility for the work credit was based solely on work (and not the presence of children) and all children were eligible for the child tax credit, then administration and compliance would be vastly simplified. All workers would be eligible for the work credit, whether or not they had children, and all households with children would be eligible for the child benefit, regardless of income.[15]

To make that work, tax rates would have to be adjusted to raise the same amount of revenue (effectively "taking back" the credits from higher income households).

But barring such an offset, even fundamental income tax reform could end up hurting the most vulnerable members of society.

1. Consumption taxes

Many tax-reform proposals would shift away from a tax based on income to a tax based on consumption. Such proposals include the value added tax; the flat tax, which is effectively a subtraction-method VAT in which the wage portion of the tax is collected from workers rather than firms and which is somewhat progressive since it exempts some portion of wages; a national retail sales tax, which is collected entirely at the retail stage; and a consumed income tax, which is a progressive variant on the consumption tax.

Although these proposals are often motivated by concerns about complexity and efficiency, they would almost inevitably shift tax burdens onto middle- and/or lower-income groups. Consumption is a much larger share of income for lower- and middle-income households than for those with high incomes. Data from the Consumer Expenditure Survey suggest that families earning less than $30,000 (in 2003 dollars) spend virtually all of their income while those with incomes exceeding $200,000 spend less than 40 percent.[16] (Table 6.) This pattern is most pronounced for necessities, such as food, housing, and clothing. Families earning $10,000 to

[14] That is an inevitable consequence of revenue-neutral tax reform so not necessarily an impediment.

[15] Jonathan Barry Forman, Adam Carasso, and Mohammed Adeel Saleem, forthcoming, "Designing a Work-Friendly Tax System: Options and Trade-offs," Tax Policy Center Discussion Paper Number 20.

[16] Many researchers have commented on the implausible ratio of consumption to income for those with very low incomes. Income is probably underreported, especially for low-income households, which is a special risk because the focus of the survey is consumption rather than income. It also excludes gifts from friends and relatives.

$20,000 spend three-quarters of their incomes on those items, compared with one-sixth of income for those earning more than $200,000.

Proposals for consumption taxes often include measures to reduce their regressivity, such as demogrants—cash transfers to offset the tax due on a basic level of consumption—for low-income households, tax exemptions for some necessities, or even progressive rates. All of those options raise issues, but most salient is that effective consumption tax rates for high-income households would have to be very large to be as progressive as the current tax system. Compared with a comprehensive income tax, a consumption tax would exclude two-thirds of income from the tax base for the highest-income households. Thus, a consumption tax rate would have to be three times as large as an income tax rate to keep the same tax burden on high-income households.[17] Otherwise, the tax burden would inevitably shift onto at least some lower- and middle-income households.

Another way to look at a consumption tax is as an income tax with an unlimited exemption for capital income and no deduction for interest.[18] In other words, the tax base would be wages rather than income. Wages, like consumption, decline as a share of income as income increases. (Table 7.) Wages and salaries make up 28 percent of income for households with incomes over $1 million in 2005, compared with 68 percent for households with incomes between $75,000 and $100,000. Among households headed by someone under age 65, almost 80 percent of income is wages for those with incomes between $30,000 and $75,000, compared with 32 percent for those with incomes over $1 million. Under a wage tax, more than two-thirds of income of the highest-income households would be exempt. In other words, they would either face very high tax rates or end up paying less tax than under an income tax.

In principle, it is possible to design a progressive "consumed income" tax that would maintain the same distribution as current law (on average). But the Treasury Department, after examining such proposals, concluded that they would be much more complex than current law and basically unworkable.[19] The implication is that a real-world consumption tax would inevitably shift the tax burden away from those with the highest incomes to those with more modest incomes. Although some proposals would protect the poor through a demogrant that would simply squeeze middle-class households even more.

Despite concerns about equity, a consumption tax might still be worthwhile if there were huge economic benefits. But there aren't likely to be. Most of the claimed benefits of switching to a consumption tax come from base broadening and the large tax imposed on existing capital during the transition to the new tax.[20] Base broadening—that is, eliminating all credits and deductions—is probably no more politically feasible under a consumption tax than under an income tax. In fact, in his executive order establishing to the Advisory Panel on Federal Tax Reform, the President insisted that incentives be maintained for homeownership and charitable contributions. Most likely, these two tax breaks are simply the tip of the iceberg.

As for the transition, switching from an income to a consumption tax would effectively devalue all existing capital. For example, if the income tax were replaced with a VAT or a national retail sales tax, the prices of all taxed goods and services would immediately rise by the amount of the VAT. The Federal Reserve Board could tighten the money supply to prevent this price increase, but the resultant increase in interest rates would reduce the value of existing capital. In either case, old people would find that their savings could buy much less than they did the day before the new tax regime was announced. Although such a lump-sum tax is doubtless efficient—effectively, the government is raising revenue by confiscating a portion of outstanding wealth—it is unlikely to be politically feasible.

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[17] In fact, our tax system is far from a comprehensive income tax, so conceivably a shift to a comprehensive consumption tax could be accomplished with much more modest rates, but that assumes that the political pressures for exemptions such as for fringe benefits, mortgage interest, charitable contributions, and so on, could be avoided under a consumption tax. It is worth noting, in that context, that the President has insisted that any tax reform retain incentives for homeownership and charitable contributions.

[18] Although this equivalence holds in the long run under certain circumstances, there are significant differences in the two tax bases in the short run. A new consumption tax would increase the price of all consumer goods or reduce the real value of old capital, placing a large burden on older people. A new wage tax would effectively exempt all capital income from tax, effectively granting a large windfall on older people who are living off of their accumulated savings.

[19] See Eric Toder, 1995, "Statement of Eric Toder, Deputy Assistant Secretary (Tax Analysis), Department of the Treasury, Before the Senate Budget Committee," February 22.

[20] See David Altig, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser, 2001, "Simulating Fundamental Tax Reform in the United States," *American Economic Review,* Vol. 91, pp. 574–595; and Don Fullerton and Diane Lim Rogers, 1993, *Who Bears the Lifetime Tax Burden?* (Washington, DC: Brookings Institution Press).

But if the government provided transition relief (for example, by continuing to allow companies to take depreciation deductions on old capital), tax rates would have to be much higher to make up the lost revenue. Old people would come out ahead, since their capital assets are worth the same amount as before and all future income from those assets is tax-free. But most other groups end up worse off because the higher taxes more than offset gains from a more efficient tax base.[21]

In fact, it is not a given that a consumption tax would raise economic efficiency more than a similarly comprehensive income tax would. Exempting capital income from tax would eliminate the tax penalty on saving, but raise the burden on labor. The reason is simple: if the return to saving is exempted from the tax base, then taxes have to increase on what is left, which is wages and salaries. If labor supply is very sensitive to taxation, and saving is not sensitive, then a consumption tax could harm the economy in the long run (and in the short run too if there is transition relief).[22] In fact, the economic evidence seems to suggest that both labor supply and saving are relatively insensitive to taxes, so any efficiency gains are likely to be modest.

The models discussed so far are largely based on empirical evidence about responsiveness of savings and labor supply to taxation, but there is another line of argument that relies almost entirely on theory to argue that taxing capital would never be optimal. The relatively simple version of this theory was advanced by Peter Diamond and James Mirrlees.[23] They showed that if there are no restrictions on commodity taxes and if economic profits either do not exist or can be taxed away, then it would never be optimal to tax capital or other inputs to the production process. But, as, Joel Slemrod points out, that the underlying assumptions behind this oft-cited economic result are extreme.[24] Tax authorities cannot measure economic profits (that is, those profits over and above the "normal" or required return to capital) and, even if they could, it would be politically problematic to apply a 100-percent tax to them.

Similarly, there are many constraints on commodity taxes. For starters, it would be virtually impossible to tax household production (e.g., caring for children, cooking, house cleaning, home repairs, gardening, etc.)—a requirement for production efficiency in the Diamond-Mirrlees set up. Policymakers might also blanch at the notion of assessing high taxes on necessities, such as insulin, even though such taxes are highly efficient since people's demand for life-saving drugs is quite insensitive to price.

A more recent line of argument has been advanced in separate papers by Christopher Chamley and Kenneth Judd.[25] Although mathematically elegant, these models rest on even less realistic assumptions about policy than the Diamond-Mirrlees model. In these models, individuals live forever and have perfect foresight. Exempting capital income from tax in the long run is economically efficient, but only after the government has levied the maximum feasible tax on capital long enough to endow the government with a huge surplus, from which it can finance all future government operations without taxing capital or labor! If people do not live forever or have unlimited ability to borrow, capital owners might strongly object to that transition path. And I would bet that there would not be many votes in Congress for establishing the government endowment fund, much less any feasible mechanism for preventing government from tapping into principal to pay for increased cash transfers or more spending. (Consider the Social Security trust fund as a less ambitious experiment on the feasibility of financing future operations with government endowments.)

Moreover, these models ignore human capital—that is, investments people make in themselves to build skills that will pay future returns through higher wages. Larry Jones, Rodolfo Manuelli, and Peter Rossi showed that if it is optimal to exempt the returns on physical capital, then it is also optimal to exempt the returns

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[21] See Altig, et al., 2001.

[22] See William C. Randolph and Diane Lim Rogers, 1995, "The Implications for Tax Policy of Uncertainty About Labor-Supply and Savings Responses," National Tax Journal, Vol. 48, pp. 429–446.

[23] See P.A. Diamond and J.A. Mirrlees, 1971, "Optimal Taxation and Public Production I: Production Efficiency," *American Economic Review,* Vol. 61, pp. 8–27.

[24] See Joel Slemrod, 1990, "Optimal Taxation and Optimal Tax Systems," *Journal of Economic Perspectives,* Vol. 4, pp. 157–178.

[25] See Christophe Chamley,1986, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica,* Vol. 54, No. 3, pp. 607–622; and Kenneth L. Judd,1985, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics,* Vol. 28, pp. 59–83.

on human capital.[26] Indeed, the logical extension of the Judd-Chamley models is that wages should also be exempt from tax. So in this economic utopia, nothing would be taxed!! But, if Congress cannot build a huge endowment, this model provides no practical guide to public policy.

Incredibly, a follow-up paper by Judd argued that in general the optimal tax rate on capital should be negative. In short, not only should capital not be taxed, but tax incentives for investment are warranted. To derive that result, the paper resurrected the heroic assumptions of the Diamond-Mirrlees model.[27]

Utopian models aside, there are other concerns about consumption taxes. If capital is exempt from tax, high-income people will seek out tax shelters to make wages look like capital (as they already do with capital gains). Self-employed people and small businesses will have an incentive to incorporate, pay the owner a low wage, and accumulate large untaxed profits. Some entrepreneurs already do this to avoid the payroll tax.

Not every theoretical argument favors consumption taxation. Shinichi Nishiyama and Kent Smetters argue that a progressive income tax is equivalent to a kind of insurance that is not available in the marketplace; it basically smooths after-tax income.[28] As income varies over time, taxpayers pay lower taxes (as a share of income) in bad years than they do in good. The progressive income tax could be viewed as a flat-rate income tax bundled with an insurance policy that pays off when income falls, offsetting part of the income tax burden. For risk-averse taxpayers, this can be quite valuable.

Perhaps most surprising, in the real world shifting from an income to a consumption tax would not necessarily increase saving, at least not for middle-income families. Currently, middle-income families save mainly by contributing to pensions and 401(k)-type plans. Employees have an incentive to participate because they avoid income tax on contributions. Nondiscrimination rules give employers an incentive to induce lower-income workers to participate. But, under a consumption tax, all saving is exempt from tax so there is nothing special about pensions. Without the inducement of a subsidy, many workers would choose to keep all of their savings in less restrictive accounts. But behavioral economics (the study of how real people, rather than *homo economicus,* behave) suggests that without the restrictions that apply to pension plans people would be much less likely to contribute without the inducements offered by employers and tax savings and more likely to withdraw balances before retirement.

There are also some connections between income taxes and other programs that help low-income families. Many tax and expenditures programs for low-income people (e.g., food stamps and EITC) phase out as income rises. But it does not make sense to phase them out based on consumption or wages only. Would we want to preserve an income tax only for low-income families?

Finally, a federal switch to a consumption tax would undermine state governments' ability to raise revenue. States rely much more on consumption taxes (mostly retail sales taxes) than the Federal Government does. But if the Federal Government imposed its own retail sales tax, the combined federal and state rates could be quite high.[29] In consequence, compliance with state sales taxes would fall sharply. But at the same time, if the Federal Government is no longer collecting income taxes, it would be very hard for the states to maintain their own income tax systems. Further, many of the claimed benefits of simplifying the consumption tax would be lost if states continued to collect income tax. As a result, states would likely have to sharply curtail services, which could further harm low- and middle-income households.

III. Conclusion

Tax reform would be a singular accomplishment if it made the tax system simpler, fairer, and more conducive to economic growth. Good starting points would be fixing the income tax to reduce incentives for inefficient tax sheltering, eliminating or retargeting the individual alternative minimum tax, consolidating income—support programs for low- and middle-income taxpayers, and eliminating complicated

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[26] See Larry E. Jones, Rodolfo Manuelli, and Peter Rossi, 1997, "On the Optimal Taxation of Capital Income," *Journal of Economic Theory,* Vol. 73, pp. 93–117.

[27] See Kenneth L. Judd, 1997, "The Optimal Tax Rate for Capital Income is Negative," NBER Working Paper No. 6004.

[28] Shinichi Nishiyama and Kent Smetters, Forthcoming, "Consumption Taxes and Economic Efficiency with Idiosyncratic Wage Shocks," *Journal of Political Economy.*

[29] See William G. Gale, 2005, "The National Retail Sales Tax: What Would the Rate Have to Be?", *Tax Notes,* May 16, pp. 889–911.

eligibility rules and phase-out provisions, adjusting tax rates to raise the desired level of revenue.[30]

But tax reform poses risks for vulnerable populations that have come to rely on the tax system for substantial income support. Broadening the base by eliminating refundable tax credits, for example, would devastate low-income families. Switching the base of the tax system from income to consumption would shift the tax burden away from those most able to pay onto those who are less able. Meanwhile, the claimed economic benefits from such a radical shift reflect questionable unproven assumptions.

Rather than radical tax reform, a surer path to economic growth is to reduce the deficit, which would increase national savings directly (by reducing public dissaving). Tax reform would be an ideal opportunity to address the deficit. Even revenue—neutral tax reform spells tax increases on many Americans. The losers from tax reform may be more willing to shoulder the greater burden if they knew that their children would pay lower taxes and enjoy a healthier economy as a result. And the best way to reduce the deficit would be to close the loopholes that allow businesses and high-income individuals to avoid their fair share of tax.

[30] More specific proposals to simplify the tax system are in Leonard E. Burman and William G. Gale, 2001, "A Golden Opportunity to Simplify the Tax System," available at: http://taxpolicycenter.org/publications/template.cfm?PubID=7599.

Table 1. Current-Law Distribution of Federal Taxes by Cash Income Percentiles, 2005[1]

	Share of Total						Average Effective Tax Rate				
Cash Income Class[2]	Cash Income	Individual Income Tax[3]	Payroll Tax[4]	Corporate Income Tax	Estate Tax	All Federal Tax[5]	Individual Income Tax	Payroll Tax	Corporate Income Tax	Estate Tax	All Federal Income Tax
Lowest Quintile	2.4	−1.4	2.2	1.1	0.2	0.4	−5.5	7.5	1.2	0.0	3.2
Second Quintile	6.3	−1.9	6.9	2.7	0.4	2.2	−3.0	9.1	1.1	0.0	7.2
Middle Quintile	11.4	3.1	14.6	4.1	1.6	7.8	2.6	10.6	0.9	0.0	14.2
Fourth Quintile	19.7	13.2	25.5	8.9	0.9	17.5	6.5	10.8	1.1	0.0	18.4
Top Quintile	60.5	87.0	50.7	82.3	93.6	72.0	14.0	7.0	3.4	0.4	24.7
All	100.0	100.0	100.0	100.0	100.0	100.0	9.7	8.3	2.5	0.2	20.7
Addendum											
Top 10 Percent	44.9	73.2	30.5	74.4	89.5	56.5	15.9	5.6	4.1	0.5	26.1
Top 5 Percent	33.7	60.8	17.1	67.2	83.8	44.4	17.6	4.2	4.9	0.6	27.3
Top 1 Percent	18.6	38.3	4.6	50.8	58.0	26.6	20.1	2.0	6.8	0.7	29.6
Top 0.5 Percent	14.7	30.8	2.8	44.5	49.1	21.5	20.5	1.6	7.5	0.8	30.4
Top 0.1 Percent	8.5	18.0	1.0	32.0	28.8	13.0	20.7	1.0	9.3	0.8	31.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305–1), Table T05–0700, http://www.taxpolicycenter.org/TaxModel/tmdb/Content/Excel/T05-0070.xls.

(1) Calendar year.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) After tax credits (including refundable portion of earned income and child tax credits).

(4) Includes both the employee and employer portion of Social Security and Medicare tax.

(5) Excludes customs duties and excise taxes.

Table 2. Effect of 2001–2004 Tax Cuts on Effective Federal Tax Rates, by Cash Income Class, 2005 [1,>2]

Effective Federal Tax Rates (in Percent) [3]

Cash Income Class	Pre-EGTRRA Law	Current Law	Change
Lowest Quintile	3.5	3.2	−0.2
Second Quintile	9.1	7.2	−1.9
Middle Quintile	16.4	14.2	−2.2
Fourth Quintile	20.3	18.4	−1.9
Top Quintile	27.3	24.7	−2.6
All	23.1	20.7	−2.4
Addendum			
Top 10 Percent	28.8	26.1	−2.7
Top 5 Percent	30.1	27.3	−2.7
Top 1 Percent	32.7	29.6	−3.1
Top 0.5 Percent	33.7	30.4	−3.3
Top 0.1 Percent	35.5	31.9	−3.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0304–3), Tables T04–0113 and Table T04–0096.

[1] Baseline is pre-EGTRRA law. Includes provisions in EGTRRA, JGTRRA, and WFTRA affecting the following: marginal tax rates; the 10-percent bracket; the child tax credit; the child and dependent care credit; the AMT; the standard deduction, 15-percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; pension and IRA provisions; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit.

[2] Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

[3] Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Table 3. Participation and Benefits from Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) by Number of Children and Cash Income Class, 2005[1]

Cash Income Class (thousands of 2005 dollars)[2]	No Children			One Child			Two Children			Three of More Children		
	Percent Who Benefit	Tax Units With Benefit		Percent Who Benefit	Tax Units With Benefit		Percent Who Benefit	Tax Units With Benefit		Percent Who Benefit	Tax Units With Benefit	
		Average Credit ($)	Percent of Income		Average Credit ($)	Percent of Income		Average Credit ($)	Percent of Income		Average Credit ($)	Percent of Income
Less than 5	14.7	193	7.8	69.1	956	34.2	60.7	1,104	39.8	26.9	1,158	45.2
5-10	14.7	323	5.0	84.6	2,036	30.6	81.9	2,587	37.1	68.6	2,495	37.0
10-15	8.1	116	1.2	88.5	2,523	22.9	93.0	3,764	34.5	84.5	3,975	36.0
15-20	0.7	143	0.9	93.6	2,664	17.6	95.5	4,348	28.6	91.1	4,379	29.0
20-25	0.3	152	0.7	96.0	2,403	12.6	97.4	4,248	21.9	98.4	4,305	22.2
25-30	0.2	100	0.4	96.7	1,815	7.8	98.7	3,800	16.2	97.7	4,228	17.8
30-40	0.1	214	0.7	87.8	1,188	4.1	98.6	2,787	9.5	99.0	3,611	12.1
40-50	0.0	314	0.7	73.9	1,025	2.8	93.0	1,933	5.2	96.6	2,925	7.7
More than 50	0.0	177	0.2	55.0	957	1.5	73.6	1,694	2.4	82.8	2,666	3.6
All	3.4	229	3.4	73.9	1,603	4.8	83.3	2,585	6.0	85.9	3,156	6.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).
(1) Calendar year. Baseline is current law without the EITC and CTC.
(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

Table 4. Variation in Average Tax Rates by Marital Status and Number of Children, 2005

Cash Income Class	Tax Units	Mean	Standard Deviation	Percentile	
				5th	95th
$15,000 to $20,000					
Married Filing Jointly	2,368,415	−4.03	9.14	−27.93	0.0
Singles and HOH	8,502,452	−3.35	10.82	−27.04	5.90
MFJ 0 Children	1,867,464	0.03	0.41	0.00	0.00
MFJ 1 Child	210,763	−13.79	7.11	−19.99	0.00
MFJ 2+ Children	290,188	−23.02	10.41	−31.63	0.00
Singles and HOH 0 Children	6,291,330	2.59	2.59	0.00	6.60
Singles and HOH 1 Child	1,212,148	−15.59	3.97	−19.96	−8.32
Singles and HOH 2+ Children	998,974	−25.97	4.44	−31.54	−19.47
$50,000 to $55,000					
Married Filing Jointly	1,630,697	3.29	3.25	−2.06	7.93
Singles and HOH	2,120,734	8.55	3.98	1.15	13.20
MFJ 0 Children	851,275	4.91	2.69	0.00	8.06
MFJ 1 Child	336,897	3.61	1.74	0.39	5.74
MFJ 2+ Children	442,525	−0.07	2.49	0.39	5.74
Singles and HOH 0 Children	1,566,384	10.03	3.00	4.40	13.30
Singles and HOH 1 Child	375,533	5.87	2.24	2.55	8.98
Singles and HOH 2+ Children	178,817	1.26	3.35	−6.75	6.11
$100,000 to $105,000					
Married Filing Jointly	825,856	7.92	2.89	3.62	12.29
Singles and HOH	219,668	13.24	4.20	2.40	18.40
MFJ 0 Children	383,282	9.58	2.55	4.97	12.65
MFJ 1 Child	169,704	7.85	2.19	4.76	11.47
MFJ 2+ Children	272,870	5.62	1.98	2.12	8.96
Singles and HOH 0 Children	182,038	13.73	4.00	5.75	18.42
Singles and HOH 1 Child	28,181	10.91	4.49	2.40	15.37
Singles and HOH 2+ Children	9,449	10.69	3.88	1.28	15.73

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305–3a).
Notes: MFJ refers to married filing joint returns; HOH refers to returns filing as head of household

Table 5. Variation in Marginal Tax Rates by Marital Status and Number of Children, 2005

Cash Income Class	Tax Units	Mean	Standard Deviation	Percentile	
				5th	95th
$15,000 to $20,000					
Married Filing Jointly	2,368,415	−0.89	7.21	−14.95	7.61
Singles and HOH	8,502,452	7.72	15.97	−14.93	25.86
MFJ 0 Children	1,867,464	0.33	2.38	0.00	0.00
MFJ 1 Child	210,763	−2.66	12.52	−33.83	15.95
MFJ 2+ Children	290,188	−7.43	14.80	−40.00	6.05
Singles and HOH 0 Children	6,291,330	9.16	15.33	0.00	17.39
Singles and HOH 1 Child	1,212,148	7.53	16.12	−14.99	25.96
Singles and HOH 2+ Children	998,974	−1.12	16.81	−40.00	21.02
$50,000 to $55,000					
Married Filing Jointly	1,630,697	15.59	9.31	0.00	24.98
Singles and HOH	2,120,734	21.79	7.31	14.97	30.95
MFJ 0 Children	851,275	16.30	11.52	0.00	27.72
MFJ 1 Child	336,897	15.39	3.35	14.79	22.25
MFJ 2+ Children	442,525	14.38	7.26	14.79	22.25
Singles and HOH 0 Children	1,566,384	23.87	6.91	14.97	33.82
Singles and HOH 1 Child	375,533	16.16	4.22	14.97	27.21
Singles and HOH 2+ Children	178,817	15.45	5.74	6.05	30.72
$100,000 to $105,000					
Married Filing Jointly	825,856	22.24	5.69	14.98	28.19
Singles and HOH	219,668	25.78	6.50	24.97	30.58
MFJ 0 Children	383,282	23.28	5.39	14.99	26.40
MFJ 1 Child	169,704	22.66	5.69	14.99	32.63
MFJ 2+ Children	272,870	20.51	5.70	14.98	27.00
Singles and HOH 0 Children	182,038	25.96	4.99	24.98	29.75
Singles and HOH 1 Child	28,181	24.00	12.50	14.98	33.52
Singles and HOH 2+ Children	9,449	27.61	4.85	14.98	30.95

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305–3a).
Notes: MFJ refers to married filing joint returns; HOH refers to returns filing as head of household.

Table 6. Consumption as a Percentage of Income, by Type

Income	All Expenditures	Food	Housing	Clothing	Necessities
$1–10K	254	52	81	10	143
10K–20K	137	25	45	5	75
20K–30K	104	18	31	4	54
30K–40K	87	15	24	4	43
40K–50K	75	13	21	4	37
50K–75K	68	11	18	3	32
75K–200K	56	8	15	3	26
Over $200K	37	5	9	2	16

Source: Tax Policy Center calculations based on Consumer Expenditure Surveys from 1993:1 to 1998:2
Note: Income is composed of earned and unearned income, and government transfers.
All items in 2003 dollars.

Table 7. Wages and Salaries as a Percent of Income, by Cash Income Class, 2005 [1]

Cash Income Class (thousands of 2005 dollars) [2]	All Tax Units			65 and Over [4]			Age Under 65		
	Tax Units [3]		Wages and Salaries as a Percent of Income	Tax Units [3]		Wages and Salaries as a Percent of Income	Tax Units [3]		Wages and Salaries as a Percent of Income
	Number (thousands)	Percent of Total		Number (thousands)	Percent of Total		Number (thousands)	Percent of Total	
Less than 10	19,560	13.5	43.5	4,083	13.8	4.7		13.5	
10–20	25,611	17.7	48.6	7,774	26.2	5.3	17,837	15.5	67.0
20–30	19,953	13.8	61.5	4,450	15.0	6.7	15,503	13.5	76.9
30–40	15,289	10.6	67.5	2,570	8.7	7.0	12,719	11.1	79.7
40–50	11,738	8.1	67.8	2,043	6.9	11.3	9,696	8.4	79.6
50–75	20,700	14.3	67.1	3,918	13.2	15.5	16,782	14.6	79.1
75–100	11,936	8.3	68.0	1,969	6.6	16.9	9,967	8.7	78.1
100–200	14,432	10.0	66.6	2,014	6.8	17.1	12,418	10.8	74.6
200–500	3,797	2.6	53.0	664	2.2	14.1	3,133	2.7	61.4
500–1,000	642	0.4	40.2	120	0.4	11.6	523	0.5	46.8
More than 1,000	335	0.2	27.9	68	0.2	10.7	267	0.2	32.0
All	144,573	100.0	58.5	29,690	100.0	12.7	114,884	100.0	68.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305–3a).

[1] Calendar Year.

[2] Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

[3] Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

[4] For married couples, at least one spouse is age 65 or over.

Chairman THOMAS. Thank you very much, Dr. Burman. Dr. Hubbard.

STATEMENT OF R. GLENN HUBBARD, DEAN, COLUMBIA UNIVERSITY'S GRADUATE SCHOOL OF BUSINESS, NEW YORK, NEW YORK

Mr. HUBBARD. Thank you very much, Mr. Chairman, Ranking Member Rangel, and Members of the Committee. This is an important subject and I appreciate your willingness to listen to five economists. I also appreciate Mr. Rangel's admonition. I visited with you all in 1995, but I swear I bear no responsibility for the complexity. I think this is a big subject because policy normally works around the edges and this isn't around the edges. Potential gains in-household incomes annually from true fundamental tax reform could be as large as 9 percent. True, fundamental tax reform could reduce significantly complexity cost the chairman alluded to and maintain tax fairness. There is an elephant in the room in the discussion of fundamental tax reform, and that is really capital taxation and business taxation issues generally. Capital income taxation as we currently implement it in the United States lies at the core of the efficiency costs of the current tax system, complexity and tax avoidance strategies that frankly undermine fairness.

Beyond capital accumulation, the way we tax business and capital in the United States also discourages risk taking and entrepreneurship, and we have recent cross country evidence to suggest very strong links to economic growth and to wages and competitiveness. I would submit to you that an interesting place for you to start as you look at alternative proposals are proposals that try to tax economic activity or income once. I would suggest a family of two-tier systems, a business tax and a household tax. Under the business tax, I would have a business tax, not a separate corporate tax that is based on sales, less purchases from other firms, less compensation, less a portion of capital spending. That would be depreciation under an income tax, expensing under a consumption tax. On the household tax, I would suggest a household tax on compensation. That kind of system can be as progressive as you like. You can have exemptions, you can have rates under the top rate. It is not difficult to replicate the progressivity of the current code.

I would also caution, and we can come back to this in questions and answers, the distinction between an income tax reform and consumption tax reform is not as large as you might hear from economists. The flip side of that is also the consumption tax reform is—can't possibly be that much more regressive if at all than income tax reform. That is a critical point on both efficiency and fairness. What are some good outcomes as a consequence of this family of tax reforms? No taxation of investor level returns, that is, you would collect the tax on businesses once at the business level. No tax distinction between debt and equity which has enormous efficiency cost. We have also seen the pernicious role of that tax distortion in corporate governance scandals. This does not again mean the capital income isn't taxed, only that it is taxed once at the business level. Second implication of these kinds of reforms would be a move toward a more territorial tax system for multi national companies enhancing our competitiveness and substantially en-

hancing simplicity. If we were to go to the consumption tax version of this, there would be a substantial additional stimulus to business investment spending from equipment expensing.

What are some big challenges here? One is the tax treatment of interest at the business level. Virtually any fundamental tax reform prototype you look at, income or consumption tax would disallow some or all interest deductions while not taxing interest income for investors. That is a big change. Special provisions in the business community would need to be swept aside. Transition costs are always mentioned to you as a big issue. Respectfully, I don't agree. We can come back to this. I think the transition costs of many tax reforms are relatively modest. Household tax challenges have to do principally with broadening the base. I assume in your discussions you would also discuss eliminating the AMT as well. It is possible to have a household tax that has roughly the same distribution as you have now. That distribution would not be accomplished with ever higher rates but with broadening the tax base.

Can we get there from here? Absolutely. Recent tax changes that this Committee has played a central role in point the way. Reductions in marginal tax rates, investment incentives and reduced taxation of dividends and capital gains all under the stewardship of this Committee were exactly the right way, and the distributional concerns can be easily satisfied so that high income taxpayers pay the same or greater burden as they currently do. Compromises could be a more scheduler version of what I have suggested, maybe small but not zero taxation of capital at the investor level. Just to close, I would like to leave you with a quick thought on the infrastructure, if you will, as you analyze any of these proposals, remembering that the growth effects are potentially large as you look at revenue estimates I would invite you to consider that. Second, following up on what some of the colleagues have said before, that you remember distributional analysis needs to take into account the fact that you can do many things in the Code at once. Finally, the obvious admonition of don't let the best be the enemy of the good. There are many of these proposals that are very close in terms of their effects. Thank you, Mr. Chairman.

[The prepared statement of Mr. Hubbard follows:]

Statement of R. Glenn Hubbard, Dean, Columbia University's Graduate School of Business, New York, New York

Thank you, Mr. Chairman, for the opportunity to appear before the Committee today to discuss options for fundamental reform of the Nation's tax code. The discussion that you and the President are leading offers an opportunity for public policy to improve living standards for all Americans, while providing a simpler and fairer tax code. Indeed, given recent estimates that annual gains in household income made possible by tax reform are as high as nine percent, few policy changes you evaluate are as significant.

CAPITAL INCOME TAXATION AS A PROBLEM

The bulk of the considerable efficiency gains from fundamental tax reform are achieved by reducing the burden of capital income taxation, which arises from the multiple layers of taxation on certain forms of productive business investment. Capital income taxation is also at center stage in the complexity of the present tax system (for example, measurement of capital gains and depreciation and the numbing complexity of tax rules governing multinational companies).

President George W. Bush has pursued an agenda of reducing the efficiency and complexity costs associated with capital income taxation. Yet fundamental tax re-

form—moving from the current tax system to a broad-based income tax or consumption tax with a simpler structure and lower marginal rates—would be on the watch list for action even without the President's interest. Part of this emphasis reflects the concerns of economists and policy mavens that tax reform could improve the efficiency of the economy and generate extra income for U.S. citizens. But practical factors in policy debates loom much larger—the perceived declining competitiveness of U.S. firms, the low rate of saving by most Americans, and the growing reach of the alternative minimum tax into the lives of millions of middle-income households.

These real-world pressures supported President Bush's tax cuts of 2001, 2002, and 2003. By means of his tax cuts and discussions of tax reform, President Bush has quietly made the case for a simpler tax system that would remove or at least sharply reduce the current-law tax bias against saving and investment. Indeed, the president's framing of the tax reform debate has corralled the real-world pressures for reform into a discussion of a consumption tax as a way of flushing out the familiar "simpler, fairer, flatter" goals of tax reform. And one would hope that this discussion will focus on how to broaden the tax base to make the marginal tax rates on investment (and work and entrepreneurship) as low as possible.

So, if capital income taxation is the "elephant in the room" of tax reform discussions, why is fundamental tax reform so difficult to accomplish? This framing will likely provoke loud outcries that consumption-based tax reform is unfair or, in the language of economists, "regressive."

One "fairness" concern about any fundamental tax reform that would broaden the tax base and reduce marginal tax rates is that top rate reductions would benefit only a handful of affluent taxpayers. This "snapshot" distributional analysis calls to mind the imagination of Tevye the Milkman in *Fiddler on the Roof,* who in the song "If I Were a Rich Man" thinks of one staircase just going up and another just going down. But in the same way that actual staircases allow for both upward and downward mobility, the tax system sees considerable income and tax rate mobility on the part of households. As a result, the reductions in marginal rates made possible by tax reform affect many more individuals than a snapshot would suggest.

In 2003, the White House Council of Economic Advisers used Treasury Department Data on households for the years 1987 to 1996 to study how households change income tax brackets over time (see Council of Economic Advisers, 2003, Exhibit 5.4). More specifically, the economists used the data to ask what tax rates would households have faced had President Bush's Economic Growth and Tax Relief Reconciliation Act of 2001 been in place over this period. The tabulations revealed that more than half of taxpayers were in a different tax rate bracket at the end of the period and that the upward and downward mobility was significant: Two-thirds of taxpayers in the lowest bracket had moved to a higher bracket after ten years, and four times more taxpayers were subject to one of the top two tax rates in at least one of the ten years than was indicated by the initial snapshot.

Another significant "fairness" concern about tax reform in the form of a consumption tax is the claim that such a tax would exempt income from saving from tax. To the extent that higher-income and wealthier houses save more, a shift to a consumption tax might appear to favor these households. Such an argument is intuitive—but wrong (see Hubbard, 2005). A broad-based consumption tax need not be more regressive than a broad-based income tax. The real challenge for tax reform is to accomplish either one.

BENCHMARKS FOR TAX REFORM

I suggest as benchmark tax reforms systems that would tax income once. To facilitate comparison between "income tax" and "consumption tax" versions of reform, I focus on two-part tax systems, with a business tax and a household tax. While I describe examples with a uniform rate of tax, it is easy to introduce progressivity with multiple tax brackets and an exemption in the household tax.

Proposals for fundamental tax reform typically suggest moving to either a more pure income tax or a more pure consumption tax. Although these two proposals appear to be on opposite ends of a spectrum, the purer income tax and the purer consumption tax may affect economic and corporate financing decisions in similar ways. Moving to a purer tax system of either type also would reduce tax-planning opportunities because tax-minimizing strategies often involve combining transactions with different tax treatments (that is, part of the transaction receives pure income-tax treatment, while another part receives consumption-tax treatment) or by taking advantages of disparities in tax rates across investors.

Broad-Based Income-Tax Reform

For economic and corporate financing decisions, the critical element of fundamental reform of the income tax is the integration of the corporate and the personal income-tax systems. In theory, integrating the systems would eliminate two distortions from the current tax system. First, integration would eliminate the distinction between corporate and noncorporate businesses by abolishing the double taxation of corporate income. Second, this reform would remove the differential taxation of debt and equity financing.

The U.S. Treasury Department's study of corporate tax integration (see U.S. Department of the Treasury, 1992) presents several alternative approaches to integrating the individual and corporate tax systems. One proposal, the Comprehensive Business Income Tax (CBIT) seeks is to tax business income once. CBIT is a business-level tax on the return to capital of businesses. Broadly speaking, the business-level tax base under CBIT is revenue from the sale of goods or real assets less wages, material costs, and depreciation allowances for capital investments. To conform to standard income accounting principles, the CBIT base uses depreciation allowances that follow as closely as possible economic depreciation. CBIT does not distinguish whether investment is financed by debt or equity. That is, in contrast with the current tax system, CBIT would not allow businesses to deduct interest payments from their tax base. Because CBIT taxes business income at the entity level, there is no need for investor-level taxes on capital gains, interest, or dividends received. CBIT can be thought of as the capital income tax component of a broad-based income tax that collects taxes form labor income through a household-level wage tax.

Converting the Income Tax into a Consumption Tax

Converting CBIT into a consumption tax turns out to be quite straightforward. Instead of measuring business income through depreciation allowances, a consumption-tax version of CBIT would allow businesses a deduction for capital investments when assets are purchased. This "expensing" adjustment converts the combination of CBIT and a wage tax into the flat tax proposed by Hall and Rabushka (1983).

Having described CBIT and the flat tax in this way, we can see that the flat tax does not exempt all of what is commonly called "capital income" from taxation (see also Gentry and Hubbard, 1997, 1998). Under the business cash-flow tax component of the flat tax, the present value of depreciation allowances for one dollar of current investment is one dollar, while the present value is less than one dollar under the income tax. For an investment project, the tax savings from depreciation allowances represent risk-free flows, which the firm would discount at the risk-free rate of interest. For a marginal investment (in which the expected rate of return just equals the discount rate), the upfront subsidy to investment provided by expensing equals the expected future tax payments. It is only in this sense that the "return to capital" is not taxed under a cash-flow tax or a consumption tax. But returns attributable to entrepreneurial skill or risk bearing are, in principle, taxed equivalently under fundamental income or consumption tax reform prototypes.

To summarize, then, I use the term "fundamental tax reform" to represent tax proposals with the following characteristics:

1. It is a combination of a business-level tax (with either cash flow or business income as the base) and a household wage tax.
2. For an income-tax version of reform, depreciation allowances are as close to economic depreciation as possible; for a consumption-tax version of reform, businesses will deduct capital expenditures.
3. The business-level tax does not distinguish between debt and equity financing.
4. In order to minimize the differences in marginal tax rates across business entities and investments, firms carry net operating losses forward with interest.
5. There are lower marginal tax rates with a single marginal tax rate across business entities and households; the household tax can have a personal or family exemption.

Fundamental income tax reform and consumption tax reform contribute to economic efficiency by accomplishing corporate tax integration. Returns to business investment would be taxed once at the business level and not again at the household level. Both reforms eliminate financial distortions under current law (that arise from the tax bias against corporate equity and dividends—see, for example, Gertler and Hubbard, 1993) and organizational distortions under current law (that arise from the tax bias against C corporations). Both reforms are consistent with a "dividend exemption" or territorial tax system for multinational companies, and this consistency is desirable (Devereux and Hubbard, 2003).

The consumption tax version of tax reform offers an added benefit: the benefit of expensing of business investment will stimulate investment, capital formation, and economic activity. Such a business tax system would also be simpler. While expensing entails a greater revenue cost than depreciation, one must be careful to note that over the long run, the difference is only the time value of money on depreciation allowances (that is, comparing the value of allowances all at once—expensing—versus allowances taken over time—depreciation).

Substantial efficiency gains estimated for corporate tax integration (see, for example, U.S. Department of the Treasury, 1992; Altig, *et al.,* 2001; and Hubbard, 2003) do not capture all the possible sources of economic gains. First, as noted above, expensing offers an incremental gain. Second, reductions in marginal tax rates can increase growth through human capital investment (as in Lucas, 1988) and entrepreneurial risk taking (Gentry and Hubbard, 2004; and Cullen and Gordon, 2002). A third channel arises if base broadening in tax reform permits a lower business tax rate. Lee and Gordon (2005) estimate using cross-country data that a lower corporate tax rate is associated with more rapid economic growth, a correlation they attribute to a lower corporate tax encouraging more entrepreneurial activity.

THE WAY FORWARD

Mr. Chairman, this Committee has the opportunity to reform the nation's tax code in ways that will enhance living standards, improve tax fairness, and reduce the enormous complexity that wastes billions of dollars each year. Reform of business taxation will be a major element of the overall reform debate, particularly given the overarching interest of tax reform in reducing tax burdens on saving and investment to promote economic growth.

As you evaluate options for tax reform, I urge you to focus on prospects for improving growth. You can address tax fairness concerns as well by broadening the tax base of both the business and household tax systems. I also urge you to include estimated effects on economic growth and incomes of tax reform in your evaluation of revenue and distributional impacts of tax reform. While many interests will approach you for "transitional relief," the case for large "transition costs" of tax reform for businesses as a whole is more difficult to make than is often thought (see, for example, the discussion in Hassett and Hubbard, 2001). Finally, as you know well, it is possible to implement tax reform as a series of steps, necessitating caution in evaluating a "horse race" among proposals for fundamental tax reform.

Thank you, again, Mr. Chairman, for the opportunity to appear before you today on the important subject of fundamental tax reform. I look forward to your questions.

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Chairman THOMAS. Thank you very much, Dr. Hubbard. Dr. Slemrod.

STATEMENT OF JOEL B. SLEMROD, PAUL W. MCCRACKEN COLLEGIATE PROFESSOR OF BUSINESS ECONOMICS AND PUBLIC POLICY, PROFESSOR OF ECONOMICS, AND DIRECTOR OF THE OFFICE OF TAX POLICY RESEARCH, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICHIGAN

Mr. SLEMROD. Thank you for the opportunity to address this Committee. I have been asked to talk about tax complexity and simplification. Certainly, one objective of tax reform should be to simplify the tax system. The complexity of the current system is one reason why the cost of collecting taxes is so high. In the written testimony I have submitted to this Committee, I provide details underlying my estimate that this cost now comes to $135 billion per year, more than 10 percent of revenues raised and more than 1 percent of GDP. The major part of this cost is the over 3 billion hours of taxpayers' time. Equivalent to 1.5 million extra Internal Revenue Service (IRS) employees. The $135 billion is the value of the resources used up each year in the process of collecting taxes and the amount of resources that could, if taxes could be collected costlessly, be freed up for whatever else Americans would prefer to use their time and money for. The negative consequences of tax complexity though go beyond dollars. Complexity causes a capricious and inequitable distribution of tax burdens because it rewards those who have the means and inclination to find all the tax angles and leaves the dutiful among us holding the bag. It undermines trust in the fairness of the tax system which may, in turn, undermine voluntary compliance. It reduces the transparency of the tax system, which I believe is inimical to a properly functioning democracy.

Because of these consequences tax simplification deserves to be taken seriously. Supporting tax simplification in the abstract is like supporting motherhood and apple pie. We must move beyond simple support for simplification and address how and how much to simplify the tax system. In so doing, it is critically important to consider three separate aspects of the tax system, the rate structure, including whether it should have one rate for all or is graduated, base integrity, that is, whether the base is messy or clean; and third, base choice, whether the base is income or consumption or something in between. Another fundamental point is that the simplest way to collect tax is not the best. There are almost always tradeoffs between simplicity and the other criteria we use to evaluate our tax system. We could have exactly the same tax burden for everyone, Bill Gates and everyone else. Most of us, maybe all of us, would judge that very, very simple tax system to be very, very unfair.

As another example, loosening enforcement would save both administrative and compliance costs but would also unfairly shift the tax burden toward those who view paying what they owe as a civic duty. Can a messy tax base be justified by an appeal to fairness? In some cases, yes, but most of the deductions, the credits and the adjustments in our current tax system cannot be justified in this way. A thorough going pruning of these programs would I believe not only significantly simplify the tax system, but would also be good for the economy. I have no suggestions for how to stiffen congressional resistance to the special interest pleading that opposes such a pruning, although I suspect a thorough going, rather than a piecemeal reform provides Congress with the opportunity to shrug its shoulders and say we are doing it to everyone.

One key to simplifying the tax system is thus, to minimize fine tuning the tax liability of individuals and fine tuning the economy by subsidizing and rewarding activities deemed to be especially valuable. Note, though, that is illusory simplification and probably not simplification at all if the same set of subsidies and rewards is reconstructed outside the tax system. If we are going to have these subsidies and rewards in any event, arguably they should be implemented through the tax system rather than by operating separate bureaucracies.

Simplifying the tax system enough along these dimensions would allow us to take advantage of large scale withholding by businesses through a return free income tax system where as many as two-thirds of individual taxpayers need not file tax returns at all. Do we need a consumption tax instead of an income tax to get a less complex tax system? I think not. Replacing the income tax with a consumption tax base is neither necessary nor sufficient for significant tax simplification. European experience with a consumption based VAT shows that consumption taxes can be as costly to operate as real live income tax. Adopting a consumption tax is not necessary for simplification because a clean base return free structurally improved tax system can achieve a lot.

I do not mean to dismiss the potential inherent simplicity advantages of basing tax liability on consumption rather than income. There are certainly structural problems that will not go away with income tax reform. We should not though fall victim to a grass-is-greener fallacy for a few reasons. With more than a trillion dollars at stake, there will be plenty of people of who will find loopholes in the consumption tax system. The transition to a consumption tax system even to one that eventually would be much simpler can be incredibly complex and riddled with loopholes that erode both revenues and fairness. In conclusion, the potential benefit from tax simplification is substantial. Choosing the right path to a simpler tax system requires facing up to several difficult trade offs. It should not be surprising because dealing with tax complexity requires addressing the most fundamental questions about the relationship between government and the people it serves. How activist the government should be, how intrusive it should be and when should it settle for rough justice. Thank you.

[The prepared statement of Mr. Slemrod follows:]

Statement of Joel B. Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, Professor of Economics, and Director of the Office of Tax Policy Research, University of Michigan, Ann Arbor, Michigan

One-third of Americans say that complexity bothers them more than anything else about the tax system. This is more than twice as many who say their biggest complaint is "the large amount of taxes they paid." Half of Americans rate the system as "very complex," and someone holding that belief is 10% more likely to favor scrapping the income tax for another system. In this testimony I address the cost of collecting taxes under the current system, what causes this cost, and what kinds of tax reform promise to simplify and reduce the cost of collecting taxes.

Tax complexity has many dimensions. To suggest its magnitude, some count the number of pages or words in the tax code or forms. Others stress that even tax experts rarely agree on the true tax liability for a tax return of even moderate complexity, or note that it often takes several years to finally resolve the tax liability of a big corporation.

In my view the most informative measure of tax complexity is the resource cost of collecting taxes. This is equal to the IRS budget plus the value of the time and money spent by the taxpayers and third parties to the collection process (such as employers who withhold tax for their employees.) Measuring the IRS budget is straightforward, but measuring the other components of the collection costs—known as compliance costs—is not. What do we know?

A recent comprehensive study done by IBM Business Consulting Services under contract to the IRS concluded that, in tax year 2000, the 125.9 million individual taxpayers had a total compliance burden of 3.21 billion hours and $18.8 billion in monetary expenditures. This translates into an average burden of 25.5 hours and $149 per taxpayer. Although self-employed taxpayers represent only about 25% of all individual taxpayers, they experienced approximately 60% of the time and money burden. As a result, the average time and money burden of self-employed taxpayers (59.5 hours, $363) was substantially greater than that of those taxpayers with only wage and investment income (13.8 hours, $75). Not surprisingly, the average compliance burden was also consistently higher among taxpayers who have more complex tax returns; for example, non-self-employed taxpayers who itemize their returns spend an average of 21.3 hours and $114 on tax compliance, compared with 11.4 hours and $63 for non-itemizers. The current system is not, however, complicated for everyone, and is generally not that complicated or costly for the tens of millions of taxpayers who file Form 1040EZ or 1040A; survey evidence suggests that 30% of taxpayers spend fewer than five hours on all tax matters over an entire year. By applying a range of dollar values to each hour of time burden, IBM estimated that the annual resource cost of compliance for individual taxpayers is between $67 billion and $99 billion.

A series of analyses by the Office of Tax Policy Research at the Ross School of Business at the University of Michigan, under contract to the IRS, have examined the compliance cost of large and medium-sized businesses. In 1996 the total compliance cost for the 1,500 largest companies exceeded $2 billion, or over a million dollars per company; for Fortune 500 companies, the average cost was nearly $4 million. For businesses smaller than the biggest 1,500, but with assets in excess of $5 million, in 2002 the total compliance cost came to about $22 billion. There is clear evidence that business compliance costs are regressive—costs as a percentage of company size are higher for smaller companies than they are for larger companies. For instance, companies with between $100 million to $250 million of assets have only about seven times higher compliance costs than companies with between $5 million to $10 million of assets, even though they are between 10 and 50 times bigger.

In written testimony I submitted to this committee on June 15, 2004, I drew on these and other studies to estimate the total annual cost of collecting the federal income tax in 2004. My best estimate came to $135 billion per year. Of this total, $85 billion consists of the total compliance cost borne directly by individuals (including sole proprietorships), and another $40 billion relates to business. Adding an IRS budget of about $10 billion produces the overall collection cost estimate of $135 billion. This is 14.5% of individual and corporation income tax receipts in fiscal year 2004, and about 1.2% of 2004 GDP.

The $135 billion annual cost of complexity is the value of the resources used up in the process of collecting taxes, and the amount of resources that could—if taxes could be collected costlessly—be freed up for whatever else Americans would prefer to use their time and money for. This is an economic cost of collecting taxes that should be added to the cost incurred when the tax system discourages people from

working as much as otherwise, businesses from investing as much as otherwise, and so on.

The negative consequences of tax complexity, though, go beyond what can be estimated in dollars. Complexity causes a capricious and inequitable distribution of tax burdens because it rewards those who have the means and inclination to find all the tax angles, and leaves the dutiful among us holding the bag. Moreover, the unfairness complexity causes—and the complexity itself—undermine trust in the fairness of the tax system, which may in turn undermine voluntary compliance. Complexity reduces the transparency—who bears how much burden and why—of the tax system, which I believe is inimical to a properly functioning democracy.

The rapid computerization of tax matters—in 2003 over two-thirds of self-prepared returns were done with software on a computer, compared to less than 20% in 1993—is a double-edged sword. Although it has undoubtedly facilitated the tax collection process, I am concerned that computerization also may erode taxpayer understanding of the formula that turns the inputted items into what one owes the government. Tax return software may be helping to turn the tax system into a black box—a more efficient black box, to be sure, but a black box nevertheless.

Given a $135 billion annual resource cost, plus unquantifiable but significant negative effects on equity and even the functioning of democracy, tax simplification deserves to be taken seriously. We must, though, move beyond platitudinous support for simplification and address how, and how much, to simplify the tax system. As we begin what I hope will be a serious discussion of how we should tax ourselves, it is critically important to separately consider three important aspects of the tax system: 1) rate structure, including whether the rate structure has one rate for all or is graduated, 2) base integrity, that is whether the base is messy or clean, and 3) base choice, whether the base is income or consumption, or something in between.

Another fundamental point is that the simplest way to collect tax is not the best, and there are almost always tradeoffs between simplicity and the other criteria we use to evaluate our tax system. For example, consider the following simple tax system. Start with the annual revenue needs of about a trillion dollars and divide that by the 130 million or so individual taxpayers; this division yields about $8,000 per return. Here's a tax system: everybody owes $8,000 per year, period, including Bill Gates, a single mother earning $10,000 per year, and everyone else. Most of us, maybe *all* of us, would judge that very, very simple tax system to be very, very unfair.

As the example illustrates, in part tax complexity reflects a belief that simpler systems can cause an unfair distribution of the tax burden. Achieving a progressive distribution of the tax burden—one in which taxes as a fraction of income are higher for higher-income families—requires measuring, reporting and monitoring a measure of well being, such as income.

A simpler, or less costly, tax system may compromise the fairness of the tax burden in other ways. For example, loosening enforcement would save both administrative and compliance cost, but would also shift the tax burden toward those who view paying what they owe as a civic duty. Thus, the simplicity of a tax system can be assessed only with respect to a standard of enforcement and, ultimately, fairness. For this reason even the most thoroughgoing simplification imaginable that also meets our shared standards of fairness would cut the resource cost of collection by no more than in half or, at most, two-thirds.

Can a messy tax base be justified by an appeal to fairness? In some cases, yes. A deduction for involuntary medical expenses arguably improves how well taxable income measures a family's true well-being and thereby improves fairness. But most of the deductions, credits, and adjustments in our current system cannot be justified in this way. The fact is that the U.S. income tax system is an awkward mixture of a revenue-raising system plus *scores* of incentive and reward programs. A few of these programs may be justified, but most cannot, and a thoroughgoing pruning of these programs would, I believe, not only significantly simplify the tax system but would also be good for the economy.

Cleaning the tax base may be the hardest aspect of tax reform to achieve politically, because nearly every bell and whistle has a constituency behind it. Many observers and many taxpayers are cynical about the ability of Congress to keep its collective hands out of the cookie jar, leading some to question the wisdom of cleaning up the tax system only for it to get dirty again. The most cynical of all expect base-cleaning tax reform to happen precisely so the base exceptions can be introduced again for political rewards. I have no suggestions for how to stiffen Congressional resistance to special interest pleading, although I suspect that a thoroughgoing—rather than piecemeal—reform provides Congress with the opportunity to shrug its shoulders and say "we're doing it to everyone." In any event, if tax reform

needs to be revisited every twenty years, so be it; that strikes me as a much better outcome than pursuing only policies that are likely to last forever.

Flaws in the political system also underlie an argument one hears in *favor* of a costly tax system—that it undermines big government. The idea is that the political system is flawed in such a way that we do not get the size of government we want—we get something bigger. Although the government cannot be downsized directly, the argument continues, it does contract when its source of funding gets more expensive. From this perspective, making the tax system more painful and more costly is a good thing. This argument (along with the separate and also controversial argument that it would make the tax burden more *visible*) lies behind the suggestion to abolish employer withholding and remittance of employees' income tax liability, which certainly makes the system much less costly to administer fairly. I don't buy this argument at all, because it relies on several arguable or dubious assumptions—that the political system systematically spends "too much," that spending responds more to raising the cost of funds than to direct political reform and that, if the muck-up-the-tax-system strategy is effective, the benefits of reducing spending exceed the higher costs of raising revenue. Whether one agrees with this argument or not, the important point is this: before we embark on serious tax reform we'd better get straight whether the objective is to make the tax system more, or less, costly. I recommend the latter, and so turn next to tax simplification.

One key to simplifying the tax system follows from the causes of tax complexity: minimize fine-tuning the tax liability of individuals and fine-tuning the economy by subsidizing and rewarding activities deemed to be especially valuable. Note, though, that this is illusory simplification—and probably not simplification at all—if the same set of subsidies and rewards is reconstructed outside of the tax system. If we're going to have these subsidies and rewards in any event, arguably they should be implemented through the tax system rather than by operating separate bureaucracies—by having just one financial account between the government and the people.

Simplifying the system enough along these dimensions would allow us to take advantage of large-scale final withholding by businesses through a return-free income tax system. Twenty years ago in its famous report that preceded the Tax Reform Act of 1986, the Treasury Department noted that, with significant base cleaning, as many of two-thirds of individual taxpayers need not file tax returns at all. Thus, base cleaning alone can, for the majority of taxpayers, achieve the ultimate simplification—no return at all—that is a natural feature of either a value-added tax (VAT) or a retail sales tax. This is, to be sure, a "populist" simplification, in that it would simplify the system for those (many) people whose tax matters are already relatively simple.

Structural changes to the way we now tax corporations, including multinational corporations, also have potential to simplify the tax system. Rationalizing the separate entity-level taxation of corporations (and the double taxation of dividends that accompanies it) would simplify tax matters by reducing or eliminating the need for complicated rules delineating when income passes from the corporation to the shareholder. This sort of reform, known as integration, has long been advocated by supporters of a comprehensive income tax, and is not inherently related to the choice of a consumption versus and income tax base, although it accomplished by all of the leading consumption tax proposals.

Although abandoning progressivity or thoroughly cleaning the tax base (or, for that matter, a rationalization of how we tax corporation-source income) would to my mind certainly qualify as fundamental reform, in recent years the idea of fundamental reform has become linked to basing taxation on consumption rather than income. Do we need fundamental reform in this sense to get a less complex system?

No. Replacing the income tax with a consumption base is neither necessary nor sufficient for significant tax simplification. European experience with the VAT has shown that a consumption tax is not sufficient for simplification: real-life VATs can be as costly to operate as real-life income taxes. Adopting a consumption tax is not necessary for simplification because a clean-base, largely return-free, structurally-improved income tax system can achieve a lot.

Recall that the three key aspects of tax systems—clean or messy base, progressive rate structure or not, and income or consumption base—are separate issues. A consumption tax can have a clean or a messy base, and can feature flat or graduated rates. So can an income tax. Most consumption tax proposals not only adopt a new base but also radically clean the base and sharply curtail progressivity.

By arguing that a consumption base is neither necessary nor sufficient for tax simplification, I do not mean to dismiss the potential inherent simplicity advantages of basing tax liability on consumption rather than income. All other things equal, and with some exceptions, tax systems are simpler when the base is cleaner, when

the rate structure is flatter, *and* when the base is consumption. Although a reformed income tax can substantially simplify the system, it leaves some potential simplification opportunities on the table. Consumption taxes can dispense with the accrual accounting required for income taxation—depreciation, inventory accounting, and so on—and its inherent problems in an inflationary environment. Consumption tax systems need not measure real capital income; any system of taxing capital income is prone to inconsistencies that reward complicated transactions such as tax shelters and tax-oriented financial products. These structural problems will not go away with income tax reform.

We should not, though, fall victim to a "grass-is-greener" fallacy, for a few reasons. With more than a trillion dollars at stake, there will plenty of people looking for inconsistencies in a consumption tax system, and some will be found. Consumption taxes based on taxing retail sales are probably not administrable at our usual standards of equity and intrusiveness. Depending on how it is handled, the transition to any consumption tax system, even one that eventually would be much simpler, can be incredibly complex and riddled with loopholes that erode both revenues and fairness.

Abolishing the federal income tax would also eliminate the availability of a fairly reliable measure of the financial standing of families (as well as businesses) that is widely used throughout the economy. If individuals did not have to file income tax returns, they would still need to keep some records. But which ones? For example, what records would they have to provide mortgage lenders or college financial aid officers? Many federal transfer and other programs now rely on an annual measure of comprehensive income, for which labor income alone will not suffice. If many states continue to levy comprehensive income taxes, the compliance cost saving is reduced if taxpayers of those states still have to calculate income. To the extent that alternative ways of verifying income would arise, these new costs need to be netted out to obtain the true cost saving from moving away from an income base.

It costs us about $135 billion a year to collect the trillion dollars or so of income tax revenue. The complexity that contributes to this cost also undermines the fairness of the tax burden and erodes the transparency of the tax system. Some of the cost arises because we have high standards for the fairness of our tax system, and would remain under any system that meets those standards. Some of the cost occurs because we use the tax system for many things other than raising revenue, and could be eliminated if the tax base were cleaned of these features. Some of it occurs because of structural problems—some fixable, and some inherent—in the income tax system. Moving to a consumption tax base addresses some but not all of the sources of complexity.

The potential benefit from tax simplification is substantial, but choosing the right path to a simpler tax system requires facing up to several difficult tradeoffs. This should not be surprising, because dealing with tax complexity requires addressing the most fundamental questions about the relationship between government and the people it serves: how activist should the government be, how intrusive should it be, and when should it settle for rough justice?

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Chairman THOMAS. Thank you very much. We went through the examinations of fairness, simplicity and growth in 1986 when we were examining it. The question I am going to ask, I always like to try to get five economists to agree, and sometimes I have to go pretty high up on the abstract level to get agreement. I hope I don't have to go up too high. It seemed to me that back then, in looking at fairness, simplicity and growth, it was basically, without

a whole lot of discussion how to change the then-present income tax structure to make it fairer, simpler, and provide growth. We all look for analogies we are more familiar with. I know in auto racing, everybody wants fast durable and cheap. The builder says I can give you two of the three. Which two do you want?

You have indicated there is a clear requirement to trade off to a degree. My question is not that. Obviously we are going to have to deal with that. My question is this: in the roughly two decades since we last went through the simplicity fairness and growth juggling, do you believe that both academically and in the real world, we have discovered, we have understood, we have conceptualized so that we have more tools today available? We may examine particular options and discard them and go back to something that we would may want to deal with, but do you believe that examining the various options is worth the Committee's effort to perhaps get out of the conceptual framework they have and examine some others because the value of that means we have a better chance to get a better trade off to produce a better product in blending fairness, simplicity and growth? Anybody respond to that?

Mr. HUBBARD. If I might, Mr. Chairman, I think that would be an excellent activity. One reason I was suggesting a family of two-tier taxes that nests income and consumption taxes, you could show yourself what the gains in economic activity are, what the distributions of the tax burden are there. I mean, that is, the trade-off, of course, is something economists can't help you with. Those are your political judgments. I think there has been an abundant body of academic work over the past two decades that would help inform that, including some very, very recent papers, so I do think it is worth the candle.

Mr. BEACH. Mr. Chairman, on the very last page of my submitted testimony is a graphic. It is the only graphic of my testimony. It shows how many tools you have invented since 1986 and how well you have used them. There is a line on this graphic which looks at the marginal tax rates that a hypothetical family of four faced in 1986 as their income changed. Then it compares it to in 1988, and then to today. There has been a vigorous application of well meaning tools, but it has created a situation in which it is very difficult to say that the current system is a fair and just system. So, there is the sort of catch-22 of having good tools, well meaning and the application kind of moving against the principles. I would say the principles, as Alan and I were talking just before the hearing, that principles are pretty much the same as 20 years ago. The tools are more vigorous but you have to be governed by the principles in order to establish a fair and just system.

Chairman THOMAS. My concern is that as we begin to learn some of these new concepts, we latch on to them in ways that perhaps limit us in our ability to be as facile as we need to be in a comparison. This is where you are going to need to help us. For example, on page 7 of Dr. Burman's testimony, he makes this statement, and I wonder if anyone here strongly disagrees with you or if all of you tend to agree with it, in which he says the flat tax, which is effectively a subtraction method VAT, in which the wage portion of the tax is collected from workers rather than firms and which is somewhat progressive since it exempts some portion of

wages. Anyone disagree with that statement? Because you see, we have begun to engage in a discussion between a flat tax and value-added taxes. Sometimes people don't walk across models to understand that with some of the minor changes, Dr. Hubbard, as you suggested, you can turn one thing into another and improve on the simplicity or the fairness or the growth issue. My goal is to not get people locked up in terminology which doesn't allow them to be flexible enough to understand, regardless of what label is placed on it, the fundamentals need to be examined because you are going to get tradeoffs no matter which basic concept you are dealing with. Dr. Auerbach for a final statement.

Mr. AUERBACH. Yes, Chairman Thomas, there is one difference that some people point to as a difference between a value-added tax and a flat tax. It relates to a point in my testimony which is the lack of border adjustments under of the flat tax. It makes it look to some people less like a consumption tax or a value-added tax. Some people have seen that as a disadvantage. As I suggested in my testimony, that really is not an important difference. So, in viewing—I think it is right to view the flat tax as basically a subtraction method value-added tax except for the progressive portion for low income wage earners.

Chairman THOMAS. Thank you. To the degree all of the economists were talking about or open a border adjustable tax is taken care of in the situation of one country versus another based on currency fluctuations and a number of other factors so that it all works out in the wash as we say. Thank you very much. Gentleman from New York.

Mr. RANGEL. Thank you. If we ever get seriously involved in reformation we can't do it without you, because I came to the Congress to close up all the tax loopholes. How little did I know that so many would be incentives, and so the targeted jobs credit empowerment zones, earned income tax credits, incentives to hire people for jobs, incentives for education, incentives for employers who provide health care, mortgage interest deduction, business deductions for their equipment. There is a long list of things and a lot of them are political. A lot of them are special interests. A lot of them are well intended. If we went toward a flat tax, a consumption tax or national resale tax, are any of you prepared to distinguish between what has no economic benefit and what is purely political and what is special interest? Because that is one way I see that you can't do this without winners and losers. We would have to make—we would need you to help us not to make political decisions so that we can work together, assuming it was possible for us to work together. Since all of this is academic you don't have to worry about that. How would we handle those credits and deductions that have no economic benefits at all? Would you, any of you be able to help us to make that decision? Yeah, you because you mentioned it, Doctor.

Mr. SLEMROD. The one thing I think you should have a high hurdle for arguments that go against a clean base, not only for simplicity purposes, but just because most of the deviations, I think, do not have a good economic justification.

Mr. RANGEL. Well, just for academic reasons, where would you put the deduction of mortgage interest?

Mr. SLEMROD. Myself, I think the tax system should not embed a favoritism toward owning a house versus renting a house.

Mr. RANGEL. Where would you put charitable contributions.

Mr. SLEMROD. I think a justification, a subsidy for charity is fine, but not the way it is done within the current tax system where the subsidy is higher for high income people.

Mr. RANGEL. Where would you put religious institutions?

Mr. SLEMROD. I would keep the rules for determining a charity that gets the subsidy the same as it is now.

Mr. RANGEL. You mean some churches could be taxed?

Mr. SLEMROD. No. The same rules about what qualifies as a deductible charitable contribution.

Mr. RANGEL. Okay. Where would you put research and development?

Mr. SLEMROD. Research and development, I think most economists, and I imagine a majority of this panel would find an economic justification for.

Mr. RANGEL. Where would you put the earned income tax credit?

Mr. SLEMROD. On the list that we need to take very seriously the impact of the tax system on vertical equity and that many of—can I—I am willing to answer all your particular questions, but can I stop for a second and say that this string of questions illustrates why consideration of any radical tax reform such as a flat tax does many, many things. In fact, a flat tax has a fundamental change on the three aspects of the tax system I said we should keep separate. It changes the rate structure radically and therefore the distribution of tax burden. It cleans the base up radically and gets rid of almost all of the provisions on the list I have heard so far and maybe on the rest of the list. It moves from an income tax base to a consumption tax base. These are separable things. So, we would could consider cleaning the base, we can consider change the rate structure and we should consider cleaning up the base, be it income or consumption. A flat tax for example, or a value added tax would get rid of every one of the provisions every one of the subsidies you have mentioned so far.

Mr. RANGEL. We would need you to help politically to justify it in terms of Republicans and Democrats working together to ease the political pressure of the losers, right?

Mr. SLEMROD. I imagine that there would be more consensus among the economists on a panel like this on those issues than you might expect.

Mr. RANGEL. So, if the chairman and I continue to send letters to each other, we would be moving forward in a very dramatic way, wouldn't you think? Are there any other comments? No. I ran out of time. Thank you so much.

Chairman THOMAS. Mr. Burman, do you want to briefly respond?

Mr. BURMAN. One of the things that strikes me is that we have a tax system now where basically people owe, middle income people owe a fair amount of income and tax to the government. Then if they jump through a whole bunch of hoops, they can get a bunch of it back. So, we make it sound like we are giving people a mortgage interest deduction, a charitable deduction and all of these

things. In fact, you know, we are saying that certain people get a benefit. Other people don't. People are working really hard to determine their tax liability. Really, as Joel said, there really ought to be a very high hurdle on the tax breaks that you put into the Code because you have to raise taxes elsewhere to pay for it. So, it is not like, you know, there has been this notion lately that tax cuts benefit everybody. They have to be paid back one way or another, future deficits or higher taxes.

Chairman THOMAS. My concern is as we try to incentivize people, I am just very concerned about having people chase asset benefits through the Code as we change it and you are not getting a real value, but you clearly are rewarding particular people in particular ways when you don't think you are. Gentlewoman from Connecticut wish to inquire?

Mrs. JOHNSON. Thank you, Mr. Chairman. I thank the panel for their really excellent presentations. It is extremely helpful to have sort of fairness laid out in a vertical, horizontal and forward manner and to hear this discussion of simplicity versus fairness. I find very troubling economists—this is gross generalization—economists general disregard for the relationship between tax benefits and incentives for actions that we as a society value, because I think the record demonstrates their power. For example, look what is happening to people when they roll over their 401(k). They are not saving it. They are not putting it in an annuity. Too often it is not going to be there for retirement security. On the other hand, the tax incentives to save are having people save. We have had testimony that if there was an opt out rather than an opt in many more people would save. You look at low income housing. There is a lot of reasons why low income housing is higher risk to build than other kinds of housing. It certainly takes more careful management. The incentive to combine—the incentives that the low-income housing tax credit puts out there to combine good quality construction with good management to provide affordable housing is kind of—has been the primary way now we are creating affordable housing.

So, I don't see how you—I mean, I don't want to ignore the power of tax incentives to produce things that a market economy wouldn't necessarily produce. It is hard at market rates to produce affordable housing. Now you can subsidize them through rent subsidies or you can subsidize them by lowering the cost of construction and not be into rent subsidies all those years. Let me just conclude by saying there is an EITC demonstration going on now for effectiveness. My district happened to be one of those districts. It was resisted. It is a very progressive view. One of the things that the IRS told me in talking about it was that tax incentives are less costly to administer and reach a larger portion of the population they are intended to reach as opposed to administered programs which are more expensive to administer and tend to reach a narrow number, narrower number of the eligible individuals. We certainly see that over and over again in health programs for children. So, you know, if you say the EITC and the child credit are serious income expanders for low income families and we would have to think about doing it a different way, well, the other way may be much more costly and much less effective. So, I just want to put my marker down

to—you have got to have better information for me to convince me that tax credits aren't powerful and important in structuring a society that has the income you need when children are young, that plans for retirement, that is able to produce affordable housing and so on. So, if any of you would like to comment on that, I would be interested in your thoughts.

Mr. HUBBARD. If I might, Mrs. Johnson, I think that most economists believe these tax provisions are powerful. The question—they do stimulate the desired activity almost always. The question is are they the best way of doing that either in terms of economic efficiency or costs. You mentioned some economists won't agree on all these things. Savings incentives an area, me speaking only for myself on the panel, I believe the Tax Code has had a very constructive and powerful and potent effect, and I think you all deserve a lot of credit for that. I would not put the low income housing tax credit in that camp. I think there are more efficient ways for the taxpayers to address low income housing if that is something that you politically want to do. So, I don't think it is a disagreement that these aren't effective. I think people think they are effective in terms of stimulating the activity. The question, given your political judgment that you want to do that, is whether there are better ways to do it that are also perhaps more fair.

Mrs. JOHNSON. Well, I do think we need to have a better discussion about what are the other ways to achieve affordable housing. section 8 has really bottomed out. So, that is a longer discussion. My time is up and I am sorry Mr. Chairman. My red light is on. It is yellow there, but——

Mr. BURMAN. I would just like to make one clarification. I think the EITC and child tax credit do a huge amount of good. My suggestion in the testimony actually is that there are ways you could simplify them so that a lot of the compliance problems they are looking at in Hartford would go away. If the EITC was really focused as a work subsidy and it wasn't tied into where the children live, who provides the support, and the child credit were just tied to presence of children, it would actually be a lot easier for the IRS to administer and make sure the money goes to families that need the help.

Mrs. JOHNSON. Thank you.

Chairman THOMAS. Thank you very much. Gentleman from Michigan, Mr. Levin wish to inquire?

Mr. LEVIN. Thank you, Mr. Chairman. I am tempted, Dr. Auerbach, to talk about the Ricardo principle of comparative advantage, but let us do that some other time. So, let us talk about fairness, because we started talking about that. I do think, and I think the chairman, you would agree that we have to find some principle other than fairness is in the eye of the beholder. Mr. Beach, you suggested one standard and that is that everybody pays their fair share, that is the total amount of taxes a person pays is proportional to their economic ability to pay taxes. So, let me ask any of you who want to, to comment on this article in the New York Times on Sunday about tax fairness.

About tax fairness, surely it would apply to the principle that Mr. Beach and others have outlined. The article says the share of the Nation's income earned by those in this uppermost category

has more than doubled since 1980 to 2.7 percent. The share of income earned by the rest of the top 10 percent rose far less, and the share earned by the bottom 90 percent fell. Then this analysis relates to fairness. I quote, "Under the Bush tax cuts, the 400 taxpayers with the highest incomes, a minimum of 87 million, in 2000, the last year for which government will release such data, now pay income, Medicare and Social Security taxes amounting to virtually the same percentage of their income as people making $50,000 to $75,000." Again, I quote, "those earning more than $10 million a year now pay a lesser share of their income in these taxes than those making $100,000 to $200,000." Now, I would ask the five of you, if you use the principle Mr. Beach outlined, how in the world is our Tax Code as recently amended fair?

Mr. BEACH. If I could just lead off, because I made that statement, I think there is almost complete agreement, complete agreement in the tax economics community on the validity of that particular measure of equity. That is, for example, someone makes ten times more than me, they should pay ten times the tax. It is a simple way of looking at proportionality. Now, we get into the question, how has the Tax Code produced the sorts of things we are seeing across income, not just at the top but at the bottom and at the middle, with this; anomalies where people similarly situated in income pay very much, very, very different kinds of taxes?

Mr. LEVIN. I agree. But one problem is the parity within income groups. We have this huge discrepancy between and among them. I wanted you to comment on that. Dr. Auerbach, maybe we can quickly go down the row.

Mr. AUERBACH. There is no doubt that incomes have been rising at the top faster than in the rest of the income distribution. There is a dispute in the economics profession how much of it is associated with the tax system, how much of it is associated with other economic factors. I think it is certainly relevant when one designs tax policy to think about the pretax distribution of income. The fact that income is more unequal in the United States now than it was say 20 years ago obviously should be cause of concern and also should be relevant as we think about the appropriate progress of the tax system.

Mr. BEACH. Just as a footnote to what I was saying, Mr. Congressman, another factor that this Committee has to deal with, as you do tax reform, you're going to have to deal with—what every Committee on the Hill is dealing with is that Baby Boomers are reshaping income distribution, and some of the rapid growth at the top is the fact that my generation is at its key top-earning capacity. We are making probably as much as we will ever make, so you have to sort that out as you go through, what has the Tax Code done to prevent these anomalies?

Mr. BURMAN. Table 2 shows the effect of the 2001–2004 tax cuts on the overall distribution of tax rates. You can see that the biggest proportion of reduction in rates applies to very, very wealthy people; top tenth of 1 percent get a 3.6-percent cut of share of income as compared to 2.2 percent for people in the middle. Now one thing that the testimony also notes is that we really don't know who the winners and losers are of these tax cuts because they're all financed by deficits. But overall, it could actually turn out to be

a lot worse if it turns out that the deficits are closed by cutting many programs that help low- and middle-income families. It can be high-income people end up worse off in the long rung if the deficits are closed off by keeping the new middle class tax rates and raising rates at the top. I wish there was a principle in general that tax changes ought to pay for themselves, especially when you look at the looming deficits that are facing us now and the projections for the future; they are just horrifying.

Mr. LEVIN. I don't know, Mr. Chairman, if they can continue.

Chairman THOMAS. Briefly.

Mr. HUBBARD. An observation and on your question about the New York Times story, I do think that most of the discussion that we have in economics suggests that the big gains in pretax incomes are just that, and Tax Code, as far as I know, plays a relatively small role. The New York Times story failed three tests that an editor could have easily used to pull such a story. One is it failed to account for distribution of business tax burdens. Second, that it assumed the AMT was permanent as a part of the President's tax agenda. He said exactly the opposite. Third is that it totally abstracted from any effects on economic growth and incomes. It was simply an unreasonable calculation of it, on its face

Mr. SLEMROD. I would like to take issue with Mr. Beach's characterization that there is a consensus among economists that a fair distribution of tax burden is the same as a proportional. I think that is not true at all. I think, in fact, I think the consensus is that conclusions about fairness are not a matter of economics. If anything, the economic theory of taxation suggestions that if pretax income is getting more concentrated, as it certainly has over the last two decades, the proper response of the tax system is to become more progressive.

Mr. LEVIN. Thank you.

Chairman THOMAS. Thank you very much. You've restored my faith in the panel for not continually agreeing. We need to hear learned opinion. Gentlemen from California, wish to inquire?

Mr. HERGER. Yes, thank you, Mr. Chairman, Mr. Beach, one option that has been—which has received attention in the tax reform discussion has been some form of a VAT. As I understand the concept, a VAT is applied at every stage of consumption from wholesale to retail and is passed along until it becomes a hidden and cloaked component of price, much like the cost of transportation or raw materials. In my view, the single largest drawback to evaluate a VAT is the fact that as a tax hidden from consumption, government can repeatedly and steadily increase the taxes without attracting the ire of the public. In fact, Europe and the United States had roughly comparable amount of taxes collected prior to Europe's introduction of the VAT in the 19sixties, but since that time, taxes have skyrocketed in Europe and have remained basically steady here in the United States. My question, shouldn't the experience of Europe with a VAT caution us in today's debate about fundamental tax reform?

Mr. BEACH. Well, yes, I would certainly agree with what you've said. I just would add one thing that what Europe did was, well, what many European countries did was adopt this credit VAT and, at the same time, not do anything with eliminating their income

taxes. Maybe countries had that, and so the combination of the two was a fairly steady increase in overall tax burden as countries decided, well, the VAT must fall most heavily on low-income people, so we have to raise the top income-tax brackets or top two-thirds of income tax brackets in order to achieve some distributional equity. If we were to eliminate income taxation in the United States by repeal of the operative amendment to the constitution, the VAT would probably be a positive thing if we could get rid of the income tax. I would strongly urge the Congress not to put both of them in place. Just look at the complexity issues, compliance issues. You may decide to tax one kind of candy bar but not another kind of candy bar. I used to do tax analysis for the State of Missouri. And every year, my greatest fear was to see all the sales tax lobbyists knock on my door. It is an extraordinarily difficult exercise to go through, and then it shuts off economic growth, Congressman. If you look at the growth rates of Europe, for many years, they have slowed down. Part of that is aging and financial problems, but clearly, I think a lot of economists, perhaps everybody even on this table, would agree that their tax system has something to do with those growth rates. So, I think there is a lot of serious thinking that the Congress must do before it goes down the route of recommending and adopting a credit form of the VAT.

Mr. HERGER. You mentioned that it might not be as bad, even though I think it would be, bad anyway because of the hidden tax factor, the fact that the consumer is not aware of the taxes they're paying, and that you mentioned that perhaps if we did away with income tax, wouldn't you agree the chances of us doing away with the income tax are, very, very slight? To change our constitution, we know, would take a two-thirds vote in the House, three-quarters of the State legislatures or two-thirds of the State legislatures and again three-quarters ratifying. I mean, the chances of that happening are pretty slight.

Mr. BEACH. I see no likelihood of that happening in my lifetime, sir.

Mr. HERGER. The proponents of that also argue that it has a few advantages, namely, business assets, expensing, border neutrality and taxing savings-only ones. Can't this be done in many other ways such as through a flat tax or national retail sales tax? Wouldn't these methods at least keep taxation transparent?

Mr. BEACH. Yes, as Glenn Hubbard has said in his testimony and as others have written, there are many ways of achieving those goals besides going to a credit form of the VAT. Most of the consumption taxes we have entertained, the flat tax, which is, as the chairman said, is a subtraction VAT because it recognizes the expenses of other firms as deductible; all of those have in some fashion or another the attributes, the positive attributes, of the VAT.

Mr. HERGER. Thank you very much, thank you, Mr. Chairman.

Chairman THOMAS. The Gentleman would yield on his remaining time?

Mr. HERGER. Yes.

Chairman THOMAS. Mr. Beach, would you make the same criticisms of the subtraction method Mr. Shaw made of the credit, i.e., a comparison between Europe and Japan? I think the subtraction form of the VAT works a little better because you have an income-

tax base you're working with. When you say VAT tax, you carefully qualify your tax as a credit.

Mr. BEACH. Yes.

Chairman THOMAS. Value-added, which was appropriate given the example of Europe, but to examine that tax in their entirety, in the various forms that they have, you would have to look at other methods of determining a VAT, and then you would have to compare cultural differences and ask yourself if you wind up with the same criticism. That is the only point I'm making.

Mr. BEACH. That is very, very true, and I believe that that is a valid consideration, every time we look at other countries and their tax systems, to look at all the differences which come in and surround those tax systems; culture being one, the application of traditional law being the other, and the way they have raised up their different tax systems from all kinds of behaviors is the third.

Chairman THOMAS. Thank you. Gentleman from Maryland wish to inquire.

Mr. CARDIN. I thank you, Mr. Chairman, and I thank you for conducting this hearing, and I thank our panelists for their testimony. I would like to see us simplify the Tax Code. I think that is an important standard for us to reach, a goal for us to try to attain, but I also want to encourage growth, and I think that is an issue we need to talk about and savings. I have been working a long time in Congress to try to encourage personal savings in this country, so I think that is a very important goal. I think when we talk about tax reform you have to look at it as revenue-neutral; otherwise, it no longer takes off the mantle of being real true tax reform but as a reason to cut taxes or to raise revenue. I want to concentrate on another objective that I have, and that is, I believe ability to pay should be a factor in paying taxes. I think the progressiveness of our tax structure or regressiveness is something that we need to be mindful of. One would argue as to whether our current tax structures is properly progressive or not, and we could get into that debate. I would certainly not want to see us do a major tax reform and find out we end up with a more regressive way of collecting taxes here in our National government. So, let me start with Dr. Burman, see if he has any thoughts, how do you maintain as least as progressive of a tax structure as we have today if we were to abolish the income tax as we know it? Can it be done?

Mr. BURMAN. Well, obviously, Glenn and I disagree on this, but I think it would be extremely difficult to do it in the context of the consumption tax. There have been proposals for so-called consumed income tax where you start with the income tax base and then you subtract savings from the base. Then there is a progressive schedule of tax that people know more about than I do. The Treasury Department looked at this in the mid-nineties. They examined it and basically concluded it would be unworkable; it would be more complex than the current tax system. The tax rates at the top, if your tax base is consumption, would have to be a lot higher than the tax rates are now, and that raises a lot of issues. It sounds like we are measuring consumption as an easy thing whereas measuring income isn't. I think, as Joel mentioned, if you're exempting savings from tax, then there is a tremendous incentive for high-in-

come people to try to make wages and salaries look like savings, and they will find ways to do that. You have to do very complicated rules to avoid that, so there is—I think a consumption tax as progressive as the current system would be a very difficult one to attain.

Mr. CARDIN. It is clear that whenever you bring in income to a non-income tax, you're going to add complexity. That is a given. We understand that. However, it would be difficult to find a tax structure that is more complicated than our tax structure. It is pretty hard for the average taxpayer to understand all the different lines on a tax return. One suggestion that has been made on the consumption tax is that we just exempt a certain level of consumption through the form of a tax refund. Is that workable? Can that be done? If there is a way of putting that into a tax structure, that actually in fact could calibrate a new tax structure to make it no less progressive than the current and still maintain a degree of simplification. Mr. Auerbach, you seem to be interested in that.

Mr. AUERBACH. The flat tax or versions of that so-called graduated flat tax or an X-tax can give you any desired degree of progressivity toward the bottom through very high exemption levels. Basically, it is like a VAT except wages and salaries are taxed to individuals rather than to the businesses. Then you can have an exemption or a rebate, a tax rebate to lower income individuals. You can even layer an earned tax credit on top of it to keep a significant degree of progressivity at the bottom. I think the real challenge for any consumption tax proposal that one included is maintaining progressivity at the top. That is, you can get progressivity between low-income individuals and middle-income individuals. What is very difficult to do is to, if you're looking at the top percent of the income distribution, for example, is to preserve the same burden at that level. That is very difficult to do through a consumption tax alone.

Mr. CARDIN. So, you have to combine with some form of income-related taxes if you want to maintain the progressiveness at the higher end.

Mr. AUERBACH. There have been proposals to do that, for example, to do a consumption tax of one form or another up to $100,000, for example, followed with some sort of income tax maintained. It is a significant tradeoff though that keeps the complexity. Most of the complexity of the income tax is at the top. It is among high-income individuals and corporations. So, if you seek to keep that piece as really the only way of maintaining progressivity at the top, you're also losing a large share of the benefits of moving to a consumption tax. I think that is a decision you have to make. I'm not sure that there is any way around that.

Mr. CARDIN. Thanks. Thank you, Mr. Chairman.

Chairman THOMAS. Just briefly on that. Obviously, if you're talking about changing the fundamental system, i.e., income versus consumption, should you at the same time take into consideration what other aspects, pensions or others, that are based on income that you're going to have to rethink statutorily? Or should you not worry about that because it will take care of itself if you come up with a new system? Just briefly because I've been given the idea that somehow to go from an income tax to a consumption tax, you

ignore all the laws that are based upon income to produce a pension system and others. You're going to have to take that into consideration; at least understand you're going to have to deal with it.

Mr. SLEMROD. I agree, Mr. Chairman. It is not only other parts of the law; it is other parts of the economy that have come to rely on income measurement from income tax returns, such as financial aid officers and mortgage loan officers. If, in the absence of an income tax system, some other system of measuring well-being arises, we have to net out the cost of that.

Chairman THOMAS. Not that the result wouldn't be useful or appropriate. You are just going to have to think about it. Okay, the gentleman from Louisiana wish to inquire?

Mr. MCCRERY. Yes, thank you, Mr. Chairman. I would like for you to talk about the goals of a tax system. Several of you mentioned fairness, and you tried to describe what fairness would mean. In your discussions of fairness, you didn't say much about economic growth and how economic growth might factor into fairness. For example, if we have a tax policy that encourages capital formation, job creation, and we have a lower unemployment rate in the country, so more people have jobs, isn't that fairer than a tax system which discourages job creation, say, Europe, for example? Many countries in Europe have very high unemployment. They have very burdensome tax systems, very high benefit structures, Federal Government benefit structures, but the tax system seems to inhibit economic growth and job creation, so it seems to me that would be unfair for people who want to work and have jobs. So, shouldn't we factor in the growth policies inherent in a tax system as part of the fairness discussion?

Mr. HUBBARD. I would think absolutely, Mr. McCrery. I think probably the biggest reason you're here at the table is exactly economic growth. In fact, in fairness, you know, when economists talk about the subject, there are really two topics that get conflated, and one—I think Alan Auerbach made this point very well—concern for low-income taxpayers as opposed to a concern for inequality itself. There are many ways you can, through the Tax Code or spending, address the needs of low-income individuals, much of which falls under the rubric of fairness. At the top, it comes with enormous costs in economic growth. The most stimulating margins for investment, for entrepreneurship, for risk-taking are taxpayers at the top, not the bottom, of the income distribution. So, I would urge you very carefully to think about what it is, your concern for poverty as opposed to a concern for inequality, but yes, I think your concern is well placed.

Mr. MCCRERY. Anybody else want to make comments on that?

Mr. BURMAN. You're absolutely right that there is a tradeoff, and if you just focused on one or the other, you would end up with counterproductive results. One thing that actually people in our panel and the rest of the people in our profession have failed the people on this Committee is that there is no consensus yet on what the growth effects are. Glenn believes that people are very sensitive to taxes at the top. There is a lot of evidence that suggests that they're not so much, but I think the hardest thing about your job is that your going to evaluate the evidence and make these tradeoffs, but it is not either/or. You have to look at both of them.

Mr. SLEMROD. Can I say briefly, Mr. McCrery, I think fairness is a code word for the fact that the objective is not only to maximize GDP—we could probably all agree that if we find some Tax Code that would increase GDP from $11 trillion to $14 trillion but, in so doing, all the income went to one person, that wouldn't be appropriate. So, we care not only about GDP but about its distribution. As your question suggests, we should care not only about distribution of income today but in the future and the economy growth more. Otherwise, incomes will be higher and what we don't agree as economists is how to trade off total GDP in a way with the distribution, and we need to hand that over to you to do that——

Mr. BEACH. I think, Congressman, we know a lot more today than we did 20 years ago about how the passage of time effects individuals who are subject to a certain tax regime. So, it would be, I think, appropriate for you to drop into the economics community and say, Well, what do we know about savings and the role of taxes on savings, because we know more today than we did 20 years ago? What do we know about the barriers taxes raise to entrepreneurship and on the reentry of women into the work force? Those are the kinds of equity concerns that are tied into economic growth, but we can answer better today than when we did last time.

Mr. MCCRERY. Earlier this year, our Joint Committee on Taxation here in Congress released a report analyzing three tax changes, each one costing about $500 billion over 10 years. One was a reduction in individual tax rates; another corporate tax rates; and another was personal exemption increases, the personal exemption. The Joint Tax Committee found that, of those three, the largest economic benefit was realized by the cut in the corporate tax rate. Also, that particular change had more feedback which reduced the actual costs, so to speak, to the Treasury. Is that plausible that that would be the winner among those three? Dr. Auerbach, you're nodding.

Mr. AUERBACH. Yes, it is. I mean, nobody would increase the personal exemption as a way of stimulating growth or capital formation. That is, there as an element of fairness as a part of an overall tax system.

Mr. MCCRERY. Agree that that is a plausible result? Thank you.

Chairman THOMAS. Gentleman from Michigan, Mr. Camp, wish to inquire?

Mr. CAMP. Thank you, Mr. Chairman, thank you all for being here. We have heard a lot of discussion about the potential problems with our current system and certainly with a variety of the reforms, VAT tax, sales tax, flat tax, et cetera. I say this somewhat rhetorically, but can anyone imagine a system in whatever shape worse in terms of complexity and impact on family budgets and savings rates than the current one we have? I think it was Dr. Slemrod who, in your written testimony, you have quite a bit about the complexity of the current system and the compliance burden, particularly with the self-employed. I'm wondering about certainly the issue you mentioned about computer programs making some of these calculations easier and making it more difficult. How much emphasis should we put on simplification if we start looking at ways to reform the Tax Code?

Mr. SLEMROD. I think you should think about simplification not as an end in itself but as a way to make the taxpayer, to make the burden on taxpayers lower because of compliance costs and other things. The estimates suggest that the cost, the resource cost is quite high. So, that, and that could be significantly lowered with clever simplification, and I think there are unfairness issues built into the system because of the complexity. Some people profit from it. Other people lose from it. So, I would urge you, in thinking about simplicity, to always think about it ultimately in its effect on the cost of the economy and the fairness in which the tax burden is distributed among the population.

Mr. CAMP. I think you mentioned particularly those large businesses which have economies of scale deal with the complexity problems. It is the smaller—or medium-sized businesses that really have the higher burden, compliance burden, there.

Mr. SLEMROD. You know that economists don't agree on much, but I think this is a case where everyone who has studied compliance costs pined that the costs are regressive. The businesses, bigger businesses have lower compliance costs as a share of their scale than smaller businesses. Although, it must be said that small businesses are problematic for just about every tax system there is. Many VAT systems, for example, simply exempt small businesses, which is certainly a way to lower the compliance costs, but have other problems for the structural integrity of the tax system.

Mr. CAMP. Mr. Beach, with regard to fairness, which obviously is an important consideration as all of you have mentioned, you talked about the lifetime consumption patterns and how those vary, and obviously, that affects the tax burden. How do we really sort that out with regard to tax fairness as we look at tax reform?

Mr. BEACH. Well, it sort of depends on how you want to define the tax base from which you draw the revenues. Keeping in mind that to tax individuals at certain stages of life means to tax a different composition of their income versus their savings versus their consumption pattern. If we were to, in the illustration I used in my testimony, rely strictly on consumption, it is the case that individuals who are very young are taking on large packages of consumed things, buying a house, raising a family, paying for education. If we just looked at the total value, net present value of their consumption and taxed that, it would be very, very unfair. So, that needs to be taken into consideration. We're coming up with Social Security reform, Medicare reform. We have got to be very careful now to recognize that the assets of people in their fifties, perhaps, are going to be very useful from a public policy standpoint when they're in their seventies, so perhaps we have to think about pulling tax burden off of those saved assets. Look, we save a lot in our houses these days. To what extent is the public purpose achieved here by recognizing that people may have to negotiate some of those equity things that we are currently not thinking about as perhaps pulling out of the tax base and allowing people to use them for other purposes. So, yes, clearly, a consideration, there are individuals here in the audience who spend their careers looking at the lifecycle of taxation and a lot of good literature on that, Congressman.

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

Chairman THOMAS. Thank you. The gentleman from Georgia, Mr. Lewis, care to inquire?

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman. Let me take a moment to thank each Member of the panel for being here today. Dr. Burman, I would like for you to assess something, comment on the evolution of the AMT. Is it true that the AMT was designed to address a situation which arose in 1966 where 155 taxpayers making over $200,000 per year paid no income tax? If you just fast-forward to today, 3.8 million taxpayers were hit by the AMT in 2004, and now it has been paid, not by the richest, but by the hardworking taxpayers with four kids making $65,000 per year. Does this seem fair to you? Is this really the intended target for the AMT? Would you agree that any talk of real tax reform must include a real fix for the AMT problem? It should be done now, not putting it off down the road to some weeks or months or years later. I've seen figures that said that, by 2010, 35 percent of all taxpayers will be subject to the AMT. If we don't address this growing problem, aren't we in effect subsidizing tax cuts for the very rich on the backs of the middle class? Isn't this really a sneaky backdoor tax increase on the middle class?

Mr. BURMAN. Congressman, I agree that the AMT has very little justification in current law. It was supposed to be a tax law on the rich, and increasingly, it is a tax on the middle class. Already, people earning, you know, between $100,000 and $500,000 are much more likely to be on the AMT than people earning over a million dollars. By the end of the decade, something like 90 percent of households with two or more children with incomes between $75,000 and $100,000 will be on the AMT. They were never the intended target. The problem with the AMT is that it brings in so much revenue. If you just eliminated the AMT, under current law, it would cost something like $700 billion, it would reduce Federal revenue by $700 billion over the next decade. If the President's tax cuts are extended, it reduces revenues by about $1.2 trillion.

Chairman THOMAS. Dr. Burman, if it would only cost us $700 billion, I'd do it today. I think we are over a trillion and moving quickly, but that is okay. So, it is even greater.

Mr. BURMAN. It is over a trillion against the President's baseline, if the tax cuts are extended.

Chairman THOMAS. We are assuming certain things, yes, of course.

Mr. BURMAN. I can't really say much to defend the AMT. It is increasingly a tax on the—AMT, it is pointless complexity, for most people, and it really does not have much to do with tax shelters, which was its original purpose.

Mr. LEWIS OF GEORGIA. Would other Members of the panel like to respond?

Mr. SLEMROD. I agree with Len that if one could find a way to maintain the distributional implications without the complexity of the AMT, we should get rid of it.

Mr. AUERBACH. Yes, I think one of the problems with the AMT is that it codes this with the regular income tax. You could conceive of a tax reform based on the AMT as the primary tax system rather than the regular individual income tax. There are some elements of the AMT that present a broader tax base than the regular tax.

The problem is that there are various defects in the AMT that cause it to affect more and more people over time, but you could take a path of repealing the regular income tax and fixing the AMT and keeping that. The current system is clearly not the place you want to be in the long run with both tax systems co-existing.

Mr. LEWIS OF GEORGIA. Do any of you have any idea, could you explain maybe to me how a consumption tax would affect the elderly? These are people who have worked all their lives, and now they live on a fixed retirement income. How would a consumption tax affect the elderly? Would it have adverse impacts on the elderly.

Mr. AUERBACH. It would depend on the type of consumption tax adopted. For example, if you adopted a VAT, the price level—the prices would likely go up to reflect the higher cost of the value-added tax. Social Security benefits are now calculated would—or are price level indexed, and therefore, recipients of Social Security benefits would be protected against the increases in the VAT, the cost of living through the value-added tax. Other types of consumption tax, that tax consumption directly, for example, would not necessarily provide that protection. Then there are still other types of consumption taxes which would provide some sort of explicit exemption or transition relief for people who have previously accumulated assets. So, that, really, it is, you have to look at the details of the consumption tax rather than just the concluding that a consumption tax taxes elderly. It is more complicated.

Mr. LEWIS OF GEORGIA. I know my time is up, but could this lead to double taxation for the elderly, for a certain segments of the society?

Mr. AUERBACH. It could, and as one of the other people pointed out and unfortunately, that is one of the quote-unquote economic benefits of consumption tax. Sometimes, in studies that people do, including some that I've done, estimate the growth effects of consumption taxation, some of the consumption taxes studies, do impose double taxation on the elderly and holders of previously accumulated wealth. If you try to relieve some or all of that double taxation, it may be a fairer tax system to the asset-holders, and it may also be one that provides lower growth opportunities.

Mr. LEWIS OF GEORGIA. Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you. Gentleman from Pennsylvania, Mr. English, may inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. Dr. Hubbard, I noticed that several of the panelists have discussed in their testimony the size of the trade deficit in recent years which is, frankly, a matter of great concern to me, representing as I do a manufacturing district. I know one possible reason among several for our disadvantage in this area may actually be a matter of trade policy. I've come to realize that every one of our major trading partners employs a border-adjustable tax system for their imports and exports. We do not. Taking into consideration that some of our largest trading partners also fail to apply free-market principles to their economic and monetary policies, what would be the impact on economic growth here in the United States if we were to utilize a border-adjustable tax system? In particular, could you discuss for

us the short—and medium-term impacts of moving to that kind of a system?

Mr. HUBBARD. Well, I think, first, in understanding the current account deficit, it is important to look at the really big trends, which are the fact that we have some large economies in the world, particularly in Asia that are not able and/or willing to absorb domestic savings. The United States has investment being more desirable here currently than saving is. I think that there are a number of tax policies that inhibit competitiveness, the corporation income tax itself, the lack of a territorial tax system. The Tax Code probably is not the single biggest feature if I were to think of public policies, I would put the tort system easily equal to that. I don't think you should expect a border-adjustable tax per se to have large positive benefits. I think the positive benefits come from the tax reforms that would in fact cut the tax burden on American corporations, and I agree with you; those are highly desirable.

Mr. ENGLISH. Intuitively, I'm trying to go from, the macroeconomic, to more of a microeconomic perspective. If we are imposing a tax burden on our exports that is substantially greater than the tax burden being carried by the products that are from our trading partners, whether it is competing in our market or in their market or in a third market, doesn't that over time, particularly in manufacturing where there tends to be a relatively thin profit margin, doesn't that tend to be a significant negative factor?

Mr. HUBBARD. I think it is a significant negative factor, Mr. English. I just don't think it is that much related to border-adjustments, per se. I think it would be worthwhile your considering cutting the rate of corporation income tax. It would be worthwhile for the Congress generally to consider tort reform. All those things would help American manufacturers greatly. My gentle pushback would be that border adjustability per se is not the source of those gains. It is the reforms.

Mr. ENGLISH. I know, Dr. Auerbach, you've also taken a position on this. Would you give us an insight into how you think border adjustability might or might not have an impact on our trade balance?

Mr. AUERBACH. I agree with what Dr. Hubbard just said, which is that there are things you can do in tax reform, in particular, encourage national saving, which would reduce the trade deficit. That could come from any number of tax reforms, border adjustments or not. Border adjustments appear to make our exports more competitive, but I think the economists generally agree that the result would be an appreciation of the dollar. So, that would undercut the apparent benefits of border adjustment. I should say, I mentioned in my testimony, it is sort of ironic because the main beneficiaries of border adjustments would be the holders of foreign holders of U.S. dollar denominated assets.

Mr. ENGLISH. Here, again, aren't you applying a macroeconomic analysis to what in many cases is a microeconomic problem that individual products when they face, you know, when they are sold at 12-percent more—let's say the cost of the tax system, relative to similar products in a third market or in a foreign market or even in our market if imports are coming in, in effect, with-

out the cost of our tax system built in, isn't a 12-percent differential or some such fairly significant for individual products?

Mr. AUERBACH. It certainly is significant. I don't disagree with that. All I'm saying is that that imbalance, whatever it is, would not be affected by introducing—by the active border adjustment. That is, it might be affected by lower costs, lower corporate income taxes, lower costs of production. It won't be affected by the simple fact of border adjustment taxes, that is, relieving the tax on exports, extending it to imports, simply because the exchange rate will adjust, and whatever benefit would have been conveyed by the reduced tax on exports, for example, or the higher tax on imports would be undone by an offsetting appreciation of the dollar, which makes our exports more competitive—less competitive and makes imports more attractive to us. So, the producers facing this disadvantage, you suggest in your hypothetical example would continue to face that disadvantage in the presence of border adjustments if other provisions were the same. Of course, tax reform can lower costs in many ways, make producers more competitive in many ways; it is simply not the border adjustment activity. It is everything else that goes on, in addition.

Mr. ENGLISH. Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you. Gentlemen from Kentucky, Mr. Lewis, wish to inquire.

Mr. LEWIS OF KENTUCKY. Thank you, Mr. Chairman. Dr. Hubbard, would you describe the tax legislation enacted in 2001 as simply changes to the Tax Code or would you say they have been incremental steps toward a more pro-growth tax system?

Mr. HUBBARD. Well, I think they are certainly both. They are important changes in the Tax Code. Each is pro-growth and also consistent with fundamental tax reform. Review what you did, you cut marginal rats in the first tax act. You introduced investment incentives, albeit it temporary in the second; and third, the reduction in dividend and capital gains taxes. I think these are all good steps. I would prefer to see a bit more of a continuation in those steps and cleaning up the base of the tax to pay for the reforms. Yes, I think they are excellent steps for tax reform.

Mr. LEWIS OF KENTUCKY. Are we seeing results from that tax legislation through—are seeing a decrease in the deficits because of the growth in the economy because of the tax cuts?

Mr. HUBBARD. I think it is certainly the case that economic activity was bolstered by all three tax cuts, focusing on the second, on the investment incentives. I think they played a particularly powerful role in the investment recovery. I think the cuts in marginal rates and dividend capital gains taxes have been important. Taxes don't, in and of themselves, don't pay for themselves. They certainly contributed to economic activity but not sufficient to pay their costs.

Mr. LEWIS OF KENTUCKY. Yes, thank you, that is all.

Chairman THOMAS. Thank the gentleman. Gentleman from Massachusetts, Mr. Neal, wish to inquiry.

Mr. NEAL. Thank you, Mr. Chairman. Dr. Burman, we have all suggested, and for many years here now, the difficulty that the AMT presence. What do you think the economic impact might be of repealing the AMT?

Mr. BURMAN. I guess it would depend on how you did it. If it was done in revenue-neutral fashion, say by closing loopholes, broadening the base, I think the economic impact would be positive. Most of the people who are on AMT actually face higher marginal tax rates under the AMT than they do under the regular tax system. That means that there are disincentives for working and saving. The AMT is a source of pointless complexity. Some of the compliance costs that Joel counted up is that everybody has to fill out the AMT form. By the end of the decade, it will be 30 million household will have much more costly tax compliance than they do now. Also, to the extent that you think that economic incentives in the Tax Code have some purpose, the fact that people don't know whether they are going to benefit from those incentives depending on whether they are on the AMT or not in the year is a bad thing. So, I mean, I can't tell you how much it would help, but the science would definitely be positive.

Mr. NEAL. I think the chairman indicated that it was his estimate that it might cost more than a trillion dollars to repeal the AMT.

Chairman THOMAS. Would the gentleman yield briefly?

Mr. NEAL. Yes.

Chairman THOMAS. When it was a $300 billion problem, it was hard to deal with. Now that its $700 billion moving toward a trillion, it seems that we might be able to deal with it.

Mr. NEAL. Is it the position of the entire panel that it is worth getting rid of the AMT?

Mr. BEACH. If I could just say, Congressman, one of the things that concerns me and, sitting next to the world's leading expert of the AMT here, one of the things that concerns me is, how is behavior changing today among taxpayers who are not yet subject to the AMT in anticipation of their being subject to the AMT? That is one of the costs that is hidden here, but the Committee should recognize that people may be changing dramatically, maybe family formation organization, and they may be changing their decisions to buy certain kinds of properties that would trigger an AMT. So, these are the kinds of issues that surround that, and you ought to also be aware and I think we are probably all should be concerned about its effects.

Mr. NEAL. Suggestions from the panel on how we fix a $700 billion problem, maybe a $1 trillion problem, Dr. Burman?

Mr. BURMAN. One of the original purposes of the AMT was to discourage tax shelters, and before 1987, the biggest AMT preference item, the thing that was added back was the difference between tax rates on capital gains and ordinary income. Virtually any kind of individual income tax shelter you can think of is designed to take advantage of the lower rates on capital gains. So, one thing you could do, and I discuss this in my testimony before a financial services Subcommittee a couple weeks ago is, you could restore the differential, restore capital gains as a preference item under the AMT—they would be taxed the same as other income—and then use the money that was brought in by that to allow people to claim their children as deductions against the AMT, index the threshold and the rates for inflation—so people don't get thrown on the AMT just by inflation—and making some other

changes. It would reduce the number of people on the AMT by 2010 by 30 million to 3 million tax returns. I wouldn't eliminate the AMT all together. You could eliminate the AMT by just building, by adjusting the tax rates to offset the revenue that you've lost. It is an unattractive prospect politically because you're replacing a hidden tax with an explicit tax, but in fact, we are taxing people anyway. By the way, the reason I emphasize revenue neutrality is that, if you finance this through deficits, I think the positive effects on the economy would unbalance the negative. It would push up interest rates over the long run, and it would crowd out private investment.

Mr. NEAL. Dr. Hubbard, Member of the Bush Administration, you indicated it was not the position of the Administration to make sure that AMT was a permanent part of the tax structure. Didn't you say that earlier?

Mr. HUBBARD. I did, and first, let me note, the AMT is a cautionary tale of what happens when you focus so much on a handful of distributional objectives. We now find ourselves in a complicated box because of that original jihad. I think it is important to replace the revenue loss of the AMT. There is no principled reason for having an AMT. You, in your wisdom, legislate tax preferences. You shouldn't be in the business of taking them away. I would not put as candidates what Dr. Burman said of getting rid of all the pro-growth features in the Tax Code. I think probably better would be State and local tax deductions, home mortgage interest deductions, base broadeners that might have the similar distribution that your trying to achieve. That's what I would suggest you look at.

Mr. NEAL. Your indication was that the Administration did not foresee this as being a permanent part of the tax structure. Do you have any indications of when the Administration might send a recommendation over to the Congress? We have questioned the Secretary of the Treasury many times since he's been here, and we all acknowledge it is a problem. I don't know that the Administration has suggested anything in terms of getting rid of it yet.

Mr. HUBBARD. Of course, the President has a tax reform panel that will advise Secretary Snow. It would be hard to believe that any fundamental tax reform that came out the Administration wouldn't involve some serious restructuring of the AMT.

Mr. NEAL. Thank the Chairman.

Chairman THOMAS. Thank the gentleman. Gentleman from Wisconsin wish to inquire?

Mr. RYAN. I do, Mr. Chairman. Dr. Hubbard, I was intrigued by some of the things you said in your opening statement on transition costs. See if I can summarize this. I just want to ask you to elaborate on this. Whether we go toward an income base or consumption base, all roads kind of lead to the same position if we adopt the principle of taxing income once at its source, meaning no taxation on savings and investments, they're on very similar tax bases. Correct?

Mr. HUBBARD. That's correct. The difference between a fundamental income tax reform along the lines of what the Treasury did in the early nineties or the American Law Institute and something like the flat tax would be very modest. It would be the time, value of money on depreciation allowances. That is it.

Mr. RYAN. Exactly. So, let's go into the transition cost issue. Anybody else, I would be interested. We in this Committee will deal with an avalanche of interests coming to this Committee trying to protect preferences they have in the Code. We'll probably hear of a lot of concern about transition costs. Give us the economic, your economic assessment of transition costs, how best to deal with those things. It seems to me you just allow a carryover of past credits and depreciation schedules, things like that moving into a new system where you sort of have a grandfather period, and that ought to settle the issue. If I'm oversimplifying, let me know.

Mr. HUBBARD. You have a fundamental choice. You can grandfather in some we hold harmless from the past. I have argued and some others have argued as well that the whole notion of transition costs may be overstated for industry in general. For example, the movement to expensing would reduce corporate equity values, but reducing dividend and capital gains taxes goes the other way. I think, on balance, transition costs may be more modest. Where they're going to be large and where you will definitely hear from people are special provisions in the Code. Those, I think, you know, economists would generally argue to resist such temptations. Those will be the really large changes, and that of course will be the core of your——

Mr. RYAN. From a macroeconomic standpoint, it ought to be superior for the U.S. economy as a whole.

Mr. HUBBARD. There is no silver bullet here. If you keep a grandfathering system, you may think of that as simple, but it actually creates enormous tax planning opportunities. On the other hand, the cold turkey method that I'm suggesting is simpler, won't create the tax planning, will cause some rough justice. So, there is no silver bullet for you in that.

Mr. RYAN. Anyone else wish to comment on that?

Mr. BEACH. Also the tradeoff of higher rates during the transition, or higher rates permanently if you bring in grandfathering as well, taught us in the 1986 situation, where we ultimately began to see the value of trading certain preferences for lower rates, and that may be the discussion you have on this.

Mr. SLEMROD. I agree that there are very large tradeoffs to face in determining how to do this transition. If you, for example, as you suggested, allow depreciation to consider past assets, and moving to expense is an enormous revenue cost. If you try to keep the old rules on with the new rules, as has been suggested, you have two parallel systems which can be very complex. So, all of the tradeoffs that one faces in designing a new system come up in thinking about the transition to a system that we might all agree is better.

Mr. RYAN. One more question, Dr. Auerbach. I want to ask you to elaborate on the exchange-rate argument. We hear this quite often about border adjustability, and the exchange rates will wash out the benefits. Is that not a measurement of long-term exchange-rate fluctuations versus medium—or short-term advantages or disadvantages that are attributed to border adjustability? Do those happen in the same time equation or not, meaning if, in the next 1 to 5 years, we border adjust our taxes, does that not give us a

competitive advantage that would not be fully washed away from adjustments in the exchange rates?

Mr. AUERBACH. No. I think in this case—this is theory, because we don't have a clean experiment where we have said, let's have border adjustments and now let us get rid of them. Our theory tells us pretty certainly that the exchange-rate adjustment would be immediate. So, the producers would never see the advantage.

Mr. RYAN. Anybody else wish to comment on that point? All right, thank you very much.

Chairman THOMAS. Gentleman yield the time he has briefly?

Mr. RYAN. Yes.

Chairman THOMAS. I think everyone understands the tradeoff between credits and deductions in a lower rate. My question, strictly based on historical analysis, is how long are you going to keep the lower rates? They didn't even last 5 years the last time the tradeoff was made. So, there has to be some commitment to a long-term exchange rather than a short-term one. Gentlemen from Louisiana, Mr. Jefferson, wish to inquire?

Mr. JEFFERSON. Thank you, Mr. Chairman. The President has laid down at least three markers with this tax reform panel. One is that he wants them to come up with a revenue-neutral result. Second is he wants them to not affect home mortgage deductions. Third is he doesn't want to effect charitable deductions. Do you think, starting out with these premises, that there is a chance to achieve true tax reform?

Mr. BURMAN. One of the two big sources of efficiency gains from tax reform is broadening the base. The fact is that, you know, if you went to say a flat tax or a consumption tax, there would be as much pressure to put things like charitable contributions, home mortgage interest deductions into the Code as there is under the income tax. Obviously, it is upon this Committee and the Congress to decide what goes into the package. It is actually a poor signal that, even before you started, that there are two of the largest tax expenditures off the table for significant reform.

Mr. JEFFERSON. Any other comment on it?

Mr. HUBBARD. I wouldn't put it quite that way. I think there is a legitimate argument to be made for charitable deductions, for home mortgage interest deductions. I at least didn't hear the President say it was off the table. He said it was there. We already have a cap on the home mortgage interest deduction. I think it is possible to have revenue-neutral and distributionally neutral pro-growth reform that has what the President had in mind, and it eliminates the tax on savings at the investor level. I think all those things can be accomplished.

Mr. JEFFERSON. Let me ask another question. This business about pro-growth and revenue-neutrality, you all made comments that the budget deficits are retardant to economic growth and that we need to fix that. How can we accomplish these goals, both these goals simultaneously, a revenue-neutral approach to reform and attacking these deficits? It seems that one has quite an effect on the other.

Mr. HUBBARD. You're leaving out one part of the equation, which is spending, and I would invite you to look at the CBO's——

Mr. JEFFERSON. Let's assume we keep the idea of spending. We don't do anything with it. Let's assume you keep it just like it is——

Mr. HUBBARD. You just eliminated the chance for adjustment, Congressman, because if you look at the CBO's analysis of the fiscal picture over the next 25 or 30 years, it is entirely a spending story. That is, revenue shares and GDP are roughly constant. Suspending is accelerated. The fiscal crisis facing the country——

Mr. JEFFERSON. The revenue share of GDP, you know, it may be constantly going forward, but has been cut quite substantially from about 20 percent to now somewhere around 16 percent. So, it isn't accurate to make that point.

Mr. HUBBARD. Congressman, Social Security and Medicare alone will consume about 10 percentage points of GDP more in 30 years than they do today under current law. The Federal tax share in GDP let's say were 18 percent, was a target. That size of a tax increase is what you're looking for. That is 50 percent if you're looking at this as a tax problem. I would submit humbly to you that it is a spending problem.

Mr. JEFFERSON. If it is a spending problem, and we are the Committee on Ways and Means, it seems that we have got to figure something out with respect to that. If we are making a tax policy here as opposed to taking care of the requirements of government, you can't leave the requirements out. At some point down the line, I suppose, there may be some changes made to Social Security and Medicare, whatever you're talking about is the entitlement programs that are driving spending. If we approach this tax reform without regard to the budget deficits, what I'm hearing from every panelist here is that it is quite an impossible task to have a revenue-neutral approach to this, and that means we're locked into deficits, even if you make changes in the spending and even if you didn't go any farther than this today. Here we are spending X on Social Security, Medicare, and X on everything else, and we still have deficits. If you stop spending on those things right now, today, we couldn't fix the deficit with a revenue-neutral approach. I'm just trying to figure out if we have made decisions already with respect to our taxing program that have us locked on to a kind of a slope now that won't permit us to make genuine tax reform without reviewing everything that has happened in the last few years and everything that may happen in the future and not just starting now and looking forward.

Mr. SLEMROD. Congressman, I agree with the thrust of your comment, that putting on the table incentives for homeownership and charity are in a way constraining the clean base that tax reform could achieve. Your second point, that putting on the table at the beginning that the tax reform has to be revenue-neutral is also constraining in a big-picture approach to the fiscal challenges that the country faces. So, I'm very sympathetic to that line of questioning.

Mr. BEACH. Congressman, I was disappointed to hear that that was the opening gambit. However, as you know, being an observer of Washington, making a good tax bill is hard enough. Reforming the Tax Code is almost impossible. It might be useful, for discussion purposes, leaving up to this Committee—as the President said,

revenue-neutrality, home-owner deductions are off the table and charitable deductions remain neutral. I doubt very seriously whether we can have a tax reform and maintain those three principles in place.

Mr. BURMAN. I think it would be better if tax reform were an opportunity to deal with the deficit problem. The problem with revenue-neutral tax reform from, a political problem, is that any kind of sensible reform is going to raise taxes on millions of people. You couldn't have a sensible tax system that would look like the current one. It would be a hard sell if you're not raising taxes overall. I think if tax reform were packaged with telling people that the consequences of tax reform is going to be lowering the taxes of our children, reducing this crushing debt burden, I think that would be positive. You could do tax reform in a way that you could raise revenue without diminishing economic incentives. There is still a lot of corporate tax breaks that have companies chasing tax incentives rather than doing their business, and you could raise a lot of revenue that way.

Chairman THOMAS. The Chair was intending to end the hearing at 12:30 p.m. We have a number of Members who wish to inquire. The Chair would offer, with unanimous consent, that the remaining Members voluntarily limit their inquiries to a 3-minute timeframe. Is that acceptable? If it is, then everybody probably can make it. With that I recognize the gentleman from Georgia.

Mr. LINDER. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much, Members.

Mr. LINDER. We have a Tax Code today that is in fact a flat tax on income, 93 years later. We flattened it out again in 1986 only to have amended it 14,000 times since then. Does anybody believe for a moment that future Congresses will keep their hands off it? Does anybody believe for a moment that we can broaden the base? We have removed 50 percent of the income earners from the income tax roles essentially. Are we going to put them back on? I doubt it. Dr. Slemrod, you said keep it clean. That would take a supermajority to change it. Do you think that we could pass that? I doubt it. Let me get to your compliance cost. You and I have discussed this one other time. You say $135 billion. Does that take into consideration the cost of the considering the tax implications of a business decision?

Mr. SLEMROD. The $135 billion figure that I refer to is the collection cost, the time and money that the taxpayers put in, the IRS budget, and third parties such as employers doing withholding. It doesn't take into account the cost to the economy when the tax system distorts decisions such as business investment decisions or labor supply decisions.

Mr. LINDER. Nor does it take into account business or opportunity costs.

Mr. SLEMROD. It does take into account the opportunity costs of the taxpayers' time that they put into dealing with their taxes.

Mr. LINDER. Why does your 3.2 billion figure differ so largely from the Tax Foundation's 6.6 billion hours figure?

Mr. SLEMROD. I am not—I don't know how to reconcile the 3 billion with the 6 billion hours' figure. There was a very extensive study done by IBM Consulting which came up with a number at

3 billion. I think that we can probably agree that whether it is 3 billion hours or 6 billion hours, it is a lot of hours.

Mr. LINDER. It is too much. Dr. Burman, you talked a good bit about protecting the poor. We have got a study from 1997 by Dale Jurgensen who argues that 22 percent at the producer price level represents a tax component, and the poor are paying that. If you were to get rid of all tax on income for consumption tax, that would go out of the system, prices would be lower, and a rebate would totally untax them. What is wrong with doing that?

Mr. BURMAN. I don't quite understand.

Mr. LINDER. Twenty-two percent of the price system today represents a tax component. People who are living at or below the poverty level are losing 22 percent of their purchasing power to the current system.

Mr. BURMAN. What you are saying is that there is—the efficiency cost of the tax system shows up in prices. I mean I don't argue that there is an efficiency cost that shows up. The fact is that the current system does a lot to help low-income people. They get, you know, as I noted in my testimony, low-income families get $4,000 or $5,000 a year in tax breaks. You know, a lot of these are families that are working full time and struggling to get by. It makes a huge difference. In a flat consumption tax or a flat rate tax, without some kind of cash grant to low-income people, I think they would be in big trouble.

Mr. LINDER. Mr. Beach, one quick question. Mr. Chairman, may I?

Chairman THOMAS. Very briefly.

Mr. LINDER. You say that a consumption tax intergenerationally hurts young people who purchase more at a young age. Dr. Kotlikoff has published that cross-generational taxes are very progressive because for the first time in history we tax wealth instead of just wages. Would you comment on that?

Mr. BEACH. Well, I think you need to keep that as one of your considerations, is how does the tax burden change as life goes forward, as we go through the life cycle? Lawrence Kotlikoff is very, very gifted on this. He is talking about an intergenerational effect. I think I was talking about an intragenerational effect. It will be something you will be thinking about, I am sure.

Chairman THOMAS. Thank the gentleman. Gentleman from California, Mr. Becerra. You will pass? Gentleman from Texas, Mr. Doggett. We had agreed to limit our comments to 3 minutes.

Mr. DOGGETT. Thank you very much. Thanks to the panel. You are here with us, of course, on the month of D–Day, and I refer not just to the very important historic event, but that this is the D–Day month, as our Chairman and the Ranking Member on the Subcommittee on Social Security have indicated, when we will see a legislative proposal before the Committee to implement the President's Social Security proposal. Let me just ask you first if there is anyone on the panel who thinks the idea of having individuals put part of their Social Security taxes into private accounts, if they oppose that idea.

Mr. AUERBACH. I——

Chairman THOMAS. I take it that there is no one that opposed that concept.

Mr. AUERBACH. I think you—one needs to say more. I think it certainly should not be viewed as a way to get a higher rate of return or as a solution to the funding problem. It has other potential advantages and those can be discussed.

Mr. DOGGETT. Okay. You have, I assume, some objection to it.

Mr. AUERBACH. I have some concerns about lending money, essentially offering a margin loan to individuals who may have very little experience in capital markets, and I think considerable protections would have to be given to them.

Mr. BURMAN. I think there are a lot of issues associated with that and Alan's point, as well as just the fact that——

Mr. DOGGETT. Because my time has been limited I will let you amplify on it more later, but I assumed you might be one Member of the panel who had questions about it. Of course, we have been told also that this proposal won't be able to stand on its own, that it will need to be cloaked, covered, combined with, merged with some kind of action on taxes, which is I suppose the only reason that all of you have been called here this morning. As far as tax simplification, since we know that the length of the Tax Code has almost doubled under Republican leadership here in the House, are there any proposals that the Republicans have added in the last decade that have added to tax complexity that you propose specifically should be repealed? I assume you have some and I would be delighted to have you amplify on them. Is there anyone else who sees—on the panel who sees specific measures that the Republicans have added complexity in the length the Tax Code that you would want to see repealed?

Mr. BEACH. Congressman, it may shock you to learn that the Heritage Foundation doesn't distinguish between Democrats and Republicans with respect to——

Mr. DOGGETT. Well, I will settle for just what the Congress has done in the last 10 years while the Republicans have been in the majority.

Mr. BEACH. We would eliminate many of those credits which are in the Code right now.

Mr. DOGGETT. Many of the tax credits?

Mr. BEACH. Yes. Deductions, of course, if we had the right kind of alternative system in place. We are on the record on that.

Mr. DOGGETT. Thank you very much.

Chairman THOMAS. The gentleman's time has expired. Gentleman from Colorado, Mr. Beauprez, wish to inquire?

Mr. BEAUPREZ. Thank you, Mr. Chairman. As a small businessperson all my life until I came to Congress a couple of years ago, believe me, I would love to spend considerable time with you gentlemen. I am going to be very brief and yield to my colleague from Georgia, though, in just a moment. What shocks me as I look at this, whether it is the 1.6 billion work years by your calculation, Dr. Slemrod, or about twice that from the Tax Foundation, it is a staggering amount. I submit to you, Dr. Burman, that if we want to eliminate the deficit, as I desperately would like to, I would like to see those couple billion work years put to use in this country actually producing something other than just trying to figure out how many dollars to send to Washington. With that statement, I am going to yield to the gentleman from Georgia, who I

think has put more time and effort into this subject matter than almost any other Member of Congress I can imagine.

Mr. LINDER. I thank the gentleman. I have spent a good bit of time over the last 10 years on this. Dr. Burman, you said in your printed statement that it is not likely to see any economic benefits from moving to a consumption tax. Over 10 years, you are the first economist I have ever heard say that. Is that a hunch or is that a study?

Mr. BURMAN. Well, there is a lot of evidence. I don't know that I—I think I said that I thought the economic benefits were relatively small. Most of the benefits come from the transition tax on old people which I think would be hard to implement, and from base broadening which you can do under the regular income tax. The fact is that the other economic effects are mixed. You cut taxes on savings, you increase taxes on work. Dr. Auerbach and his colleagues have done some research. They show small economic improvements from switching to a consumption tax, but it is not going to turbocharge the economy. There are other economists find larger effects.

Mr. LINDER. Merrill Lynch, Cap Gemini, McKenzie and Boston Consulting Group have concluded between the two of them, that there is between $9 and $10 trillion in offshore accounts right now. They are seeking both safety so they are in dollar-denominated deposits, and they seek secrecy. As long as we keep the IRS in place, will that money ever find its way into our economy? If we get rid of the IRS will that money find its way into our economy?

Mr. BURMAN. I am not an expert on the business issues. I mean, I know doing things to reduce the tax incentives that create these corporate tax shelters would, in my view, would improve economic efficiency and deal with some of those problems. I don't know that that is specifically a problem with the income tax versus consumption tax. It is with these asymmetries that you tax some kinds of income different from others and you create these incentives for tax sheltering.

Mr. LINDER. Anyone else care to comment on the offshore money? Thank you. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Gentleman from North Dakota wish to inquire?

Mr. POMEROY. Yes, Mr. Chairman. I would follow up on some questions asked by Congressman Levin. As he referenced the New York Times article, the richest are leaving even the rich far behind. The analysis states in this article, and I will just quote: "The Times analysis also shows that over the next decade the tax cuts Mr. Bush wants to extend indefinitely would shift the burden further from the richest Americans with incomes of more than a million or so. They would get the biggest share of the breaks in total amounts and in the drop in the total amounts and in the drop of their share of Federal taxes paid." I would ask the panel, have you had a chance to analyze the work of the New York Times reporters that wrote this analysis, and do you agree or take issue with it?

Mr. BEACH. Congressman, if I could just say, in that particular article—and I believe that is the one by David K. Johnson that you are referring to?

Mr. POMEROY. Yes, sir.

Mr. BEACH. He says in there that the Heritage Foundation looked and approved of these numbers. I would like to just clarify that we have not done that yet. Len and I were talking just a moment ago before the hearing that he is going to share the data with me. Len Burman's operation supplied a great deal of that data for that analysis. I will point out in addition to what Glenn has said about the defects of the study, I did note that it did not rely on an estimate of the macroeconomic effects of the Bush tax cuts.

Mr. POMEROY. Dynamic scoring. I have 3 minutes. That is all I get from you. Len?

Mr. BURMAN. The dynamic effects of the 2001 to 2004 tax cuts have been looked at by the CBO and Joint Committee on Taxation and they conclude that this sort of depends on how you close deficits. The effect of the deficits could offset a lot or even all of the economic benefits, and that the trends that David was talking about in the study I think are unmistakable.

Mr. POMEROY. You know, maybe this is not an economics-type question, but I am trying to rank the biggest problems facing our country. You have got the financial deficit, you have got the trade deficit, you have got the structure of the Tax Code. Do you have a—how would you rank those issues? Anyone care to venture? Dr. Hubbard.

Mr. HUBBARD. Well, to me, if you are restricting it to economic policy—because I can surely think of some noneconomic policy concerns that are more uppermost in my mind. In terms of economic policy concerns, the entitlement problems in the United States are clearly the largest. That is the fiscal debate over the next many years that you all will have to have.

Mr. AUERBACH. One should keep in mind that these are complementary solutions to existing problems. If, for example, one of the ways you contemplate dealing with Social Security is by uncapping or raising the cap on the payroll tax, that is going to represent an increase in marginal tax rates. It would make it even more important in an individual tax reform to reduce marginal tax rates to make room for that increase. So, dealing with Social Security, dealing with other entitlements, in a sense makes it even more important that the tax system be as efficient in pro-growth as possible.

Mr. SLEMROD. In one sense, I think tax reform ranks up with these other problems in that it is the most common point of contact between the government and its citizens. As I said in my closing remarks, how we do tax reform affects how activist the government is, how intrusive it is to its citizens. So, it is hard to put a dollar value on those things but I think it is a very important aspect of government.

Chairman THOMAS. The gentleman from Connecticut, Mr. Larson, wish to inquire?

Mr. LARSON. Thank you, Mr. Chairman. I would like to go back to a question that Mr. Neal asked before, and, Dr. Burman, I believe you answered; and I wanted to be clearer on this. With regard to addressing the AMT and looking at its potential growth, I believe you said going to 30 million, how do you get that back down? You had some specific recommendations. Did I hear that right?

Mr. BURMAN. We have a number of different options we have looked at. One is restoring capital gains as a tax preference and using that as a way to take the AMT off the middle-class families. Dr. Hubbard mentioned the idea of repealing State and local tax deduction. That raises issues. That would—under current law that would raise enough revenue to pay for eliminating the AMT. You could also build the explicit taxes in the AMT into the regular tax system.

Mr. LARSON. Dr. Slemrod, do you agree with that? Or how would you approach the AMT issue?

Mr. SLEMROD. I think both of the options that Dr. Burman mentioned are worth considering. Eliminating the State and local income tax deduction isn't something that I would put on the top of my list for tax reform, but I think it should certainly be considered in a package which cleans the tax base.

Mr. LARSON. Following along with what Mr. Pomeroy had to say with regard to—Dr. Hubbard, you mentioned entitlements. I think the question was specifically as it related to rank ordering in terms of economic impact, either the national debt, the trade deficit, or in fact the structural nature of our tax system. Given those three options, how would you rank order those in terms of importance? Or would you? Or would you come up with something else? Let's start with Dr. Auerbach.

Mr. AUERBACH. Well, I think—I don't really think there is a need to rank them. You have to deal with—if you are going to, for example, deal with Social Security and Medicare, there may be benefit cuts, there may be tax increases. The impact of those tax increases, for example, would be very much influenced by the underlying tax structure in which they occur. So, even if dealing with—I think clearly dealing with the imbalance between spending and taxes is the first order of business. As you are doing it, a tax reform is complementary to that effort; and so even if it isn't as important in itself, it is part of the overall task.

Mr. LARSON. Anyone else care to comment on that?

Mr. SLEMROD. Another reason not to make the sharp distinction is that cleaning up the tax base you are essentially dealing with scores of expenditure programs that are working through the tax system. If by eliminating some of those they just come up, you know, are reproduced outside the tax system, we may not be accomplishing what we thought we were.

Mr. LARSON. So, the panelists were pretty much in agreement, though, when it comes to dealing with cleaning up the basis. It is just a question of how you get to cleaning it up, whether you go to a flat tax or a VAT or whether or not you use the existing system but make the clean-up throughout. Is that fair to say? Thank you.

Chairman THOMAS. That certainly makes our job easier. Gentlewoman from Pennsylvania wish to inquire.

Ms. HART. I do, Mr. Chairman. Thank you all for being here. I think we could all design a system that we think would work the best and they would all be different. So, we are going to have to try to figure out, I think on two levels, what isn't working and, of course, on the other level what might work better. I want to start with Dr. Hubbard. You mentioned in a Business Week article that

tax reform needs to reduce the Code's bias against savings and earnings. Can you give a couple of examples of what specifically foremost in the Code really demonstrated that bias?

Mr. HUBBARD. Well, as I said in my remarks, I think the elephant in the room really is capital income taxation, both for capital accumulation in your question and for risk-taking and entrepreneurship. We double tax and in some cases triple tax, some returns on saving. We have a Tax Code that distorts how businesspeople make investment decisions. It would be possible for us to have a tax system that is neutral with respect to those decisions.

Ms. HART. Would the rest of the panel agree with his statement that it does have a pretty well demonstrated bias against savings and earnings? Dr. Slemrod?

Mr. SLEMROD. I think there would be wide agreement among economists that the way we tax corporate source income needs to be rationalized. I would add that although there are examples of double taxation in addition to single, there are also examples of zero taxation. I would include in a rationalization of the tax system emphasis on corporate tax avoidance.

Ms. HART. Mr. Beach, your light is on. Did you have a——

Mr. BEACH. My light was actually not on. I always have a comment. Yeah, I would definitely say, as Glenn has mentioned, that this capital taxation is key to growth; and the key to growth is the key to a lot of problems that the Congress faces. So, yes.

Ms. HART. It is a timing light I see. That is okay. You get the green light anyway. You know, ultimately I think a lot of us probably in this Committee like the idea of a flat tax, and I know some of you have expressed your interest in continuing benefits for people who are low income. I think it is mostly—Dr. Burman, just real quickly, could you tell me if there is a way we could do a flat tax without hurting the low-income?

Mr. BURMAN. Actually I don't think it is hard to protect low-income people. You could, as several panelists I think have mentioned, you could include something like the earned income tax credit or even child tax credit as part of a flat tax. The bigger concern is the shift in tax burden from high-income people on to middle, which would be harder to avoid.

Ms. HART. Okay. Dr. Auerbach, do you have a thought on that? I mean without—obviously, if you have a flat tax you wouldn't want to have any tax credits. So, is there a way to maybe do something else?

Mr. AUERBACH. Well you could—well, you say you wouldn't want to have tax credits. There is nothing structurally about a flat tax. It includes a tax on compensation. So, anybody who is working and being paid wage and salary income could be given tax credits. Whether you choose to is a different issue.

Ms. HART. Okay. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you. Gentleman from Illinois wish to inquire?

Mr. EMANUEL. Yes. Thank you, Mr. Chairman. You know, I appreciate you holding this hearing. One way—some of you have mentioned, obviously, your comments about the complexity, or difficulty rather, of getting something done on tax reform. One way to look at this is if you could not do—although I think it is worthy

of looking at the entire Code—is to take both the home mortgage, the earned income tax credit, the per child and dependent, college savings and then retirement, the four kind of pillars of middle-class life, and reforming the Code in each of those areas to bring simplicity and the access to a middle-class dream, make it closer. The ideas of—there are five separate different education breaks. You can make them a single break at $3,000 per child rather than $4,000 per family, with some service notion attached to it that would bring simplicity to the higher education component. We have, in the last 30 years, we have done 16 separate different vehicles in the Tax Code for savings; one universal 401(k) that is portable and brings simplicity as well as progressivity and maintains, kind of square, both simplicity and progressivity. You could make the mortgage deduction available not just to those who itemize but to those who don't, and I think it would bring a great piece of the American dream closer.

Then last, something I have introduced myself, which is a simplified family credit that took the EITC and the per child and the dependent care, eliminate 200 pages of the Code and bring it down to about 12 questions. Although I think it is worthy of looking at the task of taking the entire Code now and trying to bring simplicity to it, I think all those are attainable and would bring tremendous simplicity to the Code, I think would accomplish maintaining I think principles, whether it is you work for a living—that is the earned income tax that rewards work over dependency—the access to college education, and so forth. I don't want to repeat myself. Do you think that is worth at least looking at if we could not see universal tax reform as an attainable goal, from a political standpoint or economic, and not get an agreement that taking at least a look at those four areas: homeownership, retirement security, access to higher education, and then obviously revaluing the principle of work over dependency?

Mr. HUBBARD. I think it is clear the areas you have mentioned are worthy of enormous simplification. In many of those areas, we don't treat the American people like adults. We have too many opportunities. You shouldn't kid yourself that that is going to be a major increase in economic growth. If the reason for the discussion is simplification, I agree with you. It is a worthy agenda. If your agenda is economic growth, I am afraid that would fall way short of the mark.

Mr. EMANUEL. Two points. One is I run tax clinics in my congressional office from January 1 to close to April, and we have resulted in—I know I am over the time, Mr. Chairman, and I will be very quick. We have ended up returning to people a little over a million dollars when it comes to the earned income tax. Some people think there is about $8 billion—I am just using one of the areas I talked about—that, you know, there is about $8 billion worth of fraud there. I would suggest that complexity is the problem, not fraud. I believe that if you brought simplicity to that area, and I do believe, to tell you the truth, if you were end up, whether it is on home ownership, college savings, or retirement security, and also the earned income tax, I think that would lead to economic growth. My colleague and I have talked often about the consumption tax. I think it would be ironic that we would go to Eu-

rope, which has the most lethargic economic growth over 20 years compared to the United States, and use that as a tax model of bringing economic growth when one of the things that everybody always talks about is how in the last 20 years we have had huge economic growth and we haven't had the consumption tax. Europe has had a consumption tax and they have had the worst growth of any industrialized area. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. I do think as we look at the Tax Code that it really is unfair that if there appears to be something there, but that the burden of getting there denies it to a number of people is something that we have to look at. Gentleman from Indiana, Mr. Chocola, wish to inquire?

Mr. CHOCOLA. Yes. Thank you, Mr. Chairman. Thank you all for being here. I represent a district that is heavily reliant on manufacturing. I used to be in the manufacturing business in a very capital-intensive business. Something we haven't talked a lot about this morning is really how tax policy impacts when, where, and how capital is invested. I think we would all agree that the more capital available to invest in our economy the better. We can't have that conversation on tax reform in a vacuum because other countries are trying to compete for the same capital we are. Just briefly—probably, Dr. Hubbard, I would start with you. If you could comment on really some of the policies we have of double taxation, tax corporate profits, tax distribution of dividends, what that has on our competitiveness worldwide; and how capital is allocated, and also what the full taxation of U.S. foreign income has on our competitive ability to compete in a global economy.

Mr. HUBBARD. Well, two aspects. One, I think the tax treatment of business investments still needs work. I think it is possible, through any of the tax reforms various people have talked about today, to substantially lower the tax part of the cost of capital for business investment, and I would encourage you to do that. It is also important, though, to think about multinational companies. I would urge you not just to think about domestic investment as being the touchstone of reform. We as Americans own our multinationals as well, and I think we also want a Tax Code that makes sure that they have the ability to compete in foreign markets as well as here at home. So, I would urge you to consider both of those.

Mr. CHOCOLA. Anybody else have any comments on that? Daimler Chrysler has a very large facility in my district. Does our Tax Code impact why it is called DaimlerChrysler rather than ChryslerDaimler?

Mr. BEACH. Congressman I think everyone—well, several of us have said that lowering the corporate income tax rate in line with the rest of the world is a good move. It is expensive but it is very pro-growth and it does address some of the problems that manufacturers in this country have had in competing with foreign companies. I think it does explain in part perhaps why you have that DaimlerChrysler.

Mr. CHOCOLA. I mean just as a general concept, we would all agree that whenever we consider tax reform we consider how do we make U.S. companies more competitive in a global marketplace is a very critical aspect of this whole discussion.

Mr. SLEMROD. I am going to have to demur slightly on that, because making a company more competitive than a foreign company isn't the same as nor will it necessarily lead to making our citizens better off. Competitiveness is a buzz word that most economists would counsel that we have to be careful about using. Getting tax reform that is fair and simpler and pro-growth is the right way to think about it. I don't think focusing on the competitiveness of our companies adds anything to those criteria.

Mr. CHOCOLA. Well, a policy that helps create U.S. jobs by allowing companies to be more competitive in a global marketplace which results in more U.S. jobs is a good thing. I think we can agree on that.

Mr. SLEMROD. You are getting closer on that. Yep.

Mr. CHOCOLA. Thank you, Mr. Chairman.

Chairman THOMAS. Thank all of you. The Chair is mindful that although this is the first hearing, that the Chair may call on some of you in a kind of a seminar I structured around particular aspects that we have developed here today for Members. I hope if at all possible you would make yourself available. The Chair thanks you, thanks you for your contributions and knows that ongoing work with you and your colleagues can only make us better at some very difficult judgments that we are going to have in front of us. With that, the Committee stands adjourned.

[Whereupon, at 12:42 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of American Farm Bureau Federation

Farm Bureau believes there is a better way for the Federal Government to raise the money it needs to operate the government. We support replacing the current federal income tax system with a new tax code that encourages savings, investment and entrepreneurship. The replacement system must be fair to agricultural producers and should meet the following objectives:

- Be revenue-neutral so as not to produce a tax increase.
- Eliminate payroll taxes and self-employment taxes.
- End death taxes and capital gains taxes.
- Eliminate personal and corporate income taxes and the alternative minimum tax.
- Change the Constitution to prevent the reinstitution of the income tax.
- Require a two-thirds majority vote in Congress to raise taxes.
- Be transparent and require a minimum of personal information.
- A replacement income tax should be based on net income.
- A consumption tax should not tax business-to-business transactions unless for final consumption.

U.S. farmers and ranchers operate in world markets. About 22 percent of the agricultural commodities produced in the United States move into international markets. Roughly 11 percent of the food consumed in the United States now comes from foreign sources. Farm Bureau favors even greater reliance on the global marketplace and favors continued reductions in trade barriers through trade agreements, but tax policy should not place U.S. products at a competitive disadvantage in either domestic or international markets.

Horizontal equity is the concept that two taxpayers with the same amount of income and tax filing status should have roughly the same tax load. Due to the capital intensive nature of production agriculture and the unevenness of income due to weather variability and price fluctuations, farmers and ranchers can often pay more taxes than others with the same income. Any new or revised taxing system must address horizontal equity.

COMPLEXITIES, BURDENS, UNFAIRNESS AND DISTORTIONS OF THE CURRENT TAX SYSTEM

Achieving international tax competitiveness and horizontal tax equity for farmers and ranchers will require substantial changes in the current federal tax system. Farm Bureau believes that removing complexity, reducing burden, eliminating unfairness and limiting distortions are best achieved through a complete rewrite of the federal tax code. Until a replacement code is enacted, the following issues should be addressed through incremental reform.

Death Taxes—Because of the capital intensive nature of farming and ranching, many operations are multi-generational. Current income from farm land is usually quite low at about five percent or less per year. As land continues to increase in value for reasons other than its productive agricultural value, multi-generation farms can face large estate tax bills at times when their incomes are small. When the forced sale of farm assets is the result, the economic viability of farms and ranches can be ruined.

Owners of other businesses that are less capital intensive and generate more income per dollar of assets do not suffer as much from the death tax. Analysis completed by Farm Bureau in late 2003 indicated that farm estates liable for death taxes will increase from four percent in 2001 to eight percent in 2011, assuming a unified credit of $1.3 million in both years. Roughly twice as many farm estates currently pay death taxes compared to estates in general, a clear distortion.

Permanent repeal of the death tax continues to be Farm Bureau's top tax priority. Increasing the unified credit has removed the burden from some producers, but as long as this tax structure remains the chance exists for a future Congress to lower the unified credit and/or increase the tax rate. As long as the death tax remains, farmers and ranchers will be forced to continue some level of estate planning as a way to protect assets against future tax liability.

Capital Gains—For agriculture, the capital gains tax is a tax on transferring assets from one form to another. While tax rates have been reduced to a maximum of 15 percent, this is still a tax on asset transfers that most other taxpayers do not pay. Frequently a problem at retirement, the tax occurs any time a farmer or rancher wishes to redirect assets from one enterprise to another. Capital gains taxes have to be paid on the assets sold even though the operator wants to invest all of the proceeds back into the business. As with the death tax, the proper approach to the capital gains tax is to repeal it. This would reduce both complexity and the amount of record keeping needed.

Alternative Minimum Tax (AMT)—The AMT clearly adds to the complexity of tax filings. Many farmers and ranchers who include tax management in their business planning find they may owe AMT after irreversible business decisions have been made. Farm Bureau supports an end to AMT.

Variable Income Issues—Progressive tax rates can push farmers and ranchers into higher tax brackets when they have a good income year. Cash accounting and income averaging provides some help to farmers and ranchers dealing with wide swings in gross income and net income. Cash accounting continues to be an effective way to simplify tax record keeping and reduce the compliance burden, while also contributing to horizontal tax equity. Income averaging is helpful, but is not a substitute for cash accounting, and should be extended from three to five years.

Matching Income and Expenses—Under the current system, there is often a total mismatch between gross income and depreciation. Taxpayers can be forced to carry depreciation forward or try to increase gross income to use available depreciation. Direct expensing would simplify the code and create horizontal equity. Congress has moved toward direct expensing with Section 179 expansion and bonus depreciation. Farm Bureau supports further expansion of Section 179 and indexing the provision for inflation. Bonus depreciation should be continued with a full year's depreciation allowed for purchases made any time during the year.

Retirement Savings—Farmers and ranchers invest much of their savings in their farming or ranching operations and use part of the value of the operation as a retirement plan. This is unlike employees who have employer-sponsored retirement plans that can be funded on a tax-deferred basis. Self-employed professionals can use tax deferred 401K, SEP and IRA plans. Farmers and ranchers who use their businesses to finance retirement are doing so with after-tax dollars and are not treated equally.

Disaster Payments—Weather disasters are a fact of life for most farming and ranching operations and introduce tax complexities not found in most other businesses. The help provided by Federal Government disaster assistance programs can be diminished by requiring payments to be taxable income in the year received. Taxes are owed, even though the taxpayer continues to struggle with the economic consequences of the disaster. Farm Bureau supports not taxing payments associated

with weather disasters. Breeding livestock are sometimes sold during weather disasters with the proceeds treated as capital gains. Farm Bureau supports deferring taxes until two years after the disaster has ended and a ten-year carry forward for income from a forced sale of livestock with no taxes owed if livestock is replaced during that period of time.

Application of Self-employment Taxes—Problems with the federal tax system are not confined to income taxes and estate taxes. Farmers and ranchers also struggle with issues associated with taxes for Social Security and Medicare. In most years, more farmers and ranchers pay more money in self-employment taxes than they pay in income taxes. Defining income for self-employment taxes is complicated. For example, cash rent and payments for idling land in the USDA Conservation Reserve Program are a return to capital, not wage income. The IRS wrongly characterizes these payments as farm income subject to self-employment taxes for Social Security and Medicare.

Health Care Plan Deductions—After years of effort by Farm Bureau and other groups, the self-employed can now deduct 100 percent of health care plan costs from their adjusted gross income. However, the deduction does not reduce self-employment income for taxes for Social Security and Medicare. Employees with employer-provided health care plans can reduce their income for payroll tax purposes by placing money spent for health care in flexible spending accounts. A deduction in both income and self-employment taxes for health care plan costs would help both farmers and ranchers achieve horizontal equity with other taxpayers.

Statement of Daniel F. Ancona, IV, Santa Barbara, California

First of all, thank you very much for undertaking the important and awesomely challenging work of simplifying the U.S. tax code. Based on my experience with the Alternative Minimum Tax and the studies of taxation and economics that I've undertaken since being affected by it in 2000, I believe this to be among the most important work going on currently in the Congress. It's easy to get lost in the details and the thousands of pages of the tax code, but how we decide to pay for our government is an issue of fundamental import to our democracy.

I am not generally an anti-tax zealot, as it seems obvious to me that the taxes we pay and the government they fund have clearly played a significant role in what has made this country great. Yet the complexity of how we go about collecting those taxes seems to have grown out of control, partially through the deliberate rigging of the system by unscrupulous individuals and organizations, but even more so because of structural and organizational phenomena that can only be effectively counteracted by the work of committees such as yours.

I've included, below, a timeline of the exact details of my personal AMT disaster. In summary: four years ago, I was charged $55,000 worth of tax on money I literally never saw due to a botched Incentive Stock Option transaction. It was as if I walked into a casino and was taxed on the money I might have won but did not. I spent hundreds of hours on the phone with numerous branches of the IRS trying to resolve this, but only found relief after I finally found an accountant (after six tries) who understands the AMT credit—and, when the IRS classified me as a "hardship case" because I was cut to half time at my job. Therefore, the IRS has postponed further collection actions against me. Oddly—the IRS did not consider me losing my business, being plunged into debt and having to move 350 miles a hardship!

This tax severely punishes the risk-takers, technologists and companies that are willing to democratically share the fruits of the market through incentive stock options. If these people and companies are truly the growth engines of the new economy, while they don't require special treatment, they certainly ought not to be subject to an arbitrarily cruel, unusual and specific tax. Indeed, I was in the process of trying to start a technology company and create such jobs when this tax cut my dream short.

I've never tried to game the tax system, I've never looked for loopholes or been anything other than perfectly honest in dealing with the IRS and the California Franchise Tax Board, yet my good faith attempts at resolving this have been met with bureaucratic inflexibility, stonewalling and buck-passing, wage garnishments and a credit-rating ruining series of liens. I'm quite happy to pay my fair share every April 15th, but I don't believe that ought to cause personal financial devastation.

If there's an upside to this situation, perhaps it's this: there's a saying that goes "you may not take an interest in politics, but at some point, politics might take an

interest in you." My AMT disaster occurred in 2000, and by the end of 2002 it was one factor (admittedly of many) driving my engagement in the political process. Since then I have volunteered hundreds of hours in city, state and national campaigns and in building local party organizations.

I've never asked for special consideration in resolving my AMT problems in return, and I'm certainly not doing so now. I simply have come to the conclusion that greater citizen participation can mitigate problems like this; problems that are essentially inevitable in a society and economy as complex as ours.

But for this to work, the leaders have to be willing to listen, and your presence on this committee indicates that you are among those who are willing to do so. So again I thank you for your work, for the opportunity to enter this testimony into the public record, and for your help in finally resolving this matter equitably.

AMT Disaster Timeline—Daniel Ancona

As of June 2004

January 1999—I leave a startup that had been absorbed by Platinum, Inc. to join pre-IPO email company Critical Path (CPTH) as a software engineer. As a signing bonus I'm granted 20,000 Incentive Stock Options (ISOs) at a price of around $1, to vest completely over four years with a one year cliff.

Early Spring 1999—In preparation for the public offering, a 5:2 reverse split leaves me with 8,000 shares.

Spring 1999—CPTH goes public, opens at $16 and spikes to $67 on the first day of trading. Price goes to above $120 a few months later.

January 1999—At an all hands meeting, the CPTH management team tells the assembled employees "The end of the boom is coming and we all know it, but we have a real business model and we'll be one of the companies left standing." I vest one quarter of my shares and begin working nights on my own startup.

July 2000—I prepare to leave CPTH to pursue my own startup full-time, having vested 2173 shares. Believing the company's fundamentals to be sound and this to be the optimum capital gains strategy, I sell around half my shares to live on while I get my company started and execute an "exercise and hold" of the remaining shares, priced at $67.

Neither the accountant nor the broker I was working with at the time cautions me against this transaction, but (unbeknownst to me at the time) this is the transaction that triggers the AMT. I was charged AMT tax at 26% on the amount of money I would've made IF I'd sold the stock that day, which would've netted me $135,000 or so. But I HELD half the stock instead of selling it, thinking this was actually the more conservative move. I was literally charged tax on money that I never saw.

January 2001—After around five months of intense work, I decide that the timing is bad for my startup and I begin looking for work. About a week later, the SEC announces it's investigating CPTH officers. CPTH would later go on to be #2 in shareholder lawsuits—behind Enron—but as of this writing the investigation is ongoing, and no plan for victim compensation has been announced.

The stock drops from the mid twenties down to $2 in a matter of weeks. The stock I had left as my insurance pillow is suddenly almost worthless.

Early April 2001—I get my tax bill for 2000. I owe around $46,000 to the IRS and around $12,000 to the FTB, on top of my regular taxes, due to the AMT.

Mid April 2001—I fire my accountant and broker, and begin looking into bringing suit against them but am cautioned against it. I begin negotiations with the IRS and FTB.

January 2001 to April 2001—I attempt to find a job, sending out more than 80 resumes. I finally find a job at UC Santa Barbara and move, but not before nearly running completely out of money and narrowly avoiding complete bankruptcy.

Fall 2002—I receive my first OIC denial from the FTB and am faced with a lowest offer of $400 per month over five years.

January 2003—I receive my first OIC denial from the IRS and am faced with a lowest offer of $1100 per month over 46 months.

Summer 2003—After three more tries, I finally find an accountant who understands the AMT credit. He refiles my 2001 and 2002 taxes to take this into account, cutting my total liability by around $10,000.

November 2003—Due to NSF and Iraq-war related budget cuts, I'm cut to half my former salary at my university job.

January 2004—I convince the IRS and FTB of my layoff-related hardship, and they both grant 1 year reprieves against further collection action. I plan to continue to file for the AMT credit over however many more years it takes to pay off the original loss.

Mountain View, California 94041
June 17, 2005

To the members of the Committee on Ways and Means:

Thank you for taking the time to read this letter. I believe the Alternative Minimum Tax (AMT) and its treatment of pre-taxation on Incentive Stock Options is wrong. I feel that this tax, which was originally created because 155 wealthy businessmen didn't pay any taxes, was not intended to financially ruin the middle class worker. It is an unfair tax and should be abolished immediately. This tax has caused our family undue stress and anguish.

Here is my story: In 1995 I joined a start-up high tech company called VeriSign. I was hired as an Executive Assistant to the President and my salary was $45,000. Over the years, I was granted Incentive Stock Options (ISO). I tried to regularly exercise and hold my ISOs for one year in order to pay long-term capital gains on the stock. In July 2000, I decided to leave my job so that I could plan my wedding and also start to plan a family. I had stock that needed to be purchased when I quit my job in July of 2000, so I exercised the stock. As everyone knows, the stock market then suffered the **worst stock market downturn in history!** At the time, I did not sell my stock in hopes that the market may recover. Had I known about the AMT, I would have sold the stock immediately. I come from a middle class background; my father worked for AAFES (Army & Air Force Exchange Service) and my mother was a nurse. I could not go to my parents for advice regarding my stock options because they had no experience with stock. I tried to get a financial advisor but had a difficult time finding one since, at the time, here in the Silicon Valley, financial advisors would only take people with large portfolios. My only financial advisor was the broker that I used through VeriSign, who was biased since they worked for VeriSign—they suggested I hold my stock. Many people had similar situations to mine. My tax preparer told me that I would be subject to the Alternative Minimum Tax and that I could receive a tax credit and I could use that to offset a sale later on. Unfortunately, my tax preparer wasn't aware that I would only be able to recover $3000 per year in my AMT tax credit. At the time, most tax preparers hadn't had much experience with AMT and therefore, could not give any detailed advice on how to handle the stock. At that time, my salary for 2000 was $50,747 and my taxes paid to AMT were $408,627—**over 8 times my annual salary** on money that I did not have nor received!! I had to take all the stock and sell it and take a loan in order to pay my taxes. On top of that, I had to pay lawyers and accounts in excess of $20,000 to help me to understand AMT and to try to fix this problem. The amount of stress was and is still unbelievable.

I never received any benefit from my ISOs—in fact, I now have a tax credit that I will never be able to use in my lifetime. Since AMT is also a self-reported tax, I have many sleepless nights thinking about how I shouldn't have reported the stock to the IRS, how it doesn't pay to be honest, etc. I personally know many people did not report this tax because they felt that the chances of being audited were very slim. At the time, I did consider this but having spent my entire life working and paying taxes, I knew in my heart that I was not the kind of person to lie to the government.

AMT was never intended to trap the little guy. It was originally intended to make sure the very rich, who years ago had tons of loopholes to hide their money, would pay taxes. This law is flawed on so many levels:

1. It's self-reported, the IRS has no way to track who reports and who doesn't;
2. You are pre-taxed on gains that have never been realized;
3. After paying AMT, you are given a tax credits that never gains any interest (on the flip side, if we owe the IRS money, we have to pay interest plus penalties);
4. The AMT tax credits will never be fully used—mine is $408,627 and it would take me 136 years to use this credit.

The mental anguish over this tax is unbelievable. I know that many people think that those of us who were caught in the AMT ISO trap were greedy but that isn't the case. I personally feel that my lack of understanding ISOs and the stock market along with the confusing way that AMT is calculated helped to get me in this AMT mess. I just didn't have the knowledge to fully understand the ramifications of this law. Those of us who found out the hard way had to make a decision, either report it or not—many did not. I chose to report the tax even though I felt it unjust and unfair. However, my honesty only got me a huge AMT bill while others walked away and didn't report their AMT. Those who didn't report, wait for the statute of

limitations to go by and then breathe a huge sigh of relief when they find they haven't been audited. The IRS has no way of tracking stock sales and exercises and they rely solely on the taxpayer to supply this information—this seems awfully stupid to me as it can lead to under reporting, etc. of this and other taxes.

I am working with a law firm to try to recover some of the AMT that I've paid. My amended returns have been with the IRS for over two years. The IRS holds amended returns "hostage" so they can sit out the statute of limitations instead of making decisions regarding our arguments for getting credits back faster. I believe they do this because they are afraid to do the "right" thing and call this law unfair. The IRS refuses to respond to my amended returns. The only recourse that I have is to take the IRS to court—which means spending another $15,000–25,000 of money that I don't have—and then knowing that the courts don't want to make the "fair" decision but want to make the "constitutional" decision (following the law). If I did go to court—I could be tied up in court for another 5 years. The only way to get justice is for the law to actually change.

I hope that my letter puts a "face" on what this horrible law has done to the average person. I am not an executive, I am not a founder of a company, I ended my career at VeriSign as a Project Manager—nothing fancy. If you saw my tax returns for the last 10 years—you would see that I never made over $75,000 a year in actual salary. I always paid my taxes on time. I'm a responsible, citizen who has voted in every election since I turned 18. I believe that my government will do the right thing. However, in the future, I would never accept stock in lieu of salary like I did at VeriSign. I don't ever want to be in a position of having to make decisions that will ruin my financial life and the life of my family.

I hope and pray that the Ways and Means Committee will have the courage to listen to all the comments from people like myself and make some real changes in this law. We did what we thought was right, we reported our stock exercises and then ended up paying millions of dollars in pre-tax to the government on stock that we never saw any financial gain. It's wrong. Plain and simple. If it happened to you or to one of your family members—you would be outraged. Time is running out for those of us who couldn't pay their AMT—if the Ways and Means Committee does nothing—many will loose everything they ever worked for—their savings, 401Ks, their children's education funds, their homes. Please do something about this before these honest citizens end up homeless.

Sincerely,

Susan Schroeder Anderson

Hopkinton, Massachusetts 01748
June 22, 2005

Dear Chairman Thomas and Committee Members,

During 2000, my (then) fiancée, Laura Perkins, exercised and held ISOs from her company based on advice she received from our accountant. This exercise subjected Laura to the Alternative Minimum Tax (AMT), substantially increasing her 2000 Federal tax liability. Instead of receiving a return of approximately $1,050, Laura owed the IRS $174,272 on what was considered a paper gain. This was a substantial debt given that Laura's W–2 wages for that year were $84,997. Prior to finding out the magnitude of her 2000 tax liability because of AMT, Laura had exercised more shares in January 2001 and, based on guidance from our tax accountant; she also planned to hold these shares. However, in March 2001, our accountant explained to us the huge tax obligation Laura had for 2000 because of the shares she exercised that year. To pay this debt ($174,272), Laura sold 8000 shares of stock.

After Laura and I wed in September 2001, our accountant again described ways of minimizing our 2001 tax liability based on the January 2001 exercise. Our accountant calculated our approximate 2001 AMT liability as approaching $1 million if we held all the shares exercised in 2001. This liability was greater than the value of all the shares we currently had available to sell. Realizing our only option was to heed our accountant's advice, we sold the remaining shares of the 2001 exercise. The continued decline in the stock price caused us to realize only 20% of the stock's original value. Originally, we had planned on selling the shares exercised in 2000 but knew that, due to AMT, this was not an option. The proceeds from the sale of all the 2001 shares were now considered real "income" and would be subject to our actual tax rate instead of being considered for AMT as unrealized gains. This would still create a huge tax amount, but it was one that we could possibly pay by leveraging other assets.

In February 2002, our accountant did the final calculation for our 2001 taxes and determined that our liability was much larger than we could afford. We knew we would have to use the proceeds from the earlier mentioned sale (as this is why we sold them). We also took out multiple margin loans against our balance of shares to pay our anticipated 2001 liability. (We filed an extension in April that resulted in late fees) While we continued working on our taxes throughout the summer we were advised that our liability was $20,000 more than originally filed. We didn't have any more money to send and at the same time the stock we had margined against was falling through the floor causing us to get weeks of margin calls and eventually the brokers began to sell whatever shares of stock we had left.

To satisfy all of our creditors (that were due to our taxes) we decided to refinance our house. We refinanced through a local bank and even though we expressed our desire to have it go through as quickly as possible it still took them more then a month and a half to finally be ready to settle the new mortgage. (Due to the huge volume of refinancing activity) Once we closed on the new mortgage we filed our final 2001 taxes, paid in full.

While dealing with this financial mess, we planned for, and paid for, our September 2001 marriage. We have now paid our 2000 and 2001 taxes—for a grand total of $294,278 in Federal Taxes, and well over $5,000 in accountant fees to help us understand these complicated provisions of the tax code. This amount greatly exceeds our annual salaries for that timeframe, and we will probably never see the majority of the tax we paid on theoretical stock gains. We live paycheck to paycheck and have to decide which household bills we will pay late even though my wife has worked for her employer for more than 20 years. We abided by the tax code, and because of the burden placed on us due to phantom (never realized) stock gains, we struggle to resume our middle class life we enjoyed prior to filing our taxes under AMT. Please take our case into consideration when you are reviewing possible changes to AMT.

Thank you for your time and consideration,

Michael and Laura Aubut

Talking Rock, Georgia 30175
June 3, 2005

Dear Sirs,

I would like to submit my request that you seriously consider abolishing the Internal Revenue Service and establishing a national sales tax as the means to collect taxes.

I am a mother of five and a grandmother of eight. I am sixty-eight years old and have been paying payroll taxes since I was eighteen years old. I want my heirs to have a more fair, more humane, system to pay taxes.

I do not begrudge contributing to the support of our government. I do begrudge the method of collection.

I begrudge that criminals who do not earn money legally and have no payroll check, do not pay taxes. I begrudge that wealthy people can afford tax experts to find loopholes to see that they do not pay as much in taxes as a person who earns a fraction as much. I begrudge that illegal aliens do not pay taxes.

A national sales tax would address these faults.

Most of all, I think, a national sales tax would immediately raise the happiness levels of all working Americans. We would have a choice. We would be free of the oppression of the IRS. Sirs, can you imagine what American would be like if all it's workers were happy?

I have studied the plan of Americans For Fair Tax (AFFT). I agree with their findings:

- Creates jobs where IRS destroys them
- Cuts the cost of goods and services
- Dramatically lowers tax rates on lower and middle class
- *Raises the same amount of revenue for the Federal Government*
- *Will bring jobs back to America*

There are many more reasons for a national sales tax. I hope at least one of the persons testifying in this hearing will cover them all. I also hope each one of you will commit to a thorough study of the AFFT.

I beg you to take advantage of this window of opportunity afforded this Country. An opportunity to give back the dignity to it's workers—the dignity and work ethic

that my parents and grandparents enjoyed—before worker's hard earned money was illegally taken from them—before social security taxes.

My children and grandchildren will be able to afford health insurance. They will have more money to save and invest without double taxation.

Please do the right thing for America and the working people. Abolish the IRS and institute a national sales tax.

Sincerely,

Joyce Ann Barrett

Statement of Rachelle Bernstein, National Retail Federation

The **National Retail Federation** is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet and independent stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees—about one in five American workers—and 2004 sales of $4.1 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

Summary of Comments

Members of the National Retail Federation believe that the most important aspect of any tax reform measure is its impact on the economy and jobs. Consumer spending represents two-thirds of GDP, and one-in-five Americans are employed in the retail industry. The NRF believes that replacing our current tax system with a consumption tax, or adding a consumption tax to our current tax system, will present an unnecessary risk to our economy. The NRF believes that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency and will not cause the economic dislocations inherent in the transition to a new tax system.

The NRF believes it is better to engage in substantial reforms of the income tax that are designed to eliminate some of the major complications in the current Internal Revenue Code and stimulate economic growth, without causing major economic dislocation.

As many of the witnesses who appeared before the President's Advisory Panel on Federal Tax Reform admonished, a fundamental goal of reform must be to "do no harm." According to a study of major tax reform proposals performed for the NRF Foundation, transitioning to a consumption tax system will lead to a decline in the economy for several years and a loss of jobs, without stimulating much additional economic growth for a ten-year period. The United States should not experiment with a brand new tax system that will put our economic future at risk.

The NRF also opposes using tax reform as a guise to fund increases in government spending. Many witnesses appearing before the Advisory Panel suggested adopting a VAT or National Retail Sales Tax (NRST) in addition to the income tax to provide a revenue source to pay for growing entitlements, health care reform and modifications to the income tax. The NRF believes policymakers need to be forced to make choices with respect to how taxpayer dollars are spent, rather than being provided with a money machine to finance entitlements and other government programs.

Proposals to Replace the Income Tax with a Consumption Tax

Various options for replacing the income tax with a consumption tax were presented to the Advisory Panel, including proposals for an NRST, VAT, Flat Tax, and consumed income tax. Economists generally agree that the economic impact of various forms of consumption taxes is similar, although the application of the taxes may differ.

In 2000, PricewaterhouseCoopers prepared a study on Fundamental Tax Reform for the NRF Foundation.[1] The study examined the impacts of replacing the income tax with an NRST or a Flat Tax. The study's conclusions are in line with the testimony of many of the Advisory Panel's witnesses—although replacing the income tax with a consumption tax might bring *long-term* economic growth, there could be very

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[1] PricewaterhouseCoopers LLP, *Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy,* April 2000. The study is available on NRF's website: http://www.nrf.com/content/default.asp?folder=govt&file=pubs.htm

harmful short-term and mid-term economic results.[2] The study also found that the economic growth that occurred during the ten-year modeling period was relatively modest compared to the disruptions to the economy during the transition years. Specifically, the study found that following the enactment of an NRST, the economy would decline for three years, employment would decline for four years, and consumer spending would decline for eight years. The study found that following the enactment of a Flat Tax, the economy would decline for five years, employment would decline for five years and consumer spending would decline for six years.

In addition to the overall impact of consumption taxes on the economy, retailers are particularly concerned with the impact of consumption taxes on our customers. Consumption taxes are highly regressive and will raise the tax burden on lower and middle-income Americans. This occurs because lower-income households tend to spend a higher portion of their incomes, so they will pay a higher tax relative to income level under a consumption tax than will upper income households.

Many witnesses appearing before the Advisory Panel suggested that the regressive nature of consumption taxes can be addressed through the drafting process. It is impossible to speculate with respect to all of the drafting variations that might be developed to address this problem, but it cannot easily be fixed if the current tax system is replaced on a revenue neutral basis. If taxes are cut for the wealthy, which will occur if savings are not subject to tax, then taxes will be increased on lower and middle income taxpayers. To illustrate, we critique a few proposals that have been presented to the Advisory Panel:

- H.R. 25, a proposal to replace the income, payroll, and estate and gift taxes with an NRST, attempts to address regressivity in two ways. First, it repeals the payroll tax. Second, it provides a rebate of the sales tax up to the poverty level. A January 2005 study[3] of the distributional impact of H.R. 25 found that if that bill were enacted, families with income less than $18,000 a year would get a tax cut, and families with income over $100,000 would get a tax cut. However, families with incomes between $18,000 and $100,000 a year would have a tax increase. Families earning between $18,000 and $35,000 a year would have the largest percentage increase in taxes.
- The BEST[4] proposal would replace the income and estate and gift taxes with a combination of an NRST and a business transfer tax (BTT). The proposal includes a rebate of the sales tax up to the poverty level, which is supposed to operate similarly to the rebate in H.R. 25.[5] The proposal does not include repeal of the payroll tax, so it will cause even more of a tax increase on those earning less than $90,000 a year than was the case with H.R. 25.
- The Four-Piece Fair and Balanced Proposal[6] would impose an income tax only on upper income Americans, but would also impose a 10–14% VAT. To address the regressivity of the VAT, the proposal includes a refundable payroll tax offset. This proposal would impose a tax increase on lower and middle-income seniors, who are currently in a consumption stage of their lives and who receive no benefit from the payroll tax offset, since they generally do not work.

Consumption Tax as an Addition to the Income Tax

Several witnesses that appeared before the Advisory Panel suggested that a VAT be enacted as an add-on to the current income tax system, as a means to finance social security, pay for repeal of the alternative minimum tax and other income tax reforms, and fund other governmental priorities. This model is similar to that used in many European countries.

Adopting a VAT in addition to the income tax will lead to a higher overall level of taxes as a percent of GDP, which will not foster economic growth. An early NRF study of an add-on VAT found that GDP would decline for four years after enact-

[2] The PwC model was developed specifically to analyze tax reform plans. It combined microsimulation models for individual and corporate income taxes with a macro-economic forecasting model, which allowed it to provide short-term transition results on an annual basis. Id at p. 119.

[3] The study was performed for the National Retail Federation by the Barcroft Consulting Group.

[4] This proposal was presented to the panel by David Burton, who indicated that it is expected to be introduced as a bill in the Senate.

[5] It is unclear whether the rebate will be based on the tax rate for both the NRST and BTT, or only the tax rate for the NRST. If it is the latter, the proposal will be even more regressive.

[6] This proposal was presented to the panel by Michael Graetz.

ment and consumer spending would decline even longer[7] Projections will change depending on how the VAT is designed, but the study demonstrates that even when the VAT does not replace the income tax, there may be economic dislocations for a multi-year transition period.

The best evidence that a VAT will lead to substantial growth in the level of federal taxation comes from the European example. Dan Mitchell of The Heritage Foundation published a recent analysis of the European experience with VATs[8] According to Mitchell, in the mid-1960's, before any European country adopted a VAT, the burden of government in Europe was only slightly higher than it was in the United States. In Europe tax revenues were about 30% of GDP, while in the United States tax revenues were about 27% of GDP. Forty years later, taxes in Europe amount to approximately 41% of GDP, while taxes in the United States remain at about 27% of GDP. The VAT proved to be a very easy tax to raise to fund increased government spending because it is built into the price of goods and hidden from consumers. As Mitchell points out, this explosion in social welfare spending has also created a drag on European economies.

Many of the witnesses appearing before the Advisory Panel warned that adding a consumption tax to the income tax will unnecessarily increase the overall level of complexity of our tax system.[9]The dual tax system may be particularly, burdensome for small businesses, which have enough trouble meeting the burdens of collecting and remitting payroll and income tax withholdings.

Conclusion

We urge this Committee to develop legislation that would reform the income tax to simplify administration of the system and encourage economic growth, without shifting the burden to those that can least afford to pay.

Statement of Larisa and JP Bickel, Cedar Rapids, Iowa

An article published in the Cedar Rapids Gazette on Saturday, December 15, 2001, describing Senator Grassley's efforts to reform the Alternative Minimum Tax, "Grassley offers relief from 'unfair tax'" really hit home with my family. My husband and I are 30 and graduates of Luther College in Decorah, Iowa. My husband has worked for McLeodUSA since graduating (for over 7 years) and I have worked at a private school. We have been very careful to live within our means.

We have lived a very conservative lifestyle and thought we were planning responsibly for the future of our family. We have a son who is five years old who was born prematurely with a hearing loss and multiple other issues that have required hearing aids (which insurance does not cover), physical therapy, occupational therapy and speech therapy to this point. Shortly after our second son was born I hospitalized after requiring an emergency hysterectomy. Because of our prior financial planning and saving, we had always been able to meet his needs financially. The ATM tax has overwhelmed us financially, when we could have been able to me other unexpected expenses in life.

In the fall of 2000, we vested a portion of my husband's McLeodUSA stock options for the first time when the stock was at $18. We borrowed almost $40,000 to pay for the stock. As the article outlined, we did not sell any of the options in anticipation of "holding the stock for one year after exercise in order to avoid taxation at the ordinary income on the value at the point of exercise." As a result, we paid approximately $80,000 in alternative minimum taxes. We were able to pay for about one-third of this out of our own savings, but then had to take out a home equity loan for the remaining two thirds.

The stock's present value is approximately $.09 per share—which is after the stock went through a reverse split of 17 to 1—leaving us with nothing of value to sell and burdening us with the reality that we took a $50,000 loan for the alternative minimum tax which is essentially an interest free loan to the government because we can not simply obtain a refund of the overpayment. We also owe $40,000, the purchase price of the stock, which is now essentially worthless. The re-

[7] Cambridge Research Institute, *Value Added Tax,* June 1980. This study was performed for the NRF's predecessor, the American Retail Federation, the last time that serious consideration was given to enacting a VAT in addition to the income tax.

[8] Mitchell, Daniel J. *A Dangerous "VAT" of New Tax Revenue,* Heritage Foundation, February 24, 2005.

[9] For example, see remarks of Martin Feldstein at May 17, 2005 hearing of Tax Reform Advisory Panel.

ality is that this situation has been devastating for us. We are overwhelmed by the burden of the debt created by paying this tax. Because of paying this tax, we are unable to start a college education fund for our son, provide the financial resources needed to fund the special help he will require during his primary school years, and fund our retirement account. We are forced to live at a barely subsistent level.

We want you to know that this is financially and emotionally devastating to our modest-income family. We thought we were doing everything right to become financially independent and now our reality is far from that, with an incredible debt in store for the future. This alternative minimum tax is devastating to those affected in the modest-income level, as well.

We thank Senator Grassley and others immensely for their efforts to help right this situation. Please let us know if there is anything we can do to assist you in this matter.

Statement of Michael Brown, Manchester, Michigan

To House Ways and Means Committee on Tax Reform:

I am an average middle class American living in Michigan (District 7) and working in the high tech computer industry. I have been employed by Network Appliance for over 7 years. Upon my hiring, I was granted ISO stock options as part of my compensation package. During the internet boom in the stock market, my ISO stock options had a theoretical paper value of approximately $2M. I never saw this money due to the dramatic rise and then crash of the stock market valuations. In the year 2000, I had income of $100,000.

However, when my accountant calculated out what I owed due to AMT, the amount equaled $371,000 . . . 371% tax rate. This is due to unintended consequences of the AMT laws and over-inflated valuations of stock which created phantom gains. Furthermore, this was exacerbated by the dramatic crash of the stock market. I was absolutely certain the accountant was wrong, because how could tax rates exceed my entire income! I checked with many attorneys and tax accountants to find that, in fact, the accountant was correct and it was due to a little known tax called Alternative Minimum Tax, which is basically an interest-free loan to the government that gets credited back to you at $3,000 per year.

So, I entered the paperwork that says I owe $371,000, however I did not have the money, nor do I have it today. In, fact that stock that was valued at $150 per share was now trading at $5 per share and my option price was $4.28 per share. So, my stock value that was left was less than $10,000. As you can see the AMT is not working the way it was intended. I conducted a lot of research into the tax, the history, and joined an organization that is made up of many other hardworking, honest taxpayers that this has affected.

What I found was very interesting. The root development of the AMT was due to 155 taxpayers in 1968 that made over $200,000 and paid zero tax. I can completely understand that something had to be done, however what really confuses me is how in the year 2003 over 4000 people made over $200,000 and paid zero tax!!! Obviously, the AMT is not the way to address this loophole these folks have found. My wages are currently being garnished by the IRS and I am only allowed to take home $332 per week. I am borrowing money weekly to stay afloat financially and going into more debt by the day . . . My life is being destroyed by a huge, unfair tax burden and since I am also raising 2 children, I am barely able to buy them groceries, let alone put money away for their college education.

I have filed for an installment agreement with the IRS and that was denied. I have filed an appeals with the IRS and that was denied. I am currently looking for help in any fashion to pay the IRS a reasonable amount to move on and get on with my life. When the accountant did my taxes without AMT for 2000, the tax would have been $10,000 extra over what I paid thru the year. However, even when I offered to pay the IRS $1,000 every month for the next 7 years, ($84,000) they refused and continue to take my paychecks except the $332 per week they think I can live on. Please support reforming AMT especially with regards to how ISO stock options are treated. http://www.reformamt.org Thank you.

Reston, Virginia 20194
June 21, 2005

Although Congress has responded to many of the corporate fraud problems brought to light by incidents at WorldCom and others and the relationships between corporations and Investment Banks Congress has not yet addressed the impact on taxpayers who subsequently faced excessively high AMT bills with no means of satisfying their debts. I was an employee of WorldCom and this is my story.

Smith Barney (who had obvious conflicts of interest because it owned a great deal of WorldCom stock and had a "too cozy" relationship with WorldCom executives while managing the employee stock program) urged me and other employees to hold our WorldCom stock at all costs. Smith Barney did not offer us diversification and collaring strategies; in fact it actually discouraged such practices. Jack Grubman, Smith Barney's now infamous former telecom analyst, constantly barraged us with reports.

Even as the stock slid with other telecoms (long before the massive fraud and lack of regulation about Corporate/Banking relationships became known), Smith Barney and WorldCom inundated us with information encouraging us to continue holding our WorldCom stock and simply borrow against it with margin loans.

I was originally a UUNET employee and that was who granted incentive stock options to me. MFS bought UUNET and then WorldCom bought MFS. I exercised options for a dollar or so even though WorldCom stock was trading significantly higher than that. I didn't know about the AMT and followed the advice I received to hold the stock for a year to pay a lower capital gains tax. Of course, the rest is history. The stock started to fall along with the tech market, but eventually crashed completely due to the fraudulent activities that are now legendary.

I never saw any money from the stock and now I have spent years dealing with the IRS which wants to collect over $240,000 (taxes, penalties, interest from 1999) on money I never had. The "gain" was simply in my account as WorldCom stock. Between tech layoffs and job searches, I have managed to earn enough money to pay untold thousands in "legitimate" taxes and have had the IRS take my refunds every year. So far, I've paid about $70,000 or so towards this bill, which was originally about $165,000, but with mounting penalties and interest, I still owe much more than I did originally.

So many taxpayers were caught in the AMT/ISO trap, but the government makes so much noise, continues to prosecute, and passed regulations to supposedly punish the evildoers and protect the taxpaying citizenry, but the government seems to have missed this point. Many of us are now suing WorldCom and/or Smith Barney, but it would really help if the government provided some AMT relief for victims of corporate fraud.

The way the AMT is interacting with ISOs is squashing innovation. Along with some other ex-uunet'ers, I recently founded a startup. Our tech jobs proved unstable, our 401(k)s were wiped out and all other accounts were liquidated. Luckily, with the appreciation of our homes and low interest rates we were able to borrow against our last assets to start a business in June 2003. Money is tight and the road is rough but we continue to strive to build a company to give people jobs which would actually increase the tax base far beyond what would be taken in by ruining us.

However, so many facing AMT/ISO problems can't start their own business. You can't borrow money when the IRS puts liens on your credit report and it's hard to concentrate with the knocks at the door to receive the latest registered mail from the IRS constantly threatening to seize all you have left.

Quite frankly, it seems un-American. The AMT is crushing a very innovative segment of American society by devastating these (more often than not) technology-savvy folks who are caught in a situation that was not their fault. Will they want to try again? Will they be able to?

Congress should amend the law to afford relief to individuals who, like me, not only lost their investments, but their jobs as a result of corporate fraud and still face huge AMT liabilities or who have useless credits on their AMT account. Again, it just seems plain wrong, and defies common sense and fairness, to ask victims of fraud to pay a tax on a future capital gain that will, most likely, never materialize. Paying tax on money you never made is just wrong, is it not?

I am currently being told by an IRS agent (who has come to my house to tell me such news), that they are going to seize my home. I have met with them and nothing changed. They seem unwilling, or unable, to work anything out that would allow me to keep my home and not disrupt my business as we work out of the home as well. All I got were flippant comments like, "didn't it seem to good to be true?" etc. alluding to the stock gains of the tech bubble. Actually, I agree. It did seem too good to be true which is why I was positioning to sell the stock before the bottom fell

out. My only option seems to be selling my home, completely disrupting my family and business, and/or accepting a payment plan that allows me a "living wage" that is nowhere near the realities of even renting an apartment in the greater Washington, DC area.

Thank you for your consideration.

Bill Bullock

WCKV–TV
Clarksville, Tennessee 37040
June 10, 2005

Dear Ways & Means Committee,

As the owner of a small business I have studied the various alternatives being proposed to reform our tax system. The FairTax proposal (HR 25, S 25) is the only one that clearly, simply, and fairly provides the best solution. I have looked for the loopholes in the FairTax and I cannot find them.

Furthermore, as a first generation Minority, I have come to appreciate how the FairTax takes care of those at the lower end of the income spectrum. Additionally, as one who diligently pays his fair share of taxes, I am most excited that the FairTax would finally capture taxes from those who currently cheat the existing IRS-based tax system.

Please seriously consider approving the FairTax so we can free our economy to be competitive in the world as well as providing for the needs domestically.

Thank you for your diligent consideration.

Sincerely,

Dan Calderon
President

Statement of Tim Carlson, Coalition for Tax Fairness, Arlington, Virginia

The Coalition for Tax Fairness first would like to thank Chairman Thomas and the Ways and Means Committee for the opportunity to present the urgent need for legislation addressing a tax crisis caused by the Alternative Minimum Tax Treatment of Incentive Stock Options.

The Problem

Tens of thousands of American families are being financially destroyed by tax rates exceeding 100%—and reaching as high as 500% or more—of their entire income. These Americans belong to the hardworking, entrepreneurial group of workers that are the engines of the U.S. economy. They were caught in the "Perfect Storm" of events in early 2000, trapped by a complex, unintended anomaly in the tax code that subjected them to colossal taxes on phantom "income" they never will receive.

Engineers and administrative assistants owe $200,000 or more, and mid-level executives owe $1,000,000 or more on stock on which they never saw financial gain. It is almost unbelievable this is happening in America.

The Irony

These Americans are being driven into bankruptcy and ruin as a result of:

- an element of their compensation, incentive stock options (ISOs), that was intended to reward their hard work, sacrifice, and investment in their company;
- their honesty in reporting a tax element on phantom gain, that the IRS cannot independently discover or track (those who didn't report are paying nothing);
- their compliance with SEC insider trading laws and company ethics policies;
- their decision not to sell inflated stock and foist losses on the unsuspecting public;
- the AMT—a tax provision that was intended to ensure the ultra-rich paid some tax;
- a tax provision that didn't contemplate the effects of an economic meltdown.

The Tax Code Complexity and Resulting Unfairness

While one can argue that many provisions of the AMT create unfairness and undermine confidence in the tax system, by far the most severe and devastating im-

pact to individual taxpayers has occurred as a result of the AMT treatment of incentive stock options. The complex interaction between the *incentive* provisions of the regular tax code and the *prepayment* provisions of the AMT code as applied to ISOs created a crisis of unfairness in the economic meltdown of 2000. Taxpayers who followed the incentives Congress put in place, worked hard and invested in their companies, and followed the law, are being forced to pay tens of thousands, hundreds of thousands, and even millions of dollars in taxes based on phantom income, literally ruining them financially.

In normal economic times, the ISO provisions of the regular tax code and AMT code interact awkwardly, but in general balance the competing incentive and prepayment goals. However, in the challenging economy of early 2000, the conflicting provisions became a volatile mix that trapped, destroyed and is continuing to destroy tens of thousands of American taxpayers and their families, impacting hundreds of thousands of people and hundreds of companies. The tax prepayment provisions of the AMT levied on phantom income are forcing taxpayers to make gargantuan, permanent interest-free loans to the government.

Those who cannot sell other assets, or borrow by leveraging other assets, to fully pay these excessive taxes are driven to bankruptcy; many have quit working altogether as they face decades of what amounts to indentured servitude to the IRS; those who are working are having huge portions of their income taken by the IRS to prepay taxes they'll never really owe; others have fled the country. All these significant tax overpayments create useless AMT "credits" that will never be recovered or returned in the taxpayer's lifetime. People's financial lives are destroyed, as they lose their homes, retirement accounts, education accounts and future income, solely to build up massive tax overpayments that trickle back a maximum of $3,000 per year.

Distortion of Business and Personal Decisions and Congressional Intent

Congress created incentive stock options as a tool for businesses to attract and retain talented employees, and to provide employees an incentive for long-term investment in companies. To that end, ISOs were not taxed upon exercise (unlike nonqualified stock options) and employees receive the long term capital gains rate if they hold the stock at least two years from date of grant and one year from date of exercise.

The AMT, however, imposes a "prepayment tax" upon exercise that generates a credit offset on expected future gain. The critical failings of the current AMT model lie in the fact that (i) the AMT code did not contemplate the possibility of a major decline in stock value between exercise and the expiration of the ISO holding period, (ii) the AMT code did not provide for a proper "true up" of credits to actual tax owed upon sale, especially when the value at exercise greatly exceeds the value at sale, and (iii) the prepayment rate (28%) was not synchronized with the current capital gains rate (15%), forcing employees to generate overpayment credits even when the stock maintains its value between exercise and sale.

The inconsistencies of these provisions in the current tax code are resulting in the following undesirable distortions of business and personal decisions:

- businesses have lost a key component of entrepreneurial incentive as employees are viewing ISOs as a "trap" rather than a reward for hard work and investment in their company. (In a Select Revenue Measures Hearing September 2004, Chairman Jim McCrery responded to Rep. Zoe Lofgren's statements regarding this ISO AMT crisis by stating "incentive stock options [] are around in your district, but certainly everywhere across the country, that is a tool that companies can use and they want to use; and employees like it, so we ought not discourage the use of that through the tax treatment on the alternative minimum tax.");
- employees who exercised incentive stock options in the past have virtually all their financial decisions distorted by ISO AMT, as they are borrowing and selling assets to prepay tax on money they never will have, quitting work because they cannot earn a living with the extent of wage garnishment from the IRS, and losing the retirement assets they worked their entire lifetime to acquire;
- employees who were able to pay their ISO AMT taxes and now have huge AMT credits, are spending thousands of dollars with accountants and financial advisors to try and manage their financial affairs to get some of these massive overpayments back in their lifetime;
- employees who have incentive stock options now are either not exercising them at all, or are exercising them and immediately selling to avoid being trapped and financially destroyed—just the opposite of what Congress intends;
- employees who receive incentive stock options do not view them as a benefit and encouragement to build value in their company, but rather as a dangerous

trap that should be either never exercised at all or sold immediately upon exercise;
- the IRS is spending tremendous resources fighting taxpayers in offers in compromise, Tax Court, District Court, Appeals Court, and Bankruptcy Court in attempts to collect unfair taxes from people who have no money with which to pay the disproportional tax; this is neither an efficient use of resources, nor is it right.

The Critical Need for a Timely Solution

This crisis began for many taxpayers in 1999. Those honest taxpayers who reported their ISO AMT "income" and trusted in the system to work to bring about some measure of fairness, have been sorely disappointed. The IRS has refused to grant any offer in compromise unless it is based on "inability to pay," meaning that hardworking Americans trapped by this unintended result are losing everything they have ever worked for their entire lives—and also having their future wages garnished. The Tax Court recently affirmed the IRS's refusal to consider fairness or proportionality, stating that Congress must be the one to fix this problem. As a result, these honest Americans who have done nothing wrong, are being treated as tax dodgers or tax avoiders, in spite of having overpaid tens of thousands, hundreds of thousands, and millions of dollars in taxes.

After four years of struggle, the appeal process for these taxpayers is now coming to a close, and these hardworking Americans are on the brink of financial ruin. If immediate action is not taken *this year in 2005,* the solution will come to late to prevent loss of homes, retirement savings, education accounts—all due to an unexpected and unintended result of a complex tax code applied to an unprecedented time of economic crisis.

These Americans Are Only Asking for Fair and Just Treatment

These Americans have worked hard and lost everything. They are not asking for a return of the value they lost—they are merely asking not to be destroyed by being unfairly taxed on money they never received. They have waited more than four years for relief, borrowing money to prepay taxes on phantom income, paying high interest rates so they can lend that money interest-free to the IRS, following the laws and working within the system to try to bring about justice, all the while facing imminent financial ruin.

This issue has been highlighted as a critical taxpayer issue in, among others, the following venues:

- The June 2004 Ways and Means Oversight Subcommittee Hearing
- The September 2004 Select Revenue Measures Subcommittee Hearing
- The National Taxpayer Advocates 2002, 2003 and 2004 Reports to Congress
- Numerous Bi-partisan House and Senate Bills in the 107th and 108th Congresses
- Countless newspaper and magazine articles over the last four years
- CBS Broadcasts the last two years highlighting the Speltz family from Iowa, (destroyed by an over $200,000 ISO AMT tax bill on stock sold for a loss).

The Coalition for Tax Fairness thanks Chairman Thomas and the Ways and Means Committee for the opportunity to present the urgent need for legislation addressing the ISO AMT tax crisis. CTF urges the Ways and Means Committee to support much needed immediate relief for these American taxpayers trapped by a complex tax provision and subjected to an unintended, devastating, and unfairly disproportionate taxation caused by the AMT treatment of incentive stock options.

New York, New York 10016
June 20, 2005

Dear Chairman Thomas and Committee Members:

I incurred a devastating Alternative Minimum Tax of over $125,000 when I exercised options in my employer, whose stock became nearly worthless before I could sell my shares. It was my first ever stock option exercise and even though I was in a finance profession, I was unfamiliar with the details of AMT and how it worked. I have since found that few tax practitioners have a good working knowledge of AMT either. Those who do seem to universally abhor it due in part to its complexity, but more importantly due to the way it imposes cash taxes, often astronomical taxes, on gains that only exist on paper and may permanently evaporate before any realization occurs. Even in cases where the ultimate loss realized is total, the present AMT code perversely compounds the loss because most or all of the

taxes paid on the paper gain can be impossible to recover. This of course is a severe and blatant violation of any principle of fairness the tax code may otherwise strive to achieve.

I exercised my options in December 1999 with the intent of selling the stock after my company announced earnings in February. I exercised early because (a) my company's captive broker did not reliably execute trades in a timely manner; (b) I had time to do the exercise and account setup paperwork and I knew I would have very little time after the end of the year; and (c) even as a finance professional, I never suspected AMT would have such a hugely devastating, unfair effect—taxing me on gains I never actually realized.

I didn't realize that by exercising in one calendar year and holding the stock for sale just a short time later, but in a different calendar year, I was automatically subjecting myslf to AMT. By the time I should have been able to sell, my company prohibited me from selling, and I was stuck with the stock, which was rapidly diminishing in value. I had exercised the options on margin, and to pay off the margin debt I had to sell my house.

AMT turned what could have been just a lost opportunity to make money on stock options into a devastating, life-changing event that gutted my savings and cost me my home. All this to pay tax on phantom gains that had evaporated by the time I filed my income tax return the next year. This is truly the most twisted, broken, and unjust aspect of the tax code.

Craig Chesser

Foster City, California 94404
June 8, 2005

To the Honorable Members Ways and Means Committee:

Thank you for giving me the opportunity to write to you concerning tax reform. Specifically, I would like to address the Alternative Minimum Tax.

My name is Jeffrey Chou, and I have a wife and 2 daughters—one is 4 years old, and the other is 1 year old. We currently face an AMT bill, from exercising Incentive Stock Options, which is greater than all our assets.

In 1996, I left a secure, stable job at a large company to help start a communications company as an engineer. My compensation consisted of an annual salary of $80,000 and Incentive Stock Options. Cisco Systems eventually acquired us. It was a happy time for my family, thinking that my hard work in helping to build a company would finally pay off.

In 2000, we decided to exercise my stock options, and were advised to hold the stock for 1 year. We did not and do not live extravagant life styles. We live in a 3 bedroom townhouse—I drive a 1997 Toyota, and my wife drives a 1998 SUV. We have good credit and have always paid our taxes in full and on time. In April 2001, following my exercise of the Incentive Stock Options, we faced federal and state taxes of $2.4M, more than 6,000% of our normal income tax and more than everything we owned. We also faced an ethical and moral dilemma. As we sought professional help to deal with this tax liability, several CPAs advised us not to comply with the law—to simply omit reporting the exercise and the tax. We discovered that the AMT on exercising stock options is a self-reported tax. Many of my friends and colleagues took this approach, did not report their exercise of stock options, and to this day, live happy lives.

However, we decided to "do the right thing" and comply. We had faith that our country, in return, would also "do the right thing" and not ruin its honest tax payers. Since then, the IRS has sent us threatening letters, placed a lien on our names, attempted to levy our accounts, and actually visited our house demanding payment. The IRS rejected our Offer In Compromise and we appealed. The appeals officer admitted to us that our offer was in good faith and was reasonable, but that he still could not accept it. Today, we are in IRS collections.

I do know that those who did not report are certainly glad they didn't. And I also know that among the many honest people I have met over the last 3 years whose situation is similar to mine, few or none, if faced with the same choice, would comply again. Why volunteer for a 100% guarantee of ruin, when you can win the audit roulette 99.9% of the time? My friends, if caught, will simply claim ignorance of the law. I am told it will be hard to prove that they were not ignorant of the law given how many tax experts are unaware of the consequences of the interaction of the AMT with Incentive Stock Options.

You may ask "Why didn't you sell?"

We are not sophisticated investors. I am an engineer; and my wife is a stay-at-home mom. We listened to advice that told us to hold for 1 year. At the time, I had no knowledge of diversification or hedging strategies. I worked 12 hour days trying to build products and meet schedules. At night, I returned home to help my wife with our new born daughter. That was my life. In addition, our CEO, all throughout 2000, even as late as December, kept touting Cisco's optimistic future, saying "we will be the most powerful company in history", "we are growing 30 to 50% every year", and "we are breaking away from our competitors." At the time, he was never wrong before, so I felt no sense of danger for my job, for my company, or for the stock. I had faith in my company and its leaders.

I sincerely ask Congress to help those in my situation. We are all honest tax payers who want to do what is right for the country. Most of us are hard working Americans who helped build a company and who wanted to remain part of that company instead of "cashing in." We also want to pay our fair share of taxes—but please tax us like any other investor—tax us when we realize our gains, not on what we might have gained.

I believe things happen for a reason. If I can be a small part in helping to correct this injustice, the faith I have in this great country is justified.

This is the highest priority of my life. Please do not hesitate to contact me any time for any reason.

Thank you.

Jeffrey Chou

Durham, North Carolina 27705
June 20, 2005

Dear Chairman Thomas and Committee Members:

My name is John Cole, and I am writing to you to share my story of a severe problem related to the Alternative Minimum Tax (AMT) and the way it is has been applied to employee stock options. If you will bear with me I would like to begin by providing some personal background information.

I was born in 1958, and grew up in Durham, NC. In 1977 at the age of 19 I moved to the San Francisco Bay Area, and for the next dozen years had a variety of blue collar jobs including home construction, cooking and waiting tables in restaurants, and working for moving companies. In 1989 at the age of 31 I went back to California Community College where I studied Computer Science for two years. When I was 18 I had attended College for 1 year, but had no clear direction and did not do well, which ultimately led to my withdrawing from school and heading West. However, the second time around I was highly motivated and extremely focused, and although I did not earn a degree I took 2–3 classes a semester while working, and maintained a perfect 4.0 average.

I was determined to provide myself with a solid foundation so that I could break into the growing world of hi tech, but being over 30 years of age with no job experience turned out to be a significant drawback: I applied for literally scores of entry level jobs and was consistently turned down, most often without ever having opportunity to interview with anyone.

Nonetheless I persevered and finally in March of 1992 was able to land a job initially paying $10/hour with a small startup software company, and over the next 3 years was able to grow within that outfit to where when I left I was the Senior Systems Engineer, and was the primary Technical Account Manager for many corporate customers which had site licenses for our e-mail package, including several large firms based in New York City, also Motorola and Ford Motor Company. It was the norm during that period to work 70–80 hour weeks, but I loved it: It was a period of tremendous personal growth for me, and coincided exactly with the emergence of the Internet as a public phenomenon.

In January of 1996 I joined another software startup located in Silicon Valley. As was common practice at that time as part of a standard compensation package in addition to a base salary I was issued a modest number of Incentive Stock Options (ISOs) which would vest over a 4 year period. This was a model which allowed employees to feel they had a stake in the company, and again I worked on average well above a standard 40 hours/week, doing my part to help make the company a success.

In May of 1998 the company was acquired by Cisco Systems, and my startup options converted to Cisco options numbering roughly 3,000 total. A drop in the bucket compared to what management was issued, but a very healthy number for a rank-

and-file employee like me. And over the next two years the stock split 2-for-1 twice, and 3-for 2 once, for an effective 6X increase, bringing my ISO total to 18,000!

Due to the death of my sister after a long battle with cancer I decided in March of 2000 to leave Cisco and take some time off, stay close to home, and spend time with my mother, who was then 85. It just so happened that my leaving Cisco coincided precisely with the high water mark for the stock market, with the result being that the ISOs I had to "use or lose" within 90 days triggered a huge paper gain which ultimately resulted in over $225,000 in AMT liability. Unfortunately by the time the tax came due in April of 2001 the value of the stock had dropped by roughly 80% from its high point a year earlier, with the result being my tax bill exceeded the value of the stock assets that triggered it!

I never sold any of the stock, never had any money whatsoever pass through my hands, never in any way benefited from owning the stock, yet I was about to be wiped out simply from exercising and holding on to what appeared to be an excellent investment in a very good company with real products used by organizations of every kind worldwide!

I filed my year 2000 Federal return with an installment plan, but it was rejected due to the large amount of the tax liability. I called the IRS and attempted to expedite processing of my case, but was told I was "in the queue and would just have to wait to be contacted by someone in IRS Collections". For the next year while waiting for that contact on my own initiative as a sign of good faith I made monthly payments which ultimately totaled over $67,000 toward my pending tax bill! Finally in late June 2002 I was contacted by a local Revenue Officer who was unwilling or unable to discuss anything other than collection of my assets, so I engaged a former IRS Collections Officer practicing as an "Enrolled Agent" and submitted an Offer In Compromise (OIC) in July 2002.

Cisco, Nortel and other large employers in the RTP area of North Carolina had not only stopped hiring, they had laid off thousands of workers, flooding the local job market with highly qualified job seekers. The tech job market had completely dried up, and not for lack of trying I had been unable to secure work. Save for a failed attempt to establish myself as an independent consultant which resulted in only a single paying job I remained largely unemployed for over 2 years and my tax bill (which had grown due to penalties and interest) exceeded my net worth by roughly 150%, yet my OIC was rejected at the field level due to an insistence that I could pay it off in total!

I was actually told in a letter from the IRS Offer Specialist handling my case that "Mr. Cole has the ability to pay the taxes outstanding in full and should withdraw his offer from consideration. . . . no offer amount is sufficient, and no offer would be accepted". The Asset/Equity and Income/Expense tables the Offer Specialist used to justify that claim contained several computational errors, but the most egregious was that my "ability to pay" was substantiated by the Offer Specialist counting my remaining Cisco stock asset both as a source of ongoing monthly income, (to the tune of over $5,000/month), as well as a lump sum asset. In other words, the stock was counted twice, with ongoing income from it assumed after it was liquidated!!

My representative pointed out this flawed logic to the Offer Specialist, but to no avail: The OIC was rejected at the field level. I appealed, and after another 13 months the IRS Appeals office finally accepted my OIC, but only after adjusting it to a dollar amount that reflected my net worth at that time, with terms of 50% of the settlement amount to be paid within 30 days, another 25% within 120 days, and the final 25% within 240 days. I was able to make the first (50%) and second (25%) payments, but I have not been able to find more gainful employment, and at this point am unsure exactly how I'm going to make the final 25% payment, which is due mid August, 2005.

I filed and paid all my state and federal taxes for the last ten years, and have no outstanding tax issues other than these problems associated with ISO transactions from the year 2000. I was finally able to find full time employment in August 2003, yet ironically back at Cisco, working in a group which has been outsourced to a vendor which pays less than a ⅓ what I was making when I was previously a direct Cisco employee. I am grateful to have the job, yet the income barely pays my basic living expenses, and now on top of dealing with the final OIC payment I'm also trapped in a cycle of credit card debt, with high interest rates and monthly service charges. I have been trying to build on being back in the tech workplace and find more gainful employment, but to date have been unable to do so. I guess I'm one of the few lucky ones who have been able to secure an OIC settlement, but at this point it doesn't feel that way; I just don't know how I'm going to make ends meet going forward.

The payments I made proactively toward my year 2000 tax bill and the OIC settlement amount total up to about $180,000. Ironically, I have an AMT Credit avail-

able which can offset regular income tax for years to come, yet the IRS would not consider that credit as an asset to be considered as part of an OIC settlement, and due to the relatively small yearly income I make now I can't take significant advantage of that credit. The one thing that could help me stay afloat would be to return some or all of that AMT credit sooner. I implore you to consider that avenue of relief.

Thank you for taking the time to consider my case, and of those in similar situations.

Sincerely,

John Cole

Statement of Dorothy Coleman, National Association of Manufacturers

The National Association of Manufacturers, the nation's largest industrial trade association representing small and large manufacturers in every industrial sector, applauds current efforts to develop proposals to reform the nation's tax laws. The U.S. manufacturing sector accounts for about 13% of GDP and 11% of U.S. jobs. Because of the importance of manufacturing to our nation's economy, NAM supports the thoughtful consideration of an appropriate and timely path to make the tax code fairer and simpler. In developing a tax reform plan, policy makers should be guided by principles that will promote economic growth and job creation.

To this end, the NAM recently adopted the following principles on tax reform. These principles, which reflect NAM's long-standing policies on fundamental tax reform, will serve as a framework for the NAM to use in evaluating proposals and developments as the tax reform debate moves forward. Specifically, any reform plan should:

- Encourage savings and investment while minimizing the double taxation of corporate earnings;
- Include rules that permit U.S.-based manufacturers to compete on a level playing field in the global marketplace;
- Recognize the important role of research and technology investment in the growth of U.S. jobs and innovation;
- Eliminate both the individual and corporate alternative minimum tax rules, which are inherently complex and unfair;
- Strive to raise the required amount of revenue for the government without distorting a business's decision to invest capital and hire new workers;
- Include broad and strong transition rules that provide fair and equitable treatment for taxpayers who have committed substantial resources based on current law;
- Not result in a net increase in business taxes; and
- Incorporate rules that make it easier for Treasury to administer the law and for taxpayers to comply with the law. Unnecessary complexity is not productive from an economic perspective and undermines taxpayers' confidence in the fairness of the law.

Members of the National Association of Manufacturers believe that the current tax code represents a major drag on our economy and look forward to working with policy makers to move towards a simpler and fairer tax code that promotes economic growth.

Statement of Joyce E. Curcio, Cumberland, Rhode Island

My name is Joyce Curcio and I am submitting this statement on behalf of my husband, Matthew Curcio. We, along with so many others, have been affected by the Alternative Minimum Tax and I would like to share with you our particular story.

Matthew and I were living in San Francisco in 1998 when he obtained a position with Biomarin Pharmaceuticals based in Marin County, CA. He was a biochemist, earning roughly $50,000 per year. He also received Incentive Stock Options (ISOs). The market was doing fairly well at that time and Matthew thought about cashing in on some of the options. He was advised by a financial consultant for the company to hold onto the options which he did. Subsequently, the market took a large drop and the value of that stock was lowered considerably.

When tax time April 2000 came along, it came as a shock when we were told by our CPA that we now owed @$20,000 to the state of California and @$60,000 to the Federal Government. How was it possible to be taxed on so-called "income" that was never realized? We were completely incredulous as to why this was happening.

We paid off the state to satisfy that debt. The IRS bill was something we could not even fathom paying. We continued to receive threatening letters, with warning of liens, garnishing of wages and ultimate financial ruin. As long as we have been working citizens, we have duly paid our taxes, every year and in full. However, this tax seemed so unfair and unjust that we simply had to fight it. We contacted a tax attorney and looked into the OIC program. Subsequently, we moved back east to be closer to our families. Due to the move, as well as the slow process of this negotiation, our case is still in OIC in 2005. Our lives are literally at a standstill. We will owe a hefty legal bill when all of this is resolved. We are not able to purchase a home due to our this outstanding tax bill and our "bad credit". The stress and strain this has put on ourselves is unimaginable.

Please, I urge you to take action and reform this outdated tax code and lift the burden for so many hard-working American like ourselves.

Carson City, Nevada 89701
June 20, 2005

Dear Chairman Thomas and Committee Members:

I would like to take this opportunity to answer some of the questions raised at the tax hearing.

How the ISO/AMT tax code affects compliance and your understanding of the tax code

As reported in the Taxpayer Advocate 2004 annual report to congress, section one, page 2, "The Internal Revenue Code (IRC) now consists of substantially more than a million words."There are only 790,871 words in the bible (1611 King James Version), which is much more readable than the IRC.

This fact alone demands professional assistance in tax matters. In my attempts at reading the IRC, I came to realize that it's the result of many years of tinkering—at times in the name of tax code simplification, yet on each of these attempts, word count and obfuscation have risen. Taxpayers who use professional assistance assume those professionals both understand tax law and have the taxpayer's interests at heart. But if that professional assistance fails, it's the taxpayer who pays, and pays dearly.

In my case, I sued the CPA who masked my AMT liability, and delayed the timely filing of my return. The lawsuit resulted in a substantial settlement, in spite of the fact he wasn't paying his insurance premiums. The CPA never completed my return. The lion's share of this settlement was sent to the IRS. It only covered about ⅕ the Federal AMT liability.

With IRS interests and penalties, I'd expect the settlement to have been consumed by now. All this to prepay taxes on income never received, to generate credits I will never recover.

The State of California has an AMT as well. My home was forced to sell to satisfy that liability in order to pay huge taxes on the phantom gain.

I reported my ISO/AMT liability, after moving to a new CPA and having that number computed. I ***could*** have chosen not to report the phantom gain, as some have done. Instead, I reported the liability as required, and was immediately sent to collections.

My first Face to face meeting with the IRS was staffed by a collections agent. In that face to face meeting the agent stated "I hope you have relatives with money who are going to die soon." I have NEVER sought a face to face meeting since then. This is happening to hardworking, honest taxpayers.

The fact of the matter is that IRS Collections agents do not set tax policy. Thus, they are a poor choice for a face to face meeting over liabilities resulting from flawed tax policy.

How the ISO/AMT tax code distorts your financial economics and incentives

Given the result of my experience, I find it difficult to put any further trust in Incentive Stock Options, because what should have been an incentive for me to make my company successful has quite literally destroyed my life. Why would I repeat the experience?

The tax code, mixed with prevailing market conditions, timing of IPO's, blackout periods and so on, presents a Hobson's choice for the taxpayer, for example:

IRC sec. 422 permits companies to issue ISO's to employees, and if the employees meet sec. 422 holding requirements, they will qualify for the lower long term capitol gain rate.

IRC sec. 83 Taxpayers exercising ISO's must claim the fair market value on the date of exercise, even if those taxpayers are legally prevented from selling the stock for an extended period.

IRC sec. 56(a)(3) states that the spread between a stock's fair market value and its exercise price is a tax preference for AMT purposes.

For a full description of the interplay, and further background, see www.taxprophet.com/hot_topic/August_02.shtml

How the ISO/AMT tax is a burden

My continuing status of being a tax debtor, and the uncertainty of my situation have had a most damaging effect on my ability to generate an income. Homelessness doesn't help either.

Charity is out of the question. Does this kind of tax policy and enforcement promote homeownership, saving, job creation, investment and competitiveness in America? Absolutely not

Unfortunately, as I have discovered, it can cost 20 years of an individual's efforts and a 20 year marriage. In essence, my life has been destroyed by a huge, unfair tax burden. As I write this, I'm beginning the process of bankruptcy, which is something I never wanted to do, yet I'm being forced to as a result of this situation and the upcoming change in bankruptcy laws.

I would hope that congress has the wisdom to bring some sanity and morality to the IRC, to make the IRC and indeed the entire tax system a more transparent, balanced and fair system to the benefit of both taxpayers and the government.

Once again, I would like to thank the Honorable Chairman William M. Thomas and House Ways and Means Committee for this opportunity to make my individual experience known. Please do not hesitate to contact me if you have any questions.

Respectfully,

Steve Daniels

Statement of Eric Delore, Alameda, California

Dear Chairman Thomas and Committee Members:

I owe $420,000 of Alternative Minimum Tax (AMT) on under $5,000 of actual income derived from the sale of frightfully deflated Incentive Stock Options (ISOs), and the IRS's aggressive and disorganized collection activities threaten to destroy my peace of mind and ruin my family. I am not wealthy. I am a middle-classed citizen struggling to raise a family on a single income.

I have already paid the IRS $37,000 of taxes, but they want more. They want everything. One collection agent suggested that I sell my home and give them all the proceeds. Bear in mind that by raiding various immediate and extended family bank accounts, I have already paid the California State Franchise Tax Board $100,000 of AMT tax on this same $5,000 of income. That is almost $140,000 of taxes paid to date.

Like many technology professionals during the dotcom boom years, I exercised and held unvested ISOs from my company, Commerce One, so that the long-term capital gains tax period would run concurrently with the vesting of the stock options. This way, by the time the shares fully vested, I would be able to sell them and pay the lower long-term capital gains tax rate. However, the value plummeted while they were vesting and insider trading rules periodically restricted me from selling the shares that vested along the way. At exercise, the ISOs were worth 1.1 million. By the time I was able to sell the shares, they were worth under $5,000. Disastrously, the outdated and onerous AMT code forces me to pay taxes on the value of ISOs at the time of exercise, 1.1 million dollars, not at the time of sale, less than $5,000.

I hired tax attorneys, and we made two Offers In Compromise (OIC) to pay the IRS an additional $100,000 of taxes. They rejected both offers, one without comment and another time because between the time we made the offer and the time they responded, almost six months, the value of my house had increased and they wanted that equity, too.

We then were thrust into the jaws of the Automated Collection Service (ACS). The IRS cleaned out my bank accounts and intercepted my paychecks twice. They have also intercepted my state and federal tax refunds since the year 2001. My employer, Commerce One, then declared bankruptcy and laid off almost all of their work force, including me. At that point, the ACS decided to have me make another OIC, despite the fact that another IRS agent had told us that it would be impossible for us to submit another OIC. We submitted all the OIC forms and waited for months. After several months, we received a notice from a specific IRS agent, asking us to resend much of the same information and to correspond only with him. We submitted the information again and waited months again. After several more months, we received a letter from a different IRS agent asking us to resubmit much of the same information and to correspond only with her. We just resubmitted and are hunkering down for another several months wait. If the IRS rejects this OIC, this leaves only bankruptcy available to me, which basically amounts to, "I quit, come and sell everything I own to get your money." This would be a very hard step for me to take, considering that I have paid all my other taxes on time and I do not have any other debts aside from my mortgage.

The effect of this AMT debt on my family has been terrible and pervasive. I am on the brink of bankruptcy. I am on antidepressants to dull the clinical depression and dark thoughts triggered by this situation. I love these United States of America and I do have confidence in our government, but this situation has spawned in me a deep and, perhaps, irrational loathing of the IRS and State tax agencies that I struggle every day to mitigate and overcome. This loathing infects my every night's sleep, thought, decision, and familial interaction.

Headaches, unnecessary complexity, and burdens that taxpayers—both individuals and businesses—face because of the existing system

- AMT Tax—Forces taxpayer to compute taxes twice for regular income and AMT income. Hard to understand how to compute this. Places unfair burden on average taxpayers to render tax on huge phantom gains resulting from the early exercise and holding of ISOs.
- OIC Process—Lack of continuity. Slow response times. Often deal with different agents along the way who need months to come up to speed on each case.
- Tax code—Too complex. Requires accountants to complete all the forms.
- IRS Coordination—Had to inform IRS several times we had a power of attorney on file and not to contact us directly. One such instance resulted in the levying of all our money that we had to foight to reverse.

Aspects of the tax system that are unfair

- AMT on ISOs—Requires taxpayer to pay huge taxes on phantom gains realized at the exercise of ISOs rather than at the sale of the associated vested stocks. AMT credit policy is laughable. The amount the IRS refunds every year is so small that only a taxpayer with a life expectancy of 500 years could ever hope to recover the entire AMT credit.
- OIC Process—IRS refusal to accept OICs based on Ineffective Tax Administration claim when the claim arises from AMT on ISOs is unfair. Prolonged OIC process results in increased interest and penalties assessed against the petitioner.
- ACS—Unfair to levy bank accounts and salary after leaving a cryptic message on an answering machine, such as, "This is a message for Eric Delore. Please call me at xxx.xxx.xxxx regarding case number xxxxxx."

Specific examples of how the tax code distorts important business or personal decisions

- Because of the AMT on ISOs and the unfair and unpredictable associated IRS processes, we have avoided starting a business because we fear the IRS would just take all the money we made anyway, and postponed having another child because we thought we'd bee too poor to afford it and we can see the effects of this situation on our two young daughters. They haven't had vacations in years because we did not want the IRS to assert that if we can afford vacations, then we could afford to pay them 400k. We also feel that Tax law compliance is a risky choice. I voluntarily informed the IRS that I had early exercised ISOs. The unfair nature of the IRS treatment of AMT on ISOs may compel otherwise law-abiding citizens towards non-compliance.

Goals that the committee should try to achieve

- Fair and Simple—Simplify tax code. Repeal AMT tax laws. Adopt a flat tax or Value Added Tax (VAT).
- OIC for AMT on ISOs—Allow claims of Ineffective Tax Administration
- Retroactive remedy—Forgive tax AMT on ISOs tax debt for those people affected by the dotcom stock crash.

Statement of Thomas Dudley, Andover, Massachusetts

Dear Chairman Thomas and Committee Members: My name is Thomas Dudley and I am writing on behalf of myself and my family. We appreciate this opportunity to discuss the burden and unfairness of the ISO/AMT tax and the specific impact on our family.

Much as an individual who has been scammed by unscrupulous workmen, I am embarrassed and very hesitant to speak about the specific financial impact on my family. My family supported my decision to leave a secure job at a large company to pursue a goal of financial independence that might be possible through diligent efforts building a small company. We gave up family vacations, weekends and evenings together, had the disruptions of two moves and mounted financial debts. We thought the hard work and sacrifices finally paid off when my company (CoreTek) was acquired by Nortel Networks. Suddenly, the incentive stock options (ISOs) became quite valuable and our "paper" wealth was beyond anything we could have imagined. The newfound wealth was welcome, but also scary. We hired a financial advisor and an accountant to guide us through the process of exercising the options and managing our money. Without experience, we followed their advice, with the exception of large donations to charity and gifts to parents to allow them to retire. We made decisions on donations and gifts without consideration of the tax consequences because it was the right thing to do.

I felt that I had obligations to the acquiring company and believed that if I worked hard for the success of the business, everything else would fall into place. I thought the advice of my advisors was sound and I agreed to exercise and sell approximately 38% of the available options at $80 per share in July 2000, which provided me with sizable real wealth. The balance of the options were exercised at the same price and held. At the time this appeared to be a very sound financial plan.

The financial plan began to unravel as I learned of the tax consequences in early 2001. I was prepared to pay income tax at the highest marginal rate on my substantial year 2000 income which was driven by the exercise and sale of the stock options. I was not prepared for the shock of the alternative minimum tax on the ISOs that were exercised and held. Again, I prefer not to share exact dollar amounts, but we ended up paying over 90% of year 2000 income in federal taxes and over 100% when state and other taxes were included. Because of the distortions of the large income in year 2000, I estimate that we have paid between 65% and 70% of our lifetime earnings since 1974 in federal income tax and higher if other income taxes are included. To add insult to injury, the alternative minimum taxes we paid were on paper profits that no longer existed, as Nortel Networks stock had fallen to below $13 per share by the time year 2000 income taxes were due and eventually went to a low of under $0.50 per share.

I'm thankful that I was able to walk away from the experience free of debt (except for a mortgage), and I left Nortel with an excellent reputation for integrity. The payoff for all the hard work never did materialize and we have a large AMT credit that will probably never be realized. I'm still paying a mortgage, struggling to make tuition payments for two daughters and am working out of state and commuting home on weekends in order for my wife, who is battling cancer, to be able to continue treatment with her current set of doctors.

I'm comfortable paying my fair share of taxes, but the alternative minimum tax is one that penalizes hard work, success, and what otherwise would be considered sound long term financial planning. The complexity of the tax is mind-boggling and I'm not sure that I completely understand all the details of the alternative minimum tax even today.

I request that you consider changes to the tax code to eliminate the alternative minimum tax and to right the wrong to those who met an unfair tax burden through the exercise of incentive stock options.

Thank you.

Lawrence, Kansas 66046
June 20, 2005

Dear Chairman Thomas and Committee Members:

My name is Jeff Eden, I am recently married, have been severely affected by the AMT law and I want to share my story with Congress.

My AMT issue resulted from the exercise (purchase, not sale) of incentive stock options for Critical Path in August 2000. I was laid off from my job and had to either exercise my options or lose them. They were one of the only retirement vehicles I had ever had and I had worked very hard (60+ hours per week) for several years to vest the options, so I exercised them thinking they would serve as a nice nest egg for my future family. My broker advised me to hold the stock for a year for long-term gain purposes.

Then the stock market crashed in early 2001. Unknown to me (and apparently tens of thousands of other people), under the current AMT law a taxpayer who exercises incentive stock options are required to pay a tax on the VALUE of the stock the day it is exercised (purchased, not sold) even though income has not yet been earned (they had yet to be sold). I used the only savings I had to exercise (buy) the stock and I was not aware of the AMT tax until my return was prepared in March 2001. I ended up owing more than $80,000 in AMT to the IRS and over $10,000 to the State of Colorado for a stock purchase that actually resulted in a loss (I paid more for the options than I could sell them for). **The IRS was asking for money I did not have, for income I never realized since it was all on paper and was now nearly worthless.**

Up until the AMT problem I have paid my taxes on time and in full my entire working life. I am a hard working person who has been dealt a tremendous blow from a tax law (AMT) that even the IRS recognizes is flawed.

I have had to borrow money from family members, drain my savings and re-mortgage my home to pay my AMT tax liabilities (including substantial interest and penalties) in Colorado and to the IRS. In total, I have paid over $100,000 with my life savings and borrowed money to pay my AMT liabilities. I borrowed for and paid my tax liability as quickly as I could because I didn't want to be in trouble with the IRS or the State of Colorado. I was hoping my only recourse, the Offer in Compromise system, would somehow correct this inequity.

In the summer of 2003, after two years in the IRS Offer In Compromise system (two full years with interest), bounced between 4 offices across the country, over 50 hours of calls, meetings, re-submissions **(four times)** of personal and financial data to the IRS, over two thousand dollars in legal and accountant fee's and after I had paid my principle tax liabilities in full, the IRS rejected my OIC that I filed under the Effective Tax Administration rule. I was totally shocked because I thought if there ever was a reason to claim the need for Effective Tax Administration, my AMT problem was it. Two years later I am still shocked by how unfair this whole problem has been and I'm left without much hope to recoup my life savings.

I will spend the next 10 years paying back the debts I incurred to pay the IRS for this flawed law and not saving for my own family's future. The AMT law has cost me so much more than the $100,000+. It has broken me mentally. Please imagine having to go, hat in hand, to family members to borrow such large sums of money for taxes that should never have been levied. This has affected them as well and my relationships with those who lent me the money. It has been horrible. It seems terribly unfair.

I would like to see the AMT laws changed. I would like Congress to consider those of us who have paid the IRS for this flawed law and figure out a way to allow us to recoup the money we have paid in to date. I have an $80,000 plus credit with the IRS, but the AMT law says I can't really use it. It will take me over 30 years to recoup it. With the time value of money, it will be worth little. Meanwhile, I have a huge debts to pay to those who lent me money for taxes I never should have incurred.

I want to regain my confidence in our leaders and our government. I know this Committee most likely did not have a hand in creating the law, but I'm fairly certain you have the power and authority to make things right. I'm looking forward to hearing how you will help those of us who pay our taxes, follow the tax laws (even when flawed and unfair) and only want to be treated fairly. Please provide us with the vehicles to recoup the money we have paid into this flawed system.

Thank you for your consideration and time.

Jeff Eden

Evans, West Virginia 25241
June 6, 2005

As a Certified Public Accountant, I support the plan to abolish the I.R.S. and the income tax and replace it with a national sales tax. Elimination of the Federal Income Tax on individuals and businesses and the replacement thereof with a National Sales Tax is the only genuine route to a fair and just tax system. The taxation of revenue generation has served only to burden the taxpayers with costs of compliance and of implementation of tax reduction strategies. Income taxation has allowed politicians to obfuscate the actual costs of government to the citizens. It has enabled the hidden social engineering agenda of political elites. It has allowed the politicians to clandestinely redistribute income according to their own peculiar notions of fairness. It has deprived the individual taxpayer and the taxpayer's family of the unfettered use and enjoyment of earned income. It has stultified formation of capital and associated economic activity. Income taxation has necessitated and facilitated the intrusion of agents of the government far too deeply into the private lives of citizens and businesses. Taken in sum, after social security and welfare, income taxation is the most obstructive and destructive force applied to the citizens of this federal republic in its history.

There is no fix. We have long understood that the act of applying a tax guarantees the reduction of the object of the tax. Any activity which by its nature reduces income cannot provide sufficient good to overcome that reduction. It is inherent in the taxation of income that it must perpetuate, if not continually, exacerbate the malignant side effects discussed above. We have ample evidence of the futility of applying remedies to ameliorate the negative impact of the income tax in the very complexity, density, and sheer bulk of our opaque income tax statutes and regulations. Taken together with bizarre and tortuous judicial interpretations, the result is a Byzantine pile which beggars compliance. Tax avoidance, not to say evasion, is therefore weighted in favor of the high income individual and business who can afford to hire tax wonks like me to find a way to nullify the manifest intent of a piece of tax code and reduce its impact on a client's income. Not only should this malignant tumor on the economic and political body of the country be excised, the Sixteenth Amendment to the Constitution should be repealed, lest the temptation to try income taxation again prove too much for the politicians of some future time.

The Internal Revenue Service is a gargantuan pestilence which has ostensibly no other function than to coerce compliance with an opaque and cancerous code. The Service apprehends diametrically opposed interpretations simultaneously of the same bit of code in order to maximize tax due. It is infamous for overreaching its own authority to collect monies from taxpayers on the most dubious of issues. It arrogates the power to refuse compliance with the findings and interpretations of the Tax Court. The Service is the only enforcement arm of government exempt from the constitutional constraint of presumption of innocence. It cannot depend on its own computer system nor, indeed, its personnel to maintain confidentiality of tax records. It has been and will continue to be a weapon for incumbent politicians to punish the opposition. It is used as a cudgel by the left to restrict conservative political speech in § 501 exempt environments, while allowing liberals to pollute churches, unions, and NGO's, ad libidum. In the mind of the public, the IRS rates right along side of the Spanish Inquisition as a model of fairness and compassion. For all intents and purposes of the citizenry, the IRS is the American answer to the Nazi Gestapo and Russian Secret Police. It has no place in a republican federal system and should be disbanded. One could reemploy its minions as Border Patrol and ICE agents to much better effect for the benefit of the citizens of our country.

Please do not be dissuaded from the abolition of these political and economic malignancies. The blandishments of the Income Tax apologists are invitations to perpetuate a governmental disaster. On the other hand, the National Sales Tax (Fair Tax) affords the opportunity to raise taxes on individuals by attaching to their purchases of goods and services.

Sales tax is a genuinely voluntary tax (or as voluntary as a tax gets) because the taxpayer has the option of foregoing the purchase to avoid the tax. Since it is virtually impossible to exist in our culture without purchasing some durable goods, consumable goods, and services, the generation of tax is reasonably guaranteed. It has ever been the nature of the human being to acquire in proportion to his means, the tax is self graduating. Chevrolet buyers will be less taxed than will Cadillac buyers. Whatever the congruence of utility of the vehicles, the perceived value is reflected in the difference in the price of the vehicles. Wealthy purchasers may be able to control their acquisitive instincts sufficiently to content themselves with the Chevy, but most will purchase the highest perceived value which they can afford.

Thus, the Fair Tax, in effect, is self assessment and is, amazingly, completely without veiled government device.

The mechanism for efficient collection of the revenue and the assurance of compliance is in place nearly universally across the country. The Fair Tax should be collected by the vendors of goods and services and administrated by the several state tax departments. The states should provide expert remittance, compliance, and audit services conjointly with their own sales taxation effort. Remittance by the states to the U.S. Treasury should be monthly and should be directly audited by federal authorities.

To satisfy the liberal faction, exemption from the impact of the Fair Tax could be easily effected by issuance of an exemption card to be used not unlike the ubiquitous credit, debit, or smart card at the point of sale. Utilizing a smart card could allow the government to establish a continuum of exemption amounts by means testing the individual taxpayer or by exemption of a given class or classes of purchases for individual citizens. No tax returns need be filled out by huge numbers of individual taxpayers, but rather Fair Tax collections would be reported and remitted by the relatively few vendors. Compliance, while a concern in rare circumstances, becomes an almost automatic proposition with the Fair Tax as the same process that records sales, records tax collections. The only downside, if you wish to view it as such, is that the citizenry will become acutely aware of the actual cost of government and would thereby be enabled in deciding if it is a good investment.

Please take the Fair Tax forward to enactment. The abolition of the cancerous income tax and the institution of the Fair Tax must be the most important and most lasting benefits that you can provide to the country.

Respectfully submitted,

Noel H. Eyster, CPA

New Orleans, Louisiana 70125
June 4, 2005

Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Chairman and Committee Members:

Having been a businessperson as well as a taxpayer, I believe that the Fair Tax proposal (HR 25 /S25) provides the most even-handed and effective means of providing the necessary funds for government expenditures. I have formed this belief after examining the competitive proposals as well as the current taxation system.

I have reached the following conclusions that I hope Committee members will consider carefully:

The Fair Tax proposal provides the necessary revenue.

The Fair Tax proposal is based on consumer consumption. The quantity of consumer consumption is calculable and currently well understood. Therefore, the amount of tax that may be raised is predictable. By setting an appropriate tax rate, the Government can be assured of raising the needed funds. Other proposals (including the current taxation system) do not permit the same level of predictability nor the assurance of a "revenue neutral" implementation.

The Fair Tax proposal is transparent to citizens.

The Fair Tax proposal, for the first time in American history, will give the taxpayers a clear understanding of what they are paying to support the Government. All other proposals now being considered have some form of hidden taxation or unnecessarily complex exceptions, exclusions, and loopholes.

The Fair Tax Proposal can be implemented almost immediately.

Retailers are already capable of collecting taxes on sales. The implementation of a federal consumption tax is trivial compared to the current income tax collection mechanisms. And only the Fair Tax proposal does this without additional taxpayer identification or classification at the retail level.

The Fair Tax Proposal is fair to all economic classes.

Only the Fair Tax proposal rebates the taxes on basic living expenses evenhandedly. Stratified tax rates, complicated tax formulae for special classes, and

welfare payments through "unearned negative taxation" will be a thing of the past. Everyone, including the poorest Americans, will receive and spend, without tax penalty, 100% of their income whether from government support programs, sales revenue, or wages.

Taxpayer confidence will be enhanced by the Fair Tax Proposal

Currently, most taxpayers despise paying into a taxation system that they believe is slanted toward special interests. Due to the Congress' using the taxation system to foster certain political, economic, and cultural programs, this opinion is not entirely wrong. The Fair Tax proposal will strongly demonstrate that the collection of necessary taxes is based on the fairest basis—the ability to pay.

The Fair Tax Proposal offers a dramatic boost to the American economy

Only the Fair Tax proposal offers straightforward taxation based on consumption with no tax on producers or the poor. The results are a dramatic decrease in producer prices, an increase in foreign sales, and lowering of interest rates due to the increase in domestic savings. With these benefits, every person in America is a winner.

The Fair Tax proposal injects $250 billion into the economy.

The savings in tax compliance costs is estimated to be $250 billion each year if the Fair Tax proposal is implemented. That money will be spent instead on productive business activities and not squandered on tax avoidance efforts as it is now.

The Fair Tax proposal will create jobs for Americans.

The current convoluted tax system encourages business to export jobs to countries where tax rates and systems are less onerous. The Fair Tax proposal will permit companies to employ Americans to produce products at competitive prices for sale both domestically and overseas. The result will be more income from foreign markets and more spending by gainfully employed Americans.

The Fair Tax proposal will help charities and persons on fixed incomes.

The Fair Tax proposal will allow every American to receive 100% of their income and decide for themselves how it should be spent. This means that the retired on fixed incomes will receive an immediate benefit. Wage earners can decide to save more or donate a larger portion to charity.

The Fair Tax proposal will effectively tax all Americans.

Currently, income tax is only collected from those with paychecks, investment income, or sales revenue. Additional "hidden taxes" target specific products, commodities, and producer segments. The Fair Tax proposal will, for the first time, collect taxes from every American regardless of how the income was derived and remove "hidden taxes".

Thank you,

Michael Fermanis

San Francisco, California 94118
June 20, 2005

Dear Chairman Thomas and Committee Members:

Like so many others, my former employer issued me Incentive Stock Options several years ago. I am no financial whiz, so I sought advice from a highly-respected accounting firm in San Francisco on how to best deal with the potential tax consequences. I paid several thousand dollars for the advice, which I followed, and now, I find myself in the following predicament.

On calculating my year 2000 income tax, the combined state and federal taxes came to $80,000 due to the Alternative Minimum Tax. In a good faith effort, I sold the stock in January of 2001 for $26,000.

That's right, the taxes I owed were equal to 311% of my actual gain. I'm glad to pay any percentage of tax, even up to 100% of my gain, but a tax in excess of 300% is difficult to comprehend.

I gave the state of California and the IRS my entire stock gain, and all of my additional savings, but I still "owed" in excess of $45,000 on a $26,000 gain!! And the IRS adds penalties and interest every day . . . my liability has incurred over $10,000 in interest and penalties so far!!

I can't use my phantom gain to pay off my debt—the government only accepts real income and I never actually had real money from the stock. I had to look to other

income (my salary), on which I first paid normal income tax to pay the tax on my "phantom gain."

Unfortunately, I've since been laid off. I've given the state and the IRS all of my savings. Nevertheless, I'm told that although I have tens of thousands of dollars in AMT and Capital Gains credits, I have to pay my "debt" now. I can collect my credit at a rate of roughly $2000/year over the next 30+ years. And, although I must pay significant interest on my "debt," the IRS will pay me no interest (or penalties) for the credits which I'm owed.

The AMT was designed to prevent the wealthy from avoiding paying taxes. I'm not wealthy, nor am I trying to avoid paying taxes. I am an honest hard-working taxpayer. I tried to understand this portion of the tax code that even Taxpayer Advocate Nina Olsen sees as extremely confusing and problematic. I went to highly respected accountants. I'm still trapped.

I've contacted the IRS on multiple occasions to discuss this issue. Each time the individuals with whom I've spoken tell me that they agree with me that the law is unjust, but my only recourse is through legislative action.

Please address this situation! The tax law should not be so confusing that—even with the planning advice of accountants—a taxpayer owes 311% of actual gain.

Clearly this is not what the law intended.

Thank you for your consideration,

Mike Fleisher

Statement of Jolynne Flores, American Society of Pension Professionals and Acutaries, Arlington, Virginia

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the House Committee on Ways and Means on tax reform and the detrimental affect certain reform options could have on the employer-sponsored retirement plan system. A 50-page report—"Savings Under Tax Reform: What Is The Cost to Retirement Savings?"—discussing ASPPA's concerns in depth can be found at www.asppa.org.

ASPPA is a national organization of almost 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad-based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

We understand this hearing is in anticipation of tax reform recommendations to be made by Treasury Secretary John Snow to Congress. The President's Advisory Panel on Federal Tax Reform (Advisory Panel) has been tasked with recommending ways to improve and simplify the tax code to the Treasury Secretary by July 31, 2005. These recommendations are to focus on ways to benefit all Americans by making the tax code fairer, simpler and more pro-growth.

ASPPA applauds the Committee's leadership in working to fashion such a fairer, simpler, and more pro-growth tax system. Like you, ASPPA believes our tax system can and should be improved. But this belief is balanced by wariness that the enthusiasm for broad reform may jeopardize some tax provisions that have played an important role in America's economy. ASPPA looks forward to working with Congress and the Administration on strengthening America's economy through the tax system, while at the same time recognizing that any reform to the federal tax system must continue the current policy of providing tax incentives for long-term savings through the employer-sponsored retirement plan system.

Tax Reform Could Undermine Long-term Retirement Savings

On May 27, 2005, the ASPPA Pension Education Research Foundation (PERF) released a Report titled "Savings Under Tax Reform: What Is The Cost to Retirement Savings?" that examines several possible tax reforms and their impact on retirement savings.[1] We are attaching the Executive Summary of the Report at the end of these

[1] The Report and its Executive Summary can be found at www.asppa.org.

comments. We ask that the Report and its summary be included in this hearing's Congressional Record.

The Report looks specifically at several suggested tax reform options, including a consumption-style tax or the reduction or elimination of the tax on capital gains and dividend payments, as a strategy to boost national saving. Many tax reform advocates favor proposals such as these. The Report concludes that while this goal might be achieved, it would be at a high cost—the loss of retirement savings plans for millions of Americans with modest means who already have difficulty putting aside adequate funds to support their senior years. Frankly, this is too high a price to pay, particularly when there are other mechanisms that could increase savings without jeopardizing the nation's retirement system.

Any tax reform plan that reduces or eliminates the incentives for long-term savings would erode both sponsorship and participation in employer-sponsored retirement savings plans, threatening employees' future financial security and leading to greater wealth disparities. Today's workers could face a much bleaker retirement. Indeed, radical reform that would eliminate the current tax incentives for long-term savings could virtually destroy the existing system.

The need to preserve successful sections of the tax code is reflected in President Bush's charge to the Advisory Panel where he stressed the need to retain incentives that promote home purchases and charitable giving. ASPPA believes a compelling case can be made to afford equal protections to provisions that encourage retirement savings. As the Social Security debate has shown, Americans are appropriately worried about economic security in retirement.

Employer-Sponsored Retirement Plan System

America is not a nation of savers. Even today about a third of workers are not saving for retirement and many who are saving have retirement accounts that are inadequate to fund a comfortable retirement. Further, demographic shifts illustrate a growing retiree problem: approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.

The existing provisions of our nation's income tax system that incentivize long-term retirement savings have encouraged a significant number of Americans of modest means to save for their retirement security. These current long-term savings incentives in the tax code have been extremely successful and deserve to be retained. The current employment-based retirement plan system is the backbone of an "ownership" society, which has made middle-income Americans significant investors in the stock market.[2] However, more needs to be done.

The Report states that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy. As a result, one goal of tax reform should be expanding coverage under the employer-sponsored retirement plan system.

Much of today's savings is spurred by plans offered by employers, which often offer a synergistic combination of advantages. In many cases, because of employer matching contributions, a dollar contributed by a worker grows immediately, before interest and other earnings are added. This means $1 contributed by a worker today may result in an immediate deposit—before any interest is earned—of $1.50 or more.

Putting money in an employer-sponsored plan is also much easier than saving independently. Low—to moderate-income workers are 11 times more likely to save when covered by a workplace retirement plan, in part due to the convenience of payroll deductions, the culture of savings fostered in the workplace, and the incentive of the matching contributions provided by the employer.[3] The workplace retirement plan has been shown to be the only effective means to get these workers to save.

This is not a blanket defense of the status quo. The federal tax system is imperfect. Its retirement savings provisions could be changed for the better. But history strongly recommends continuation of priorities embedded in the existing system:

- The opportunity for individual retirement savings tied to employment should remain. Research shows that many Americans would not save at all if not offered employer-sponsored retirement plans.

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[2] As of July 2003, an estimated 36.4 million U.S. households, or almost half of all U.S. households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, U.S. Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

[3] According to the Employee Benefits Research Institute (EBRI), 77.9 percent of workers making from $30,000 to $50,000 and covered by an employer sponsored 401(k)-type plan actually saved in the plan, while only 7.1 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account.

- The system should maintain nondiscrimination rules to assure maximum coverage of all workers.
- The system should favor long-term savings, thereby discouraging savers from withdrawing funds prior to retirement.
- The system should acknowledge the priority of retirement savings plans by assuring that their incentives are more attractive than other savings incentives.

Small employers hesitate to offer retirement plans for several reasons, including administrative complexity and cost, and the unpredictability of their financial condition. These hurdles are offset partly by the knowledge that the small business owner cannot maximize personal retirement savings without providing a plan for workers as well. Any changes that allow small business owners to meet their retirement savings goals on an individual basis, such as through a reduction or elimination of the tax on capital gains and dividends, would inevitably threaten the future of the plans they provide their workers.

High-income earners are more likely to have retirement savings than those who earn less. The largest group of workers without access to an employer-sponsored retirement plan is comprised of those employed by small firms for a modest wage. The good news is that coverage for this segment of workers has been steadily rising. Tax reform ought not to reverse this positive trend.

Many proponents of tax reform share the goal of increasing savings. No one opposes that priority. But there is a need to focus on who is saving and how they are saving. The question is not solely how to get society to save more, but how to encourage low—to moderate income workers, who are often not saving, to save for retirement.

Tax Reform Must Accommodate Retirement Policy

From a retirement perspective, the most important and daunting goal involves convincing the low—to moderate-income workers to increase their retirement savings. The political and policy challenge lies in ensuring that any plan retains these critically important retirement savings incentives.

Some tax reforms under consideration would provide greater tax advantages to individuals investing in stocks, mutual funds and other capital investments through a reduced tax on capital gains and dividends. This would undoubtedly create a significant disadvantage to investing through the employer-sponsored retirement plan system because individual savings in capital investments generally is not "locked-up" until retirement. If retirement savings no longer enjoy a special tax advantage, low—to moderate-income workers would save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these savings will be spent, in whole or in part, well before retirement.

Summary

Prudent retirement policy suggests that the most efficient and effective tax retirement policy system must continue to provide long-term tax incentives to employers to establish and maintain retirement plans. As the tax reform debate accelerates, it is vital that Congress acknowledge, protect and extend the positive impact that tax policy has had on the individual retirement security of millions of Americans through long-term savings incentives.

Attachment

Savings Under Tax Reform:

What Is The Cost To Retirement Savings?

Executive Summary

More than any other issue, a reform of the federal tax system represents a significant threat to the tax incentives available for long-term savings provided through the employer-sponsored retirement plan system. Any reform to the federal tax system that would diminish these incentives would jeopardize the individual economic security currently achieved through the employer-based retirement plan system.

The President has established a tax reform commission that is exploring various ways to simplify the current tax system. Its findings are due to the Treasury Department by July 31, 2005. Among the proposals under consideration are major reforms such as consumption-style taxes or targeted approaches, such as those that eliminate the tax on capital gains and dividend income.

This research paper focuses on the crucial need for continued long-term savings incentives through the employer-sponsored retirement plan system. It illustrates the potentially devastating effect certain potential tax reform solutions could have on savings into qualified retirement plans. It concludes that any reform to the federal

tax system must continue the current policy of providing tax incentives for long-term savings through the employer-sponsored retirement plan system.

Highlights

The Need for Long-Term Savings

- On their own accord, American workers do not save adequately for their retirement and other long-term financial needs. While 63 percent of Americans are saving to some extent for retirement, more than one-third of the working population is not.
- Demographic shifts illustrate a growing retiree population. Approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.
- The growing retiree population also reflects increased longevity, with the number of people aged 85 or older expected to increase five-fold in 2050 over the 2000 population.
- Our current tax system provides the strongest incentive for taxpayers to accumulate assets for long-term savings through the employer-sponsored retirement plan system by providing for an exclusion from income for contributions made to a qualified retirement plan or IRA.
- Any reform to the tax system that does not provide incentives for long-term savings would inherently favor short-term savings choices, which provide current access to such savings.
- The policy implications of reduced long-term savings by working Americans could be substantial, particularly given the projected shortfalls in Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings.
- The current employment-based retirement plan system is the backbone of an "ownership" society, which has made middle-income Americans owners of the stock market.

Employer-Sponsored Retirement Plans

- Employer-sponsored retirement plans are heavily dependent on federal tax incentives and are clearly the most effective method for encouraging savings by low—to moderate-income workers.
- According to the Employee Benefits Research Institute (EBRI), 77.9 percent of workers making from $30,000 to $50,000 and covered by an employer sponsored 401(k)-type plan actually saved in the plan, while only 7.1 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account. In other words, low—to moderate-income workers are 11 times more likely to save when covered by a workplace retirement plan.
- This striking disparity is due to the convenience of payroll deductions, the culture of savings fostered in the workplace, and the incentive of the matching contributions provided by the employer.
- The likelihood of retiring with adequate savings depends upon whether an individual participated in an employer-sponsored plan. Overall, 55 percent of households covered by employer-sponsored retirement plans will have adequate savings compared to 24 percent of those without.
- Suggested approaches to tax reform, including consumption-style taxes and/or the elimination of tax on capital gains and dividend income, would tend to encourage savings outside of qualified plans since access to such savings is not restricted.
- Employers—particularly small employers—would be able to accomplish their savings objectives outside of a qualified retirement plan and would be unlikely to incur the cost and potential liability associated with establishing or maintaining a qualified plan.
- As a result, low- to moderate-income workers, now not covered by a workplace plan, will save less for retirement, impairing their future economic security.

Tax Reform Must Accommodate Retirement Policy

- While some level of reform is needed given the complexity of the tax code, tax reform proposals must strive for a higher savings rates for all American workers across all income classes, not just to increase savings in the aggregate.
- Providing favorable tax treatment for individual savings outside of the employer-sponsored retirement plan system will erode both sponsorship and participation in qualified retirement savings plans, threatening financial security and leading to greater wealth disparities.

- A switch to a consumption tax system, which would only tax amounts consumed and not saved, could result in an alarming reduction in individuals' retirement savings as employers would choose not to establish or maintain qualified plans.
- Reductions in capital gains and dividend tax rates would provide greater tax advantages to individuals investing in stocks, mutual funds and other capital investments, which would create a significant disadvantage to investing through the employer-sponsored retirement plan system.
- Prudent retirement policy suggests that the most efficient and effective tax retirement policy system must continue to provide long-term tax incentives to employers to establish and maintain retirement plans for their workers.
- It would be unacceptable to risk the retirement security of working Americans by creating a tax system that fails to recognize the need to encourage long-term retirement savings over short-term individual savings vehicles (e.g., mutual funds held outside of a plan).

Statement of Kevin R Frank, Cary, North Carolina

I am in a very bad situation because of the tax liabilities that were generated in year 2000. Because of the economic down turn of the telecommunication industry, I was laid off from Cisco in March of 2000. This situation forced me to execute the NQ stock options I had accumulated over the 5+ years I had worked at Cisco, or lose them forever.

I did not know that the single act of executing NQ stock options becomes a taxable event in the eyes of the IRS. I did not sell stock; I did not receive any cash; I did not realize any gain whatsoever in the transaction—not a single dime!

Because of the complexity of the tax forms, I paid a CPA $900 to prepare my taxes and tell me I owed $1.7 million in taxes for the year 2000 even though I make less than $100,000 a year! How can this be? The CPA office that prepared my taxes commented to me:

"This is the most unfair and unfortunate tax return our office has ever prepared. Many officers have verified the accuracy of your return and we believe it to be correct."

I was a habitual saver and lived a very meager lifestyle. At the time I executed the NQ stock options, I lived in a 1,400 sqft house with my wife a dog and a cat. I drove a 1979 F100 pickup, no air, manual steering, 3 speed on the column, 160,000 miles—worth about $600. My wife drove a 1987 Olds Cutlass with 224,000 miles. I did not live the life of our executives—I was just an engineer trying to save for a brighter future.

The Cisco stock that I bought declined more than 80%. I sold everything and took out multiple loans to pay the IRS. Because of my prior savings, my meager lifestyle, and the kindness of my bank; the IRS received the money April of 2001. My bank has given me two interest only loans. Today I live in a 60 X 14 trailer by myself. My wife and I divorced in 2004. I still drive the same Ford pickup (over 200,000 miles now). 70% of my salary goes to maintaining these loans, which I have been paying for over 4 years now.

This unfortunate situation has taken my financial future from me. I am addressing this letter to you so that you may know how this stealth tax is destroying the lives of so many common people, like me. It is just plain wrong to tax people on all of their assets when they have realized no financial gain whatsoever.

Chicago, Illinois 60647
June 17, 2005

Dear Chairman Thomas and Committee Members:

In 2000, I exercised stock options with the company I work for, PurchasePro.com. As the stock market continued to fall, I was forced to sell my stock well below the price I paid for them to pay my 2000 AMT bill. I paid my 2000 AMT taxes in the amount of $286,000 after getting nothing back from the sale of my stock. I was married in December of 2000 and our family has been set back a great deal financially. I had to sell many of my assets and borrow a large amount against my house. We are way too young to have financial problems for the rest of our lives. The way current tax code is written it will take 43 years before I get all of my money back with-

out interest! I am now stuck holding onto thousand of shares of a company that is out of business with NO HOPE of recouping my money.

Sincerely,

Scott Frisoni

Thousand Oaks, California 91320
June 17, 2005

Dear Chairman Thomas and Committee Members: My name is Brian Fuchs and I am writing on behalf of my wife Leslie, and our twin children. We appreciate the opportunity to discuss the hardships we are suffering due to an outdated and complicated portion of the tax code called Alternative Minimum Tax.

In April of 2000 I took a job as an engineer with a small startup telecommunications company in Calabasas, California called Ixia. The company gave Incentive Stock Options (ISOs) to the employees to help stay competitive with the offerings of larger corporations and to give the employees a true sense of ownership and interest in the profitability of the company.

Being what I consider to be tax-savvy, I knew a little about AMT and realized that attempting to exercise my ISOs and then hold them for one year exposed my family to a huge potential 'invisible tax' liability—one that taxed me based on potential gains—not on actual money I had in my hands. The threat of AMT scared me from the possibility of investing in my company and reaching out for the chalice known as "long term Capital Gains". Instead, I simply 'flipped' some of my ISO shares, and instead was exposed to what amounted to 48% gains tax on my shares (38% Federal and 10% State).

More recently, I was granted ESPP shares in my company. ESPP shares differ from ISO shares in that the company sets aside post-tax dollars from your paycheck to purchase shares at a discount. These shares are owned; they do not need to be exercised so as to expose oneself to AMT. Again, being tax-savvy, I held these shares for the period of 1 year so they would qualify for Long Term Gains (15% Federal rather than 38%). After all, these shares couldn't possibly expose me to AMT liability, right?

Imagine my surprise when I found out that due to AMT, my Long Term Capital Gains were almost completely wiped out! You see, although my gains were in fact taxed at the lower 15% rate under AMT, these gains exposed more of my regular earnings to the AMT. To be specific, I wound up paying 7% for AMT on top of my 15% Capital Gains.

Let's recap.

One decision I could have made with my ESPP shares was to flip the shares and expose myself to the aforementioned 48% tax (Federal + State).

Instead, I chose to hold my shares and go for the Long Term Capital Gains rate of 25% (Federal + State)—A savings of 23%. Thanks to the archaic AMT, my actual tax bill amounted to an additional 7%.

Gentlemen and Ladies, my wife and I are not rich. We are the definition of "Middle Class". We have a budget that we find difficult to stick to. We are a two-income family, and must hire full-time help to watch our children. I would much prefer our children to have a full-time parent, but the ultra-high cost of housing in California prevents that. Finding Ixia was the proverbial needle in the haystack. It has provided a wonderful addition to our income, but AMT has completely penalized us at every opportunity from realizing the gains that our Tax System had intended.

Instead, this system called AMT—that was invented to punish fewer than 20 persons—has never been adjusted for inflation. It now affects millions, with tens of millions of taxpayers in its sights. Even if it were not for my company stock, our family would still be exposed to AMT. You see, having children and owning a home in California these days almost guarantees you will pay AMT. The last time I checked, having children and owning a home was called "The American Dream". AMT makes it "The American Tax Liability".

The notion of paying taxes on POTENTIAL earnings rather than actual earnings is completely immoral. It is akin to being taxed at a higher rate simply because your neighbor is rich.

Being penalized because you live in a state with a high tax rate is immoral.

Being penalized because you have a huge mortgage is immoral.

Being penalized because you have children is immoral.

The longer Congress does nothing about AMT, the larger the problem will grow. I urge you all to wake up, and do the right thing.

Eliminate the AMT.

Thank you,

Brian Fuchs

Government Finance Officers Association
Washington, D.C. 20004
June 22, 2005

The Honorable William Thomas
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas

On behalf of the over 16,000 members of the Government Finance Officers Association, we appreciate the opportunity to comment on the tax reform measures that the Committee is considering, in conjunction with forthcoming report from the President's Advisory Panel on Federal Tax Reform. Our membership includes cities, counties, states, and other governmental entities that are very interested in the tax reform discussion and its impact on state and local governments.

In April, state and local governments had the opportunity to appear before the Advisory Panel regarding the relationship between the federal tax system and state and local governments. Timothy Firestine, CFO of Montgomery County, Maryland, appeared before the Panel and discussed the impact that any changes to the current federal tax system would have at the state and local levels, and how major tax reform could dramatically reduce state and local tax revenues and services.

A chief concern raised by GFOA and other local and state government organizations, are possible changes to existing state and local income, sales, and property tax deductions. Deductibility of these taxes preserves the ability for state and local governments to raise revenues and to provide services; promotes equity in the federal taxing system, discourages the migration of businesses and individuals for tax purposes; avoids excessive cumulative federal/state/local income tax rates; and preserves the autonomy of state and local governments. We urge you to consider the ramifications that would impact nearly every community across the U.S. if limits to these deductions were made.

Another area of great interest to local and state governments is preserving the tax-exempt status of municipal bonds. We cannot emphasize enough the importance of the tax-exempt bond market and the need to keep its integrity intact as major tax reform is discussed. Tax-exempt bonds are the mechanism used to provide for essential infrastructure at the local and state levels. Nearly all schools, transportation infrastructure, water and wastewater facilities, jails, airports, and municipal utility facilities exist today because of tax-exempt bond financing. Altering the federal income tax or imposing new limitations on issuers or purchasers of tax-exempt bonds would cause a significant increase in bond interest costs. At a time when direct aid from the Federal Government is decreasing, it is imperative for local and state governments to be able to provide these essential infrastructure and services to their citizens at the lowest possible cost. Without the ability to access the low cost, tax-exempt bond market, communities across the United States would suffer, and greater demands would be placed on the Federal Government to provide additional direct funding to local and state governments.

In addition, included with this letter are proposals that would promote economic growth and job creation through simplification measures in the tax-exempt bond market. We believe that to foster long-term growth in the United States economy, federal, state and local governments must act in concert rather than at odds with each other. These proposals would help increase flexibility and reduce costs for state and local governments—and taxpayers—and expand the positive characteristics of the tax-exempt bond market for the future.

Thank you for your consideration of these matters.

Sincerely,

Susan Gaffney
Director, Federal Liaison Center

I. SIMPLIFY ARBITRAGE INVESTMENT RESTRICTIONS

A. Provide a Streamlined 3-Year Spending Exception to the Arbitrage Rebate Requirement in Lieu of the Present 2-Year Construction Spending Exception

Present law. Generally, interest earnings on investments of tax-exempt bond proceeds in excess of the bond yield must be rebated to the Federal Government. The main exception to arbitrage rebate is a complex 2-year spending exception that applies only to governmental bonds and qualified 501(c)(3) bonds issued to finance certain construction projects.

Reason for Change. The present 2-year rebate spending exception is unduly complex due to unrealistic spending periods, complex bifurcations, difficult computations, and unclear multipart definitions. Thus, the permitted prompt spending period should be extended from two to three years. The recommended streamlined 3-year rebate spending exception should apply as broadly as possible, recognizing that limited arbitrage potential exists for short-term investments in most long-term tax-exempt bond issues. This exception should also be broadened to include both governmental and private activity bonds and both acquisition and new construction of capital projects. A rarely-used election to pay a penalty in lieu of rebate should be removed. A de minimis rule for minor amounts of unspent bond proceeds should be added. This 3-year rebate spending exception would provide meaningful administrative relief from complex arbitrage calculations and related burdens to a broad number of tax-exempt bond issuers. This exception could be limited to fixed rate tax-exempt bonds in recognition of some possible arbitrage potential with short-term floating rate bonds.

B. Increase the Small Issuer Exception to the Arbitrage Rebate Requirement from $5 Million to $25 Million and Remove the General Taxing Power Condition

Present Law. A small issuer exception to arbitrage rebate applies to governmental units with general taxing powers that reasonably expect to issue not more than $5 million in tax-exempt bonds (excluding private activity bonds and most current refunding bonds) in a calendar year.

Reason for Change. The size of this small issuer exception to rebate should be increased from $5 million to $25 million in recognition of the dramatic increases in capital costs since the enactment of this exception in 1986 and the disproportionately-broad relief from this change. The increased size of this exception will substantially reduce the administrative burden imposed on a large number of small issuers while affecting a disproportionately smaller amount of tax-exempt bond dollar volume. In 2003, tax-exempt issuers of $10 million or less of bank purchase qualified bonds represented about 32% of the total number of like bond issues but only about 4% of tax-exempt bond dollar volume. Further, the general taxing power constraint unfairly narrows the use of this exception for many common tax-exempt bond programs. This exception should be broadened to cover other State or local governmental entities eligible to issue tax-exempt bonds which lack general taxing powers.

C. Add an Exception to the Arbitrage Rebate Requirement for Equity-Funded Reserve Funds

Present law. Although present law limits the amount of tax-exempt bond proceeds that may be used to fund a debt service reserve fund to 10% of the bond proceeds, the arbitrage rebate requirement nonetheless continues to apply to debt service reserve funds for most bond issues. The rebate requirement will continue to apply to these reserve funds throughout the term of the bonds even if all other bond proceeds are spent promptly under a rebate spending exception.

Reason for Change. Most tax-exempt bond proceeds typically are spent within the first several years. During the remainder of the term of the bonds, the ongoing costs and administrative tracking burdens of the arbitrage rebate requirement result mainly from debt service reserve funds. These reserve funds remain unspent (except to pay debt service on the bonds in the event of unforeseen financial difficulties). To relieve these administrative burdens, an exception to the arbitrage rebate requirement should be created for debt service reserve funds that are funded from sources besides tax-exempt bonds. This change would provide an incentive to issuers to reduce the size of tax-exempt borrowings.

II. SMALL ISSUER BANK BOND PURCHASE EXCEPTION

Increase the Small Issuer Bank Purchase Exception from $10 Million to $25 Million and Conform it to the Parallel Small Issuer Exception to the Arbitrage Rebate Requirement

Present law. *Banks generally cannot deduct interest on loans used to carry tax-exempt bonds. A small issuer bank purchase exception allows banks to deduct these carrying costs for purchases of tax-exempt bonds issued by certain small issuers which issue not more than $10 million in tax-exempt bonds (excluding private activity bonds and most current refunding bonds) in a calendar year.*

Reason for Change. This small issuer bank purchase exception aims to preserve the ability of small issuers, with limited access to the capital markets, to place bonds with local banks. The size of this exception should be increased from $5 million to $25 million in recognition of the dramatic increases in capital costs since the enactment of this exception in 1986 and the disproportionately-broad relief from this change. The slightly different eligibility requirements for this exception and the small issuer exception to arbitrage rebate (a trap for these unsophisticated issuers) should be conformed with a single, simplified definition of a "small issuer." Moreover, increasing this exception would provide access to bank purchasers for a disproportionately large number of issuers while affecting a comparatively small amount of bond dollar volume. Despite the increase in state bond banks and pooled loan programs, many states have no such programs. Many small issuers still rely heavily on local banks as their main financing source. Also, for bond-financed loan programs, an issuer should be permitted to elect to treat each conduit borrower as the issuer of a separate issue under this exception.

III. SIMPLIFY RULES FOR GOVERNMENTAL TAX-EXEMPT BONDS

A. Repeal 5% Unrelated or Disproportionate Private Business Limit on Governmental Bonds

Present law. If private business use is unrelated or is disproportionate to the governmental use of tax-exempt bond proceeds, then a more restrictive 5% private business use restriction applies to tax-exempt governmental bonds instead of the general 10% private business restriction on such bonds.

Reason for Change. The unrelated or disproportionate use test is cumbersome, vague, arbitrary, and especially complex in multiple-project financings. Out of an abundance of caution, some issuers automatically reduce their otherwise-permitted level of private business involvement from 10% to 5% to avoid the interpretative difficulties of this requirement. The general 10% private business use limit effectively controls excess private business use of governmental tax-exempt bond issues.

B. Repeal Volume Cap Requirement for Governmental Bond Issues with a Nonqualified Private Business Amount in Excess of $15 Million

Present law. Tax-exempt governmental bond issues are subject to volume cap for private business use or private payments that exceed $15 million, even if it is within the general permitted 10% threshold.

Reasons for Change. This special volume cap requirement has no sound tax policy justification in traditional governmental tax-exempt bond issues. The general 10% private business limits adequately address the level of private business involvement in traditional governmental tax-exempt bond issues.

C. Modify Private Loan Financing Limit on Governmental Bonds

Present law. If more than the lesser of 5% or $5 million of the proceeds of a tax-exempt bond issue are used to finance a loan to a private person, the bonds generally are treated as private activity bonds (even if there is no private business use).

Reason for Change. The private loan test should be modified to be a straight 10% limitation that corresponds to the general private business limitation. The Federal tax distinction between a "use" and a "loan" of bond proceeds is complex. The main intent of the private loan test was to limit the use of proceeds to finance non-business loans (e.g., consumer loans), such as single-family housing and student loans. The existing provision inappropriately could be interpreted to impose an additional, lower private business restriction on loans made to private businesses.

IV. ALTERNATIVE MINIMUM TAX

Repeal the Alternative Minimum Tax Preference on Private Activity Bonds

Present law. Interest on qualified tax-exempt private activity bonds is excluded from Federal gross income but is included in a bondholder's tax base for purposes of the Federal alternative minimum tax.

Reason for Change. The repeal of the alternative minimum tax preference on tax-exempt qualified private activity bonds will simplify the tax-exempt interest ex-

clusion, enhance market demand for these bonds, and increase market efficiency. Private activity bonds that are subject to the alternative minimum tax carry a punitive higher interest rate. This higher interest cost adds to Federal tax expenditures without a corresponding increase in Federal tax revenues because investors subject to the alternative minimum tax generally do not purchase these bonds. The increased demand for tax-exempt private activity bonds from this proposed change should have the effect of lowering the interest rates on private activity bonds by an estimated 10 to 25 basis points and a positive Federal revenue impact.

V. ADVANCE REFUNDING

Permit One More Advance Refunding of Governmental Bonds and Qualified 501(c)(3) Bonds

Present Law. In general, issuers of tax-exempt governmental bonds (i.e., excluding most private activity bonds) and qualified 501(c)(3) bonds are provided one "advance refunding" for new money tax-exempt bond issues issued after December 31, 1985. Here, an "advance refunding" means an issuance of refunding bonds used to refund or refinance other bonds ("refunded bonds") where the refunding bonds are issued more than 90 days before the redemption of the refunded bonds.

Reason for Change. Presently, because State and local governments and Section 501(c)(3) exempt organizations generally have only one opportunity to advance refund their debt, they are put in the inflexible position of having essentially to guess when would be the optimum time to do that advance refunding to achieve the lowest net borrowing costs. These entities should be allowed one additional advance refunding to give them more flexibility to lower their borrowing costs, to restructure their debt service payments, and to incorporate more flexible and modern financing techniques. Debt service represents one of the most significant items of operating expense for these entities, and they need more flexibility to enable them to finance the nation's public infrastructure at the lowest possible cost.

Madison, Wisconsin 53703
June 22, 2005

Dear Chairman Thomas and Committee Members:

I am writing to ask for your support and would appreciate your taking a moment to read this. I feel compelled to increase your awareness about an issue which is causing devastation amongst many taxpayers; the inequitable taxation of individuals via the Alternative Minimum Tax (AMT). This has become a particularly critical issue for our family.

I'm currently 43 years old and have worked very hard for 9 years for a start-up Internet Service Provider that was successful. In 1999 I left the company to move back to Wisconsin to be with family and raise my own family. When I left the company I was required to exercise my stock options (WorldCom stock).

Doing so caused us to incur an AMT liability well in excess of $1million, which we paid in April 2000. It's now well known that the WorldCom stock lost virtually all its value. Our AMT tax payment is now a credit that we can never effectively use because the ways in which we can draw it down are too restricted. In essence, we've lost almost all of our investment money simply to create a tax credit in our IRS account. It is fundamentally unfair to have been forced to pay a large AMT bill on a phantom gain rather than an actual gain.

Along with many of my co-workers, friends and family, I now find myself in this situation, many others are much worse off. Several of us had to declare bankruptcy and others are forced to sell or liquidate assets (including college funds, savings, cars, 401k/IRA pension plans, homes, etc.) or to refinance homes to help pay the taxes. In our case, we're hardworking, honest taxpayers who are incurring financial difficulties due to the unintended consequences of the AMT laws.

To summarize, it's fundamentally unfair that we have provided the government a substantial (over 1 million dollars) interest free loan that will never be repaid while we're having to defer college and retirement savings. Further aggravating the unfair situation, the complexities of the AMT law require us, an average middle-class family, to pay premium accounting fees to navigate the complexities of our tax situation.

We respectfully ask that you further investigate the disastrous consequences of the Alternative Minimum Tax and please support all efforts towards reform.

Shari Galitzer

Aloha, Oregon 97007
June 22, 2005

To Honorable Chairman William M. Thomas and House Ways and Means Committee—Tax Reform Hearing

Dear Chairman Thomas and Committee Members:

We are Liles and Naomi Garcia and we are homeowners. Liles was in the Air Force for four years, and has worked for three high-technology companies for a total of thirty years. Naomi has worked for a high-technology company, Tektronix, for thirty two years. When Liles was working for PMC-Sierra, Inc, the company gave him some stock options which often occurs in high technology companies. At the end of September, 1999, PMC-Sierra laid off some employees and Liles was terminated at this layoff.

There was no warning of the PMC-Sierra layoff; it was a complete surprise. Because of the layoff termination, Liles had to purchase his stock options within a short period of time or else lose them. At that time the stocks were worth about $965,000.00, and when Liles purchased his stock, we unknowingly incurred a $273,000 Alternative Minimum Tax. We have been doing our own income taxes for many years, and did not know what the AMT was.

We submitted an Offer-in-Compromise to the IRS in July, 2001. The IRS rejected our OIC and an OIC Appeals Officer told us that he would only settle for the entire amount. This decision devastated both of us because of the large amount that we will be required to pay. We are currently making monthly payments to the IRS, but we still owe more money than we will ever be able to pay. The IRS can take everything that we have through their collection process. To us, this does not seem right. Many thanks for any help that your committee can give us.

Sincerely,

Liles and Naomi Garcia

Southbury, Connecticut 06488
June 21, 2005

Dear Chairman Thomas and Committee Members:

As a 64 year old retired taxpayer the current alternative minimum tax is of great concern. Each year more and more Americans fall prey to this unfair tax. Approximately five years ago, because of the ISO AMT provision, I incurred a huge federal and state tax bill, which I paid. **The year following my huge tax overpayment my accountant informed me that I would have to live another 60 years to recoup my AMT credit.** This was hard for me to believe! Five years have since passed and I have reduced my AMT credit by about 8%. At age 64, I do not believe that I will last another 60 years. The Federal Government continues to hold my money without paying me one penny of interest. Once I leave this earth my AMT tax credit will become property of U.S. Treasury coffers. The credit will not be passed on to my heirs. Does this seem fair?

One thing that I do know is that my federal tax credit will follow me no matter where I reside in the United States. This is not true on the state side. If I move out of Connecticut I lose my ability to recoup my state AMT tax credit. This foolish law that was intended to prevent wealthy individuals from escaping federal income tax has become a burden to the all classes of taxpayers.

I would appreciate hearing from you on this matter and I please urge your leadership in righting this insidious aspect of AMT.

Sincerely,

Leonard P. Garille

Paso Robles, CA 93446
June 21, 2005

Dear Honorable Panel Members:

I am writing to let you know about the devastating effects the Alternative Minimum Tax (AMT) as applied to incentive stock options (ISOs) has had on my wife and I. ISO AMT has devastated our life, financial situation and our future. I would

respectfully request that part of your recommendation to the President and Secretary Snow be to work with my California Senators and my Congressman, the Honorable Bill Thomas, Chairman of the Ways & Means Committee to help quickly change this grossly unfair and unintended tax application.

My wife received stock options from her company as part of her compensation for all her hard work. Throughout the year in 2000, we saved money and used it to exercise the options. We considered the tax implications of selling or holding. We were advised and agreed to follow the strong tax incentives Congress put in place for ISOs to hold on to the stock for long term capital gain and support her company, rather than selling immediately and paying approximately $50,000 more in short term taxes. We believed strongly and still do in our company, and in the market for the long term, looking to accumulate stock and other assets for our future and for our eventual retirement.

In 2001, the market's steep decline reduced the value of our stock by over 90%. To make matters worse, we received a tax bill from the IRS and the California Franchise Tax Bureau (FTB) for a combined amount of close to $150,000. **This was over 5 times the amount we realized from our stock holdings.** We had never heard of the AMT, nor could we have ever imagined we would have to pay taxes on stock GAINS WE NEVER REALIZED.

Our situation grew steadily worse, I lost my job, our savings were dwindling quickly, and we started getting calls from IRS and FTB collection agents demanding that we pay the taxes due. We could barely pay our bills much less pay $150,000 in cash to the IRS and the State of California. The IRS had suggested an installment agreement, but the $3,800 a month they required was far beyond anything we could afford. We were also warned that if we accepted the agreement and missed or were late on a single payment, the full amount would be due immediately and collection actions would be taken, i.e. seizing of assets and property.

The IRS knew we never made the money on the stocks for which we were being taxed, but that didn't matter to them. They were aware I had been unemployed for 18 months, and they didn't care. They said I had the potential to earn, which in their mind is the same as cash.

Meanwhile, we tried to refinance our home to lower our payments so we could have additional money to pay bills, but the IRS had placed a lien on our property and we were denied the opportunity to take advantage of the lowest interest rates in history. The IRS refused to lift the lien, even temporarily, to allow us to refinance.

We were forced to hire tax attorneys and CPA's to help us with our predicament, all to no avail. We submitted an Offer In Compromise. We were rejected, the IRS claimed we had the ability to pay, even though I had been unemployed for over a year and a half and had been dipping into my home equity line of credit just to survive and pay our bills. For over three years we lived in constant fear of losing our home, our car, our bank accounts, everything. All the while dealing with harassing calls from the IRS and the FTB. My wife was afraid we'd be sent to prison for not paying the taxes. She had heard so many horror stories of what the IRS does to people who don't pay their taxes.

Having been an independent contractor for many years and using credit cards to pay for travel and business expenses, I had established a fairly high credit limit. The IRS told me that I had access to credit so PAY UP. I was forced into an installment agreement to keep from losing our home (the IRS had placed a lien on it). The IRS demanded $50,000 in cash and monthly payments of $730 per month to pay of the remaining $74,000. I was forced into putting it on my credit card. Since the IRS compounds interest daily, we will never be able to pay off the balance in our lifetime. Prior to that, we had been forced into an installment agreement with the FTB, paying $700 per month. There was no way we could pay both monthly payments, equaling over $1,400 per month (remember, I had been unemployed for 18 months), so we were forced into paying the remaining $18,000 balance due the FTB with my credit card to eliminate at least one of the monthly payments.

I was unable keep up with the credit card payments on an outstanding balance of close to $70,000. Now, I am several months behind on credit card payments. The credit card companies and collection agencies are now making threatening calls daily. I'm now getting letters from attorneys on behalf of the credit card companies. My credit rating, which was perfect all my life, is now ruined. This nightmare just keeps going on and on——

I'm 51 years old and I should be turning my thoughts toward retirement and a comfortable future. My own government has dashed these hopes and dreams forever. We are being punished in the worst way possible, and our crime? Our crime was working hard and being honest. I always felt that these were the values that

America embraced. Study hard, get a good education, get a good job, work hard, be honest and be rewarded. Unless relief comes quickly, I will have been sadly mistaken.

This law needs to be changed immediately to help the thousands of people who are in the same predicament as my wife and I. We hope that you will understand that there are some very good people who have been caught in the AMT nightmare and are facing financial ruin for the rest of their lives. Please show your leadership and do what you can to change this law.

Sincerely,

Mark Garner

Germantown, Maryland 20876
June 17, 2005

Dear Chairman Thomas and Committee Members:

My name is Mark Gorokhov and I am writing on behalf of my wife Nadezhda Gorokhova and our family. We appreciate the opportunity to discuss problems we faced due to an outdated and not fair portion of the tax code called Alternative Minimum Tax.

In August of 1998 I took a job as a software engineer at Celera Genomics. The offer letter stated that I was granted a stock option (ISO). The essence of employee stock options involves employees sharing in the future growth and success of a company by receiving financial rewards based on future increases in stock price. In 2000 I exercised my Incentive Stock Option. In plain English this mean that I bought my company stock at discounted rate $8.56 while its market value was in $70—$100 range. I did not have any monetary gain when I exercised my ISO because I did not sell my stocks. However, the tax law required us paying huge AMT tax on this phantom gain. This had dramatic impact on our family. The taxable income we reported on form 1040 in 2000 was $118,300 and a total tax was $153,458. This was a 130% effective tax rate which significantly exceeded entire our family income.

The deadline to pay this huge sum to IRS was April 15, 2001. By that time stock price plunged and we could not pay our tax even we if sell all stocks we acquired. We borrowed all available money from my wife's and mine retirement investments, from 2nd mortgage and credit cards. Also, we emptied all our assets on bank accounts. In year 2005 we are still paying loans we made to pay tax year 2000.

The tax we paid for exercised ISO stocks is a prepayment of tax with a corresponding Minimum Tax Credit that applies against capital gains tax when we sell stocks. Now when the stock price drops we do not have an efficient way to recover the leftover excess pre-payment of tax. Thus we gave the Federal Government an interest free loan in the sum of $125,717.

In 2001 tax return we recovered $2,433 from our AMT tax carry forward. At this pace it would take 51 years to recover the whole sum.

In 2002 tax rate was lowered, but AMT rate stayed the same. In 2002 tax return we recovered $820 from our AMT tax carry forward. At this pace it would take 149 years to recover the whole sum.

In 2003 tax rate was lowered again, but AMT rate stayed the same. In 2003 and 2004 tax returns we recovered $0 from our AMT tax carry forward. At this pace we NEVER recover the whole sum of credit we gave to a government.

We ask your help to change the outdated AMT tax law and help us to recover the AMT tax we paid in year 2000.

Mark Gorokhov

San Jose, California 95132
June 17, 2005

To: Honorable Chairman William M. Thomas and House Ways and Means Committee—Tax Reform Hearing

Dear Chairman Thomas and Committee Members,

I have been directly affected by AMT. I have worked for 18 years in California. During that time, I accumulated Incentive Stock Options from my previous employer, which I exercised at various times. The stock market dropped dramatically in 2001. Because of the current AMT tax laws, I was taxed based upon the value of his shares at the time I exercised them (approx. $60/share), not on what they are

worth when I sell them. The company I worked for and bought these shares in, Clarent Corporation, committed fraud and has since gone bankrupt and is out of business. As such, I have been unemployed since October of 2001. The stock is now all but completely worthless and I recently sold 12,080 shares at $0.05/per share and received $573. The stock currently trades at $0.045/share, yet I paid approximately $40,000 for the stock, had to get a second mortgage to cover a $91,000 AMT tax bill and am now paying $19 every day to pay off this loan, in addition to my first mortgage. To have had to pay a $91,000 tax on a LOSS of $40,000 is more than ridiculous. Further, should I regain employment and claim $3000/year off of my taxes, I will never live long enough to use my tax 'credit', minus of course the interest I will have paid over the life of the second loan. I was also subject to trading windows where selling the stock was prohibited for six months, only open to trading three weeks out of every quarter, and the government encouraged me to hold on to the stock for at least one year for long-term capitol gains. Even though I have owned my house for 13 years and was paying my 30-year mortgage off at a 22-year rate, I now owe over $80,000 more then when I first purchased my house in 1991. I am one of literally thousands in this country right now who are in a similar or worse position.

The citizens affected by the AMT are not looking to avoid taxes, only to pay their fair share. Please work to retroactively reform the tax code regarding the AMT. Changes to this law must be made now in order to save the savings, homes and futures of many families. These are people working on the cutting edge of technological industries that will be our future—their success will be our success. Please help.

Regards,

Howard Greenstein

Arlington, Tennessee 38002
November 7, 2005

The Honorable Marsha Blackburn
7975 Stage Hills Blvd, Suite 1
Memphis, TN 38133

Dear Honorable Blackburn:

I want to first thank you for dedicating your time to serve in public office. Holding public office in America today is very tough with all of the media pressures, and I appreciate all that you do for us. I am writing today about the Alternative Minimum Tax (AMT). This tax is new to me and I have tried to understand it, but it is far too complex for the average college graduate to understand. Luckily, I have not been personally affected by this tax, yet. But I am researching it because I fear it is only a matter of time before it rears it's ugly head and affects my family. As a married woman and the primary wage earner in the household, taxes are something I have to consider on a very serious matter, and this tax scares me. Mainly because it is talked about so much by average wage earners like myself. We are middle class, college degreed, business persons that have no clue how to calculate the tax and all the research says is it is too complex to calculate, just hope you are not hit with it.

From the research I have done on the tax, it is affecting more and more average middle class American's every year it stands unreformed. Taxes are eating us alive, literally. I believe with your record as a representative and looking at the way in which you have stood on issues in the past, this was an issue I should bring to your attention, if you are not already aware of it. To quote SmartMoney.com, http://www.smartmoney.com/tax/filing/index.cfm?story=amt, the people that are especially vulnerable today are those that make $75,000 or more annual income, that income used to seem like a millionaire's income, not anymore. As the price of inflation increases, so does the annual income of households, therefore, along with those increases we, also need to increase the tax brackets.

Of all the pervasive impacts of AMT the tax as it applies to stock options seems to be the must unfair and punitive, to see exactly what I mean please visit WWW.ReformAMT.org

Please take the time to read about the AMT to make your own decision. This tax is affecting more and more American's as each year goes by that it is not revisited and reformed. Thank you for taking the time to read my letter.

Sincerely,

Kayla D. Griffin

San Diego, California 92102
June 17, 2005

Dear Chairman Thomas and Committee Members:

In 1998 I started working for a company called Ask Jeeves as a project manager. Although it was a mid-level management position, my compensation package included a very generous grant of 75,000 options at $0.26 per share. The terms of this grant were standard for the industry: After one year of employment I would receive one quarter of my shares. From that time forward I would receive monthly blocks of shares until I either left the company or ran the course of my four-year grant and vested all 75,000 shares.

Prior to Ask Jeeves' IPO, I sought the advice of both my accountant and company-internal experts regarding my shares. Both recommended that I take part in a special program that allowed employees to pre-purchase shares—**even shares that had not yet vested,** as was the case for me. My risk? If I left the company before I vested all of my shares, I would lose those shares that I had pre-purchased but had not yet vested. My upside? Buying then holding onto my shares for one year afforded me a long-term capital gain rather than a short-term capital gain. As the stock market was going up at the time, my future looked bright.

In the spring 1999, I borrowed nearly $20,000 to buy all of my shares. On the day that I purchased all of my shares, Ask Jeeves' stock was trading on the open market at $42 per share. Little did my accountant or I realize, the moment I pre-purchased all of my **still unvested shares** I incurred a huge tax liability. $560,000 to be exact.

As strange as it seems, I owed taxes on shares that I had not yet vested—shares that I had no legal right or ability to buy or sell. But that was the law under AMT.

By September 1999, I vested my first chunk of shares. At that time the stock price was still rising, and I would have been able to pay my tax liability. Unfortunately I was precluded from selling any of those shares because of an SEC-mandated, sixth-month post-IPO lockout. Because of this SEC-mandated lockout, I would not be able to trade until January 2000. Unfortunately for me, by the time January 2000 rolled around my accountant—who had no experience with stock options or AMT—still did not know that I would owe $560,000 in taxes. Additionally, I was still locked out of trading—this time because of quarterly earnings statements.

In 2000, the IRS stalked and threatened me. Under threat I sold all of the shares that I could whenevers small windows of trading opened (usually just two weeks per quarter, again due to earnings announcements). At the end of 2000 Ask Jeeves shares were in the doldrums. It was obvious I couldn't vest quickly enough to continue making my $10,000 per month payments to the IRS, and my IRS representative knew it. He informed my new accountant that they would no longer accept payments, and that I needed to pay the nearly $100,000 remaining immediately.

Remember, I was salaried at around $75,000 / year at this time. A good living to be sure, but I was not wealthy.

Desperate and in despair, I seriously contemplated suicide. Police officers were called to my home after I left a particularly dark message on a friend's answering machine. Although I was extremely embarrassed, my friend was right to call. I was truly on the edge of ending the deep pain of my complete financial failure. I was on anti-depressants just to maintain a semblance of hope about life. I thought that I might get out of the situation by getting a better paying job, which I did, but it still didn't afford me any greater negotiating power with my assigned IRS representative. The IRS told me that they would place a lien on my property—a Honda CRV (I owned nothing else)—and start proceedings to garnish my wages. My credit would be ruined, my shame complete.

In December 2000, under the advice of my new accountant, I made the most humiliating call of my life. It was to my brother and sister-in-law. I will always owe them the greatest debt for the compassion they showed me when I requested a nearly $100,000 loan to cover my remaining liability: "We'll wire it to you tomorrow," my sister-in-law said.

My husband and I are lucky. We are young; we hadn't bought a house yet; we have no children; we had family members who could help us. We made it through, and are now living happy, healthy, and productive lives in San Diego. We are also, by the way, active contributors to the U.S. economy and tax coffers, filing a combined household income in 2003 of nearly $240,000.

Despite more recent threats from the IRS regarding so-called "frivolous" claims,my husband and I are pursuing legal action. We hold no hope of recovering any of the money I paid to the IRS, nor do we hold any hope of recovering the

$22,500 in legal fees. We only seek two things: To make a statement to the U.S. Government that we will not be bullied, and to prevent others from falling prey to the AMT through legislative action to repeal this unfair and unethical law.

Lauren Guzak

Orland, California 95963
June 17, 2005

Dear Chairman Thomas and Committee Members:

The current AMT law and how it is applied to stock options specifically has had a devastating impact on my family and our financial future.

In 1998 I was given stock options as part of my compensation package at a small start up company for $2.00/share. My company had a provision that allowed the employee to purchase the options before they were actually vested. I did not have enough cash to purchase my options prior to the company going public and was not comfortable taking out a loan to purchase the options.

When my company went public the fair market value of our stock was already $24/share. I purchased my first block of shares the day we went public and incurred the AMT on the delta between my option price and the FMV of the stock on the day I purchased it.

The stock priced soared over the next several months, split twice and reached a maximum value of $198/share. I purchased two more years of my options and signed an 83-b form when the stock was trading at around $70/share. The purchase triggered the AMT and for tax year 2000 my AMT income was over $1.5 million dollars. The stock continued to rise until late summer 2000, so I felt confident in my decision to exercise my options at the $70 FMV.

Like most high tech stocks, my companies stock started to plummet in the fall of 2000, by December of 2000 the stock had dropped below the $70 mark. I got a phone call from my accountant late in December and they suggested I sell my options before the end of the calendar year in order to avoid the huge AMT liability. Unfortunately, I was not able to sell because I was in a stock trading black out period which lasted through the first week of January 2001.

Once the black out period lifted, we started to sell the stock in order to cover our tax exposure. We were forced to sell many shares just a few weeks before we had satisfied the holding periods that would have qualified us for the most favorable taxation, but since the stock was by then trading below $40/share we decided to try to cut our losses. Over the course of the next few months we sold most of our vested options for an average amount of $30-$35 a share.

We did not have enough money to pay our 2000 AMT of $700,000, so we hired lawyers to try to work out an offer and compromise with the IRS. To add insult to injury, I was laid off from the company prior to vesting in large amount of the shares I had purchased in 2000. The company repurchased my unvested shares, but of course the tax liability was still mine since the repurchase was not in the same calendar year of the purchase.

We have been negotiating with the IRS for more than four years now and with interest and penalties now have an unpaid tax bill of over $1.2 million dollars.

Karen Hamerquist

Statement of Kathy Hamor, the Savings Coalition of America

On behalf of its 75 member organizations, the Savings Coalition of America ("Coalition") is pleased to submit these comments to the House Committee on Ways and Means concerning the need to simplify the federal tax code. The Coalition is extremely encouraged by the Committee's initiative towards tax simplification.

The Savings Coalition of America was established in 1991 to support incentives to increase the level of personal savings in the United States. It has actively supported the expanded Individual Retirement Account (IRA) provisions that increased contributions to spousal IRAs from $250 to $2000 in 1996; the increased income limits for IRAs and the establishment of the Roth IRA in 1997; and the recent increase in contribution limits for IRAs and the creation of catch up contributions in the 2001 tax bill.

The Committee's hearing focuses on fairness, simplicity and impacts on groups. While there are many aspects of the current system to be addressed, the Savings

Coalition of America brings to your attention the provisions of the tax code that concern income eligibility for making contributions to IRAs and required minimum distributions from IRAs. Both are unnecessarily complex, unfair and distort personal financial decisions for Americans.

In 2001, the Congressional Joint Committee on Taxation made recommendations for tax simplification in which it recommended the elimination of income limits on all IRAs and the elimination of the age requirement for minimum required distributions and described the complexity surrounding these sections of the tax code. The Coalition shares the view that these sections of the tax code are complex and confusing and urges the Committee to review them.

Required Minimum Distributions

Under present law, Americans who reach age 70½ are required to begin taking distributions from their IRAs. This is one of the most complex areas of tax law affecting retirees. For this reason, the staff of the Joint Committee on Taxation has recommended that the age limit for minimum required distributions be eliminated. One unintended consequence of the requirement is that individuals may be forced to take a distribution at a time when their investment has declined in value. Over the past several years, many retirees and workers about to retire have seen a drop in the value of their retirement nest eggs. Those subject to the requirement may be forced to realize losses on part of their investments at a time when they can least afford to do so. The minimum required distributions rules merely determine when taxes will be imposed on retirement savings, not if. When the IRA owner withdraws funds, it will be taxed as ordinary income.

In addition, tax reform should take into account such things as a longer life expectancy for most Americans. For example, as Americans live longer, we have learned that the minimum required distribution rules have become more burdensome and need to be eliminated or at the very least, changed to reflect gains in life expectancy.

Universally Available IRAs

Currently the tax code has a number of income limits for eligibility to contribute to IRAs. In addition to different income limits for single and married Americans, there are different income eligibilities for the traditional, deductible IRA, the Roth IRA, the nondeductible IRA and conversions from the traditional to the Roth IRA. Income limits for the Coverdell Education Savings Accounts add further confusion. The lesson that we learned in the early 1980s, when IRAs were universally available to all Americans, is that more Americans saved. The universal eligibility led to mass marketing of these savings vehicles, which increased participation. When income limits were imposed after the Tax Reform Act of 1986, there was a precipitous drop in contributions to IRAs. The 1986 experience teaches us that limiting IRA eligibility based on income confuses people and scares them away from establishing a pattern of savings that IRAs would otherwise promote. One of the most important effects of the IRA cutbacks in the Tax Reform Act of 1986 is the fact that IRA contributions *for those who continued to be eligible for deductible IRAs* dropped by more than 40% in the first year and have since dropped by over 65%.

Members of the Savings Coalition believe that eliminating income limits and creating a universally available IRA will help more Americans save. An IRA that is universally available to all American workers would leave no doubt to their understanding of their eligibility. Universally available IRAs will be marketed and advertised on a massive scale and this advertising will have an ancillary benefit of educating people about the need to save. History demonstrates that the simpler it is to save, the more Americans are inclined to save.

Annual income limits are also unfair to taxpayers with fluctuating income. For many people, income fluctuates from year to year. A universally available IRA ensures that these individuals can make IRA contributions in the good years—the years in which they actually have the financial resources to make a contribution. This is particularly important for the self-employed and for individuals in cyclical industries like farming. It simply is not fair to these people to say you can have an IRA in the years that you don't have the resources to contribute, but if you have a good year then you can't have an IRA. Moreover, the uncertainty over whether an individual will be above or below the income limit tends to force potential savers to wait most of the year before determining whether or not to contribute, thus reducing the power of compounding interest. Americans tend to err on the side of caution, so an individual worried about possibly bumping up against the eligibility limit is more likely to skip saving altogether.

Another area of confusion with income limits are the restrictions, for joint filers, around contributing to an IRA and deducting it is limited by participating in an em-

ployer plan in addition to income. If one spouse is covered by an employer plan and the other is not, as long as their income is below $150,000, the non-covered spouse is eligible to make a deductible traditional IRA contribution. If they are both covered, then the phase out is in place which eventually will be between $60,000 and $80,000. For making a Roth IRA contribution, income is considered. Over the limits the person simply can't make a contribution. Also, if a person is not covered, or both spouses are not covered by an employer plan, then there is no income limit to making a deductible traditional IRA contribution. This adds a layer of complexity and confusion to already complex eligibility requirements which can have the result of reducing Americans savings in these important savings vehicles.

In the end, income limits hurt all Americans. Right about the time someone starts getting interested in setting up a new IRA, they hear a disclaimer that only certain individuals are eligible for IRAs and that they should immediately check with an advisor to see if they qualify. That just scares people, especially middle income families that most need to start the retirement savings habit. They automatically assume that they are one of the ones that are excluded. Or they decide not to start the pattern of saving in an IRA every year because they will assume they won't be eligible next year and that, as a result, it is just not worth the trouble. And, in a vicious circle, that taxpayer confusion and uncertainty will lead to substantially less advertising that will probably not be sufficient to change Americans' savings attitudes.

Members of the Savings Coalition of America feel strongly that tax reform should encourage Americans to take more responsibility for their retirement. One way in which this can be achieved is to promote values that we all share; such as savings and thrift. When it comes to savings, our tax code should encourage Americans to save for their futures and make it easier to do so. The variety of income limits for current tax-favored savings vehicles are cumbersome and confusing and we encourage the Committee to recommending substantial simplification in this area. Provisions that encourage individually responsible behavior such as savings should apply to all Americans. Our current tax-favored savings vehicles already limit the amount that can be saved. We should not limit eligibility of the people who can save through them. That just makes them more confusing and frankly, penalizes success.

The Savings Coalition supports the Committee's goals of simplifying the federal tax system and offers its assistance in this effort. We look forward to working with you on this important initiative.

Village of Lakewood, Illinois 60014
June 21, 2005

By way of introduction my name is Michael Hansen. My wife, two daughters and myself live in Lakewood, Illinois.

In July I will be 54 years old. The son of an auto mechanic I put myself through school and have worked hard and played fair my entire life. All in all, I was living the American Dream—up until I stepped on the IRS landmine in the form of the AMT treatment of ISOs back in 2000. Now I owe the government more than $750,000, my bank account was seized, there is a lien on my house and my wages are garnished.

As a model taxpayer I always had my taxes professionally prepared—same tax CPA for 16 years. Prudently, I consulted this firm BEFORE exercising my options in 2000. We agreed on an options exercise strategy and I followed it. What an incredible shock it was when in early 2001 my CPA informed me that I owed far more money in taxes than I realized in dollars! At that time (Mar 2001), this same accountant—and I swear this is true—took me into his private office and told me the following " I'll deny that this conversation ever happened but this AMT treatment of ISO options is totally unfair. I'll give you a tax return that treats the ISOs based on the money you really made, I just can't sign it". My response to Mr. Joyce was "you charged me $7,200 for tax advice including exercising my options and tax preparations and now your best advice is to commit a felony?" He responded that "if you pay on what you realize you'll never get audited." I told him that I had no intention of doing anything like filing a false return and that furthermore I was no longer a client of his firm!

I immediately started seeking a tax lawyer—that took a considerable amount of time. I was stunned when the first several firms I contacted had NO IDEA SUCH TREATMENT WAS IN THE TAX CODE! I contacted the office of my Congressman, Don Manzullo—they hadn't yet heard of the AMT/ISO problem—my neighbor who was our State Representative actually scoffed at me claiming that what I was talk-

ing about was unconstitutional! Even practicing lawyers I knew through my church hadn't heard of anything like what I was describing.

Finally, I did find a tax lawyer who knew of this area of the tax code. He had my return once again prepared and filed per the code. At that time I owed the IRS $650,000—worse yet, the remaining stock that I had was unsellable as it would have generated an even worse tax problem (or to put it another way, I was in the 170% tax bracket)!!!

Then came 9/11/01—my unsellable stock kept decreasing in value. I finally was able to sell some to pay off the State of Illinois and, to date, $30,000 to my tax lawyer. The real laugh here is that the State of Illinois owes me roughly $28,000 per the perversion in the tax law—money that I'll never see!

Sure, my tax attorney and I tried the OIC route. The figure that the IRS suggested that they might accept is "only" equal to 100% of my gross wages for FOUR YEARS! That's some "Effective Tax Administration"!

Now I am strongly considering a bankruptcy. If you can't assure me of some REAL legislative relief I'll have to go that route because I fear if I wait to file the new bankruptcy legislation will not help my struggle to return to a normal life.

Even though I have paid well over $150,000 towards my 2000 Federal Tax bill the interest and penalties increase faster than I could ever match—much yet repay in full.

Please don't think that I'm some sort of millionaire—even when money was plentiful I didn't buy a "McMansion", Rolex watches or jewelry, an Aspen ski chalet, etc, etc. I did however get my eyes fixed, supplied food and housing for a single mother with 3 children so she could attend school for 3 years (she's now a respiratory therapist!) and helped start a new church that I'm proud to say is now the spiritual home to more 400 families.

Of course, there is much more to my story—and the stories of thousands of honest Americans who face this monstrosity of the tax code with integrity and courage. However, I also ask relief not only for the victims of the AMT/ISO trap, but for the many good and decent IRS employees who have little choice but to enforce the law as it is written—if our positions were reversed, I'd resign, but I haven't "walked a mile in their shoes".

So Congressmen, stand tall, right this wrong! We love our country, always pulled more than our own weight and played fair—now is the time for our government to play fair with us!

Sincerely,

Michael C. Hansen

San Diego, California 92129
March 17, 2005

In 2000, few people were even aware of the AMT, and even fewer understood it, including many tax professionals and even some IRS agents. When I exercised Incentive Stock Options in 2000, I followed the standard recommendation of holding that stock for one full year to achieve the capital gains treatment for which Incentive Stock Options had originally been designed. Imagine my surprise when I discovered that there was a parallel universe called the AMT, where the rules were opposite of common sense and regular IRS rules, and instead of benefiting from long term capital gains treatment like an ordinary stockholder, I was penalized for NOT selling my stock.

As a result, my effective tax rate for 2000 was almost 250% and left me with state and federal tax obligations well over $300,000. This was impossible to pay because it was many times my annual income and the stock had dropped to a fraction of its former value. Although I have made payments against the debt, it grows too rapidly to ever pay off.

The irony is that the AMT also allows a credit back to me that would offset this liability—but there is a cap on the amount of credit I can recover each year—it will take over 90 years for me to gain the entire credit back, and unlike my AMT liability to the government, I receive no interest on the money owed back to me by the government. So my debt grows by leaps and bounds and the government holds my money interest-free indefinitely.

I have offered all the equity in my 1500 square foot home, my car, my life savings, and my retirement to settle this—everything I have managed to put aside over my entire working life to pay arbitrary and excessive taxes on profits I did not receive (by the way, the IRS refused this offer as insufficient). Actually, after paying over $100,000 so far, I have only about $11,000 left out of my savings/retirement and the

IRS has a lien on my house, which also serves to ruin my credit. I am 52 years old and have been a compliant taxpayer since I earned my first dollar, paying in full and on time, without complaint, but I fail to see how bringing an honest middle-class taxpayer to financial ruin serves any purpose.

Legislation is being introduced that would allow me to pay the proper percentage of whatever gains were actually realized from the stock sale. While I realize the entire AMT needs to be addressed, the first logical step would be to support relief for those who have suffered the most unfair and egregious effects of this outdated law. Please stop the unnecessary financial crippling of some of your most hard-working and productive citizens. We can't wait two or three more years—we are losing our homes, our retirement, and our entire economic futures today!! There is no way a "fix" several years from now will ever allow us to recover.

The AMT no longer serves its intended purpose, if it ever did, and is increasingly punishing hard-working families. We respectfully ask that each of you understand the enormous risk involved in ignoring this growing malignancy in our tax system, and take action now.

Sincerely,

Angela Hartley

Statement of David A. Hartman, Lone Star Foundation, Austin, Texas

Introduction

The current series of hearings by the House Ways and Means Committee on federal tax reform could not come at a more appropriate time. The U.S. manufacturing sector is in a state of crisis that threatens its very survival, principally due to a federal tax code that handcuffs U.S. competition with foreign produced goods.

I urge you to use these hearings to put the public spotlight on the border adjustable (destination based) value added taxes of all U.S. foreign competitors which have no counterpart in the federal tax code. The result is a 15 to 25 percent price advantage for foreign goods as imports to the U.S., and against U.S., exports to foreign markets. While consumption based tax reform could assist competitive U.S. taxation, it will not suffice without border adjustment.

This submission is based on *The Case for Border Adjusted Federal Tax Reform Via the Business Transfer Tax,* a paper recently presented to the American Enterprise Institute. My presentation plus debate of its findings by Dan Mitchell of the Heritage Foundation and David Burton of the Argus Group can be viewed at www.aei.org, the AEI website. It presents the virtues of a border adjusted subtraction method value added tax as the vitally needed competitive response to foreign VATs. It further constructs a more efficient and equitable basis for consumption based comprehensive tax reform replacing progressive income taxation with a 17.5 percent BTT and rebates to prevent regressivity on a tax burden neutral basis. It may prove necessary to patiently undertake at this time only the first fundamental step, comprised of a tax neutral replacement of the corporate income tax and the employers' share of social insurance taxes with the BTT. However, when one considers its virtues of border adjustable, compatibility with the trend to VAT taxation worldwide plus its simplicity, economic efficiency and equity compared to progressive income taxation, the BTT will be found to be the optimal basis for comprehensive tax reform.

The Lone Star Foundation and its predecessor, Texans for Responsible Government, have been undertaking visionary studies for reform of state and federal taxation since 1990. Papers on federal tax reform have included *Priorities for Taxation of Capital* presented to the House Ways and Means Committee; design, editing and sponsoring of the Institute for Policy Innovation's *RoadMap to Tax Reform* series; co-sponsoring with the Heritage Foundation a series of papers on federal tax scoring currently being published; and *Comprehensive Federal Tax Reform by the Business Transfer Tax* presented to the President's Panel on Tax Reform. Other publications in Tax Notes have included *The Urgency of Border Adjusted Federal Tax Reform,* and *The Strategic Steps to Tax Reform.*

Summary of the Case for the Business Transfer Tax

The U.S. manufacturing sector is in critical decline due to inability to compete with foreign producers and U.S. production relocated abroad. The U.S. currently has a trade deficit totaling 6 percent of GDP, reflecting a deficit with virtually every trade competitor and in every class of goods. The U.S. now produces only $2 worth of every $3 of goods Americans consume.

The precipitous decline of manufacturing employment's share of U.S. employment is a principal cause for declining middle and blue collar share of U.S. incomes. Just since 1998 manufacturing employment has declined 20 percent, the worst layoff since the Great Depression. Despite doubling manufacturing productivity since 1978, the real factory wage has declined 11 percent. A similar trend to manufacturing appears to be developing in the business services sector due to foreign outsourcing, although not yet as severe.

The U.S. manufacturing crisis began soon after foreign replacement of radically reduced tariffs with border adjusted value added taxes (VATs) on tradable goods not provided U.S. manufacturers by the federal tax code. Starting with France and the EU, all OECD competitors have adopted VATs averaging 18 percent abated on their exports to the U.S., and 18 percent levied upon imports from the U.S. not matched by abated U.S. taxes. The transition from U.S. trade surpluses in goods to huge deficits coincides with previous adoption of border adjusted VATs, by foreign competitors which in effect replaced tariffs.

The Importance of Replacing the Income Tax with a Business Transfer Tax

The relentless growth of the U.S. trade deficit has *not* provided evidently beneficial investment of the resulting "foreign capital surplus". Virtually all foreign investment has been in *existing* rather than *new* productive assets; instead, the U.S. trade deficit has been reflected in excessive consumption at the expense of U.S. saving for investment.

The U.S. trade deficit will not be successfully resolved without border adjusted federal tax reform which equalizes competitive terms of foreign taxation. This 18 cents on the dollar advantage for foreign producers cannot be overcome by innovation and productivity given the rapid rate of diffusion abroad (and by U.S. firms which move abroad) or by devaluation. Nor will devaluation of the dollar provide more than temporary relief at an excessive price. What is required is border adjusted and consumption based federal tax reform if the U.S. is to restore competitiveness.

The Business Transfer Tax is the most efficient and competitive alternative for federal tax reform. As a tax on the entire Gross Domestic Product after expensing of Private Commercial Investment and on Imports, but not on Exports, it will restore competitive U.S. terms of trade for U.S. manufacturers as well as territorial taxation of corporations to restore the U.S. as the preferred location for **The Importance of Replacing the Income Tax with a Business Transfer Tax** headquarters. A 17.5 percent BTT will replace all federal income taxes, including personal, corporate, employer share of social insurance, and the "death" taxes; except for personal share of social insurance. Rebates will replace exemptions, deductions, and credits in order to prevent regressivity. Transition costs can be funded from making foreign trade subject to the BTT and from increased growth due to BTT tax reform.

The U.S. needs to confront the reality that since the industrial revolution all major powers have been leaders in manufacturing as the source of competitive advantage in growth of incomes, wealth, and military strength. Preservation and restoration of the manufacturing sector is vital to U.S. national interests, and adoption of border adjusted, consumption based BTT taxation is the vital condition for this remediation. The BTT is the optimal basis for fundamental federal tax reform enabling equitable and competitive taxation of consumption, growth of investment and income, and restoration of the U.S. economy as the leader of free enterprise and freedom.

The Importance of Replacing the Income Tax with a Business Transfer Tax

As the U.S. begins the Twenty-first Century it finds itself increasingly constrained by an uncompetitive and inefficient federal tax code. Confiscatory marginal tax rates adopted during the Depression and WWII which were successively reduced by the Kennedy and Reagan cuts stimulated resurgent economic growth, subsequently restrained by rising average income tax rates on capital. The rest of the world has heeded the effects of these tax cuts, and has entered an era of corporate income tax reductions being replaced by value added taxes and even isolated individual income tax reform not matched by the U.S., while the border adjusted feature of these value added taxes adopted by all U.S. OECD trade competitors have rendered the U.S. uncompetitive with world trade at home and abroad.

U.S. federal tax reform debated over the past decade to little avail has been initiated by President Bush's tax cuts, who now seeks fundamental reform of the federal tax code. Reform advocates define neutrality, transparency, and efficiency as the goals of tax reform by consumption based taxation, by an end to double taxation of saving for investment, and by lower marginal rates, all worthy objectives.

But it will be shown in this report that missing from these goals is the most pressing current urgency of tax reform, "border adjusted" (or, destination based) taxation to provide equal competitive terms of trade to the advantage of border adjusted value added taxes of all U.S. trade competitors in order to restore a competitive U.S. manufacturing sector.

Presentation of Findings

The U.S. manufacturing sector is in critical decline due to inability to compete with foreign manufactured goods.

U.S. manufacturing's share of GDP has fallen over 50 percent since the Fifties, and this decline in share has accelerated to less than 13 percent share of GDP since 1998. The U.S. has a growing trade deficit in goods with every principal country and in every category of goods except government subsidized aircraft—including agricultural goods. The result has been a "production gap" in manufactured goods which is over 6 percent of GDP; the U.S. now produces only $2 of every $3 of manufactured goods which it consumes. The annualized trade deficit in goods increased to three quarter of a trillion dollars by 1st quarter 2005, and the cumulative deficit from 1982 to present has converted the U.S. from the world's largest creditor to the world's largest debtor, with net foreign ownership of U.S. assets now approaching four trillion dollars. The National Association of Manufacturers (NAM) warned last year that "the country may be dropping below critical mass in manufacturing."

The continuation of the disintegration of the U.S. manufacturing sector threatens future progress and prosperity of the U.S. economy and loss of the most vital source of U.S. military security. Manufacturing has perennially been the leading sector in the technological progress which drives productivity across all sectors of the U.S. economy and enables superiority of defensive weaponry. The accumulating obligations from massive trade deficits is irresponsible public policy for a nation all ready facing unfunded multi-trillion dollar welfare obligations for "baby boom" retirees.

The precipitous decline of manufacturing employment's share of U.S. employment is a principal cause for the declining middle and blue collar share of U.S. incomes.

Employment in manufacturing as a share of U.S. employment has fallen over 60 percent over the same period, with a 20 percent decline just since 1998, the worst layoff since the Great Depression. The real average factory hourly wage, which traditionally had been the vanguard of "blue collar" compensation, declined 11 percent from 1978 to 2001. This decline took place despite a doubling of productivity in manufacturing, compared to an increase by one-half in the U.S. business sector as a whole. Laid off workers from manufacturing seeking reemployment in the highly price—elastic services markets have helped depress blue collar wages in general. The often cited increasing share of income enjoyed by the top 10 percent of incomes is not due to excessive growth of returns to physical and intellectual capital, it is because of the stagnation of middle and labor income. The retrogression from the 40 hour work-week for one breadwinner to the 80 hour two person work-week is now a necessity for the typical American family.

The U.S. manufacturing crisis began soon after foreign replacement of radically reduced tariffs with border adjusted value added taxes on tradable goods not provided U.S. manufacturers under the federal tax code.

Under U.S. international leadership, average tariffs of OECD members declined from 40 percent just after WWII to 4 percent on average at present; U.S. tariffs now average only 1.7 percent of imports' value. However, starting with France in the mid-Sixties, Europe sequentially adopted border adjusted value added taxes now averaging 19 percent, and all OECD countries other than the U.S. since have adopted VATs or equivalents averaging 18 percent. Consequently, U.S. goods carry a full burden of federal, state, and local taxes plus an added average of 18 percent VAT in foreign markets, and face foreign goods which enjoy 18 percent VAT abatement in U.S. domestic markets. The transition of the U.S. manufactured goods trade balance from surplus to deficit coincides with the successive conversions of foreign competitors to border adjusted taxes, which in effect have replaced tariffs.

A similar trend to manufacturing appears to be developing in the business services sector due to foreign outsourcing.

Growth of the historically positive trade balance in services has now flattened out and started to decline as well. Relocation of corporate headquarters of multinational corporations to secure lower corporate effective tax rates and territorial taxation of international income is adding to the loss of U.S. business services abroad.

Outsourcing is rapidly expanding in both professional and unskilled white collar services, with an estimated 14 million jobs possibly at risk.

U.S. services employees who are U.S. residents pay U.S. taxes, while those living abroad typically only pay taxes in the county of residence that uses their services. But the employees of outsourced services produced abroad serving U.S. producers are subject to no U.S. taxes.

The relentless growth of the U.S. trade deficit has not resulted in evidently beneficial investment of the consequent "foreign capital surplus."

Lured by bargain imports for consumption, personal saving as a percent of GDP has declined to post—WWII lows, as shown by comparable decline in personal saving as percent GNP to the increase of the trade deficit in goods. However, corporate saving has offset personal saving on average such that Gross Private Fixed Investment has remained relatively constant at 15 percent of GDP over this period. Reoccurring excessive federal deficits have been the additional principal reason for declining U.S. saving as a percent of GDP. The so-called "foreign capital surplus" has primarily funded excessive U.S. consumption and acquisition of existing assets; 96 percent of foreign investment in the U.S. has purchased existing assets, rather than new investment, while private fixed investment has not increased on average. The net growth of foreign held prime income assets and obligations funding consumption by "America for Sale" will result in further unfunded liabilities to be claimed as the "baby boom" retires.

The U.S. trade deficit will not be successfully resolved without border adjusted federal tax reform which equalize competitive terms of foreign taxation.

Given the effective VAT advantage of 18 cents on the dollar, the U.S. is the ***most profitable*** market for ***foreign producers***—and also for ***offshore U.S. producers.*** No realistic economic analysis shows that consumption based federal tax reform ***without*** border adjustability would come close to remediating an 18 percent price advantage from VATs for producers of foreign goods that makes the U.S. their most profitable market and renders U.S. goods uncompetitive in their markets.

U.S. productivity gains and innovation will ***not*** level the playing field given the rapid diffusion of U.S. technology and management to foreign producers. The largest trade deficit measured by exports as a proportion of U.S. imports is in telecommunication and EDP goods, for which the U.S. is the world technological leader, which bears witness to this reality. The recent transfer of manufacturing abroad by U.S. companies to secure foreign VAT tax advantages has enabled U.S. corporations to join foreign competitors in further seriously undermining remaining U.S. competitors.

The U.S. Department of Commerce and MAPI/NAM agendas for restoring competitiveness of U.S. manufacturers ***if fully achieved*** would only offset ***30 percent*** of the typical foreign manufacturing advantage due to border adjusted VAT taxation. In order to level the taxation "playing field" in international commerce, a 15 percent consumption based and border adjusted tax is the minimum requirement, comparable to Canada and Mexico border adjusted taxation.

According to the National Bureau of Economic Research (NBER) devaluation of the dollar will not impair competitiveness of foreign competitors until devaluation considerably exceeds the OECD average of 18 percent. Furthermore, devaluation is not a likely remedy as long as foreigners continue to have a special appetite for reinvesting trade surpluses in prime U.S. assets. Devaluation to close the trade deficit will be frustrated by offsetting increase of U.S. costs of first commodities, then productive assets, followed by wage increases. Also, the Fed will likely be forced to limit the extent of devaluation due to unfavorable effects on domestic inflation, plus preserving the role of the dollar as a store of value and as a standard for international exchange.

The "Business Transfer Tax" is the most efficient and effective basis for restoring U.S. competitiveness in manufacturing and business services via border adjusted, consumption based federal tax reform.

Of the five principal alternatives for fundamental consumption based tax reform, the "Flat Tax" and the "consumed income tax" do not differentiate between origin and destination, and are "direct taxes" that cannot be border adjusted under WTO rules. Both the "retail sales tax" to not differentiate between origin and destination, and the European-type "credit invoice VAT taxes" are "indirect taxes" and therefore WTO qualified. But as state retail sales taxes in the U.S. and credit invoice VATs in Europe and elsewhere have demonstrated, they tend to be limited in breadth of assessable tax base beyond levy upon goods for political reasons, resulting in higher marginal rates and/or lesser revenue yield. The "business transfer tax (BTT)" as a

"subtraction method VAT" is an "indirect tax" on consumed income at the producer level, which should be more easily assessable on all commerce and government to enable the broadest base and the lowest marginal rate, *and* WTO qualification for border adjustment.

Determination of BTT Base

As proposed, the BTT Base is Gross Domestic Product, less Gross Private Commercial Investment and less the Balance of Trade (if a surplus, additive if a deficit). Tax returns simply require the following:

All Commercial Entities:

All Revenues

less: Exports of Goods and Services

All Purchases of Goods and Services (Including Equipment and Structures)

Employer Share of Social Insurance Taxes

plus: *Purchases of Imports*

equals: BTT Base

All Governments and Not-for-Profits:

All Employment Expenses

plus: *All Purchases of Imports*

equals: BTTBase

Federal Taxes to be Replaced by the BTT

The BTT as proposed would replace the following, comprising more than two-thirds of all federal revenues:

Individual Income Taxes, (less EITC replaced by Rebates)

Corporate Income Taxes (less "Corporate Welfare")

Employer Share of Social Insurance Taxes

Estate and Gift Taxes

equals: BTT Revenues

The Federal Government would deposit an equal match to individual payroll taxes for the OASI, DI, and HI Trusts, which would result in ending "the bubble" which is created by currently capping applicable incomes levied as employer direct taxes. The remaining *individual* portion of social insurance taxes should not be considered direct income taxes, but instead considered conceptually as variable insurance premiums contributed to secure future retirement benefits.

Addressing Regressivity Concerns

In order to prevent regressivity, the BTT as proposed would provide rebates of the BTT to *all* taxpayers on the basis of the product of the BTT tax rate and the sum of (1) the poverty level for a given family size, (2) home mortgage interest, and (3) philanthropic giving. The termination of employer paid matching contribution to social insurance generally considered to be incident upon employees in a additional abatement of regressivity.

Tax Rate

Based upon FY 2003, ***the BTT could replace all federal income and capital taxes*** (other than individual FICA and Medicare taxes) ***with a 16.4 percent BTT on a "tax neutral" basis.***

The inclusion of imports and exclusion of exports for determination of BTT taxation will result in "found money" while the trade balance is in deficit and thereafter when the U.S. "grows" an end to this deficit. This results in lower tax burden on U.S. taxpayers at "tax revenue neutral BTT receipts". An alternative BTT level, ***the "tax burden neutral" rate at 17.5 percent*** would be preferable in order ***to make this surplus available to transition funding.***

What are the strategic steps required to replace income taxation with border adjusted consumption taxation via the BTT?

There are three alternative strategic routes to replacement of federal income and wealth taxation with the BTT:

A. Terminate income taxation by sequential replacement of current income and wealth taxes with the BTT.

Step 1. Replace the corporate income taxes, corporate welfare expenditures, employer social insurance taxes, and inheritance and gift taxes with a 5.25 percent BTT.

Step 2. End progressive income taxation with increase of the BTT to 11 percent to enable flattening the personal income tax to a simple 11 percent individual income tax rate, subject to current exemptions, deductions and credits of the present tax code.

Step 3. Replace the personal income taxes entirely with a 17.5 percent tax burden neutral BTT and rebates of BTT on poverty level incomes, residential mortgage interest, and charitable giving to complete federal tax reform.

B. Sequential transition from the current tax code by reducing current taxes by one third (or one fifth) and phasing in the BTT by one third (or one fifth) increments over three (or five) years.

C. Replace the current income taxes with the BTT and rebates in one complete step.

It is unlikely that Congress would "throw caution to the winds" and reform the tax code in one "giant step" as in alternative "C". Alternative "A" would address priorities by addressing corporate and manufacturing first, then reform of personal taxation. But alternative "B" is probably the most realistic since by proportional increments of adopting reform and phasing out the current code, benefits more proportionally match burdens.

Given that foreign border adjusted VAT taxes are the principal cause of the U.S. manufacturing crisis, why hasn't the U.S. adopted the BTT or some other form of border adjusted taxation?

Conservative and libertarian economists alike appear to have visceral objection to value added taxation and to border adjusted taxation in general, and also to addressing remediation of the U.S. manufacturing crisis in particular. Yet value added taxation as proposed by the Business Transfer Tax potentially has the exact same base as their popular Flat Tax alternative except for border adjustment, and is more transparent and more politically assessable in format. What is really at issue is the question as to whether or not the U.S. is entitled—much less morally obliged—to provide equal terms of trade for the survival of its industries and workers' jobs, in its national interests.

One cause of misconception has been the effective concealing of the manufacturing crisis from the public in the form of disinformation as to the seriousness of the manufacturing sector's decline, its evident consequence of foreign border adjusted VATs, and its implausibility of self-correction under the present tax code. This misrepresentation has been promoted by the U.S. Commerce Department, and key trade organizations representing discount retailers and multinational corporations, without challenge from the economic policy community, or the media. In effect, they appear to give priority to expansion of international trade and current consumerism over long term U.S. national interests. A good example of this misrepresentation is shown in the trend of U.S. manufacturing, in a recent study by NAM based on Commerce Department data for manufacturing share of "real" GDP in manufacturing, explained as "physical" output rather than dollar value GDP share. What is "real" about physical output as opposed to value? Ever since currency replaced barter it is ***money*** that has measured economic phenomena, and what one can take to the bank or to the store. The result is a highly misleading impression of the shocking relative decline of the manufacturing sector. An endless stream of bad news regarding U.S. manufacturing which has similarly been reported from the Commerce Department as good news, augments these misconceptions, which is uncritically repeated by the media and policy experts.

Also, VAT taxation, the prime source of U.S. competitiveness problems, and the prime candidate for effective tax reform, has been disparaged as the source of runaway growth of the European welfare states. This misconception fails to recognize that this growth of their welfare states should be attributed to their adoption of VATs ***in addition to*** rather than ***in replacement of*** income taxation. Adoption of border adjusted taxation has been erroneously labeled as "protectionist"—but as proposed, the BTT is ***strictly neutral*** in terms of international trade for ***all*** parties. VATs also have been represented as complicated, lacking transparency, inefficient to administer and too easily evaded; whereas a subtraction method VAT such as the BTT is simpler to assess and enforce than income taxation, and can be made comparable in retail transparency to a retail sales tax or a credit VAT; and, in addition, the BTT has a larger plausibly assessable base.

The most beneficial reform of the federal tax code will not only incorporate border adjustability of the BTT, but should also permanently end income taxation and progressivity.

Direct taxation of income and wealth taxation have especially undesirable arbitrary features with respect to assessment and exemption—namely, complexity, discrimination, intrusiveness, and economic inefficiency. It invites taxation of the few for the benefit of the many until the increasing burden on success causes economic stagnation. Small wonder that historically such direct taxation prior to "social democracy" was considered unfit for freemen, and suitable only for slaves.

Progressive income taxes which incorporate these undesirable features at their worst are typically "justified" as the price of "social equity", but the evidence shows the contrary. Over the course of the four decades 1957–1997 it has been demonstrated that as share of individual income taxes paid by the top 10 percent of incomes rose (representing taxation of intellectual and financial capital) the after tax share of the incomes of the other 90 percent declined. Simply stated, progressive taxation appears to have worsened rather than improved income maldistribution. As shown earlier, this was *not* due to excess growth of incomes of the top 10 percent; instead it was due to stagnant incomes of the other 90 percent. Similarly, over the same period relative rises and declines of taxation on financial capital did not appreciably alter the real return to financial capital. The effective incidence of changes in taxation of capital was upon labor. It has also been shown that at least 70 percent of returns of income from capital are distributed to labor, in effect showing that growth of labor income depends primarily upon growth of capital.

Tax reform could best secure economic efficiency and equity ***not by progressivity,*** but instead ***by proportional*** taxation of consumption which mitigates regressivity by exempting necessities. Arbitrary determination of "equitable levels" of profits and taxable income determined by progressive income should have no place in tax reform, but rather, should be left to the impartial arbitration of free markets.

Consumption taxation in combination with income taxation, such a BTT combined with an upper income personal income tax would be a modest improvement over the present code for as long as such a political compromise would last. But a consumption based tax, such as the BTT, adjusted by limited rebates to prevent regressivity is the optimal compromise for economic efficiency and equity. Given the opportunity to demonstrate the results of such reform, repeal of the Sixteenth Amendment would be the best guarantee of taxation in the best interests of all Americans.

The Reader's Digest polled a wide range of classifications of Americans inquiring what was the maximum rate of taxation on income any citizen should have to pay regardless of amount of income. The median answer was 25 percent for *all* groups but one, which proposed 29 percent. The BTT at 17.5 percent would be considered their "best buy", particularly if compared to the current tax code with marginal rates that are *double* the 25 percent standard.

Conclusion

The U.S. needs to confront the reality that since the industrial revolution all major powers have been leaders in manufacturing as the source of competitive advantage in growth of incomes, wealth, and military strength. Preservation and restoration of the manufacturing sector is vital to U.S. national interests, and adoption of border adjusted, consumption based BTT taxation is the vital condition for this remediation. The BTT is the optimal basis for fundamental federal tax reform enabling equitable and competitive taxation of consumption, growth of investment and income, and restoration of the U.S. economy as the leader of free enterprise and freedom.

The BTT will achieve these goals by direct remediation of the serious problems facing the U.S. economy. The manufacturing crisis and the soaring U.S. trade deficit will be resolved by the BTT's border adjusted exemption of exports and imposition on imports to equalize terms of foreign trade. As a consumption based tax code it will close the deficit in saving for investment. Border adjustment of business services will curb outsourcing before it creates additional deficits. And it will restore the U.S. as the preferred location for corporate headquarters by the best possible resolution of making corporate taxation territorial—the termination of the corporate income tax. The end results of adopting the BTT will be not only reversing labor's share of income, but by increased growth of *all* incomes. By ending complex, inefficient, and inequitable income and capital taxation, the BTT will provide a simple broad based tax that offers the lowest possible rate for a proportional consumption tax with adequate rebates to prevent regressivity.

President George W. Bush and the Congress could leave no better legacy than the vigorous economic future proposed by BTT federal tax reform.

Cupertino, California 95015
June 29, 2005

Dear Chairman Thomas and Committee Members: My name is Joseph Cena and I am writing on behalf of my family, Dawn and Justin. We appreciate the opportunity to discuss the hardships we have suffered due to the challenges that have been set forth by the Alternative Minimum Tax Laws. We hope that our situation can assist with putting into place changes that will allow for more reasonable tax policy as opposed to such restrictions that have been causing financial turmoil & ruin for so many Americans.

I am attaching the original letter that we submitted June 04 to the Ways & Means Oversight "Tax Simplification Hearing" although the language is a tad bitter, I felt it needed to be included as we truly feel that this has come to harm so many taxpayers. It was a plea for help because our situation, while unique, is so similar to many other Americans and we felt helpless. My only hope is that you will read it with compassion and be open-minded as there are thousands of stories that are more heart wrenching than ours.

Please help us implement a new tax law that does not create a phantom tax on unrealized gain. No one should have to pay tax for something that is not tangible, but rather looks good on paper. We beg of you and your committee members to take a look at how this would affect you if you were faced with the same situation. Only then will change be possible.

Respectfully,

Joseph Cena & Dawn Hasegawa

I write to thank you for taking on the difficult task of simplifying our tax code. I respectfully enlist your support and ask you to please act for the sake of thousands of families who are being financially decimated (mine included), for the sake of the general U.S. economy that is being adversely affected, to help hard working taxpayers regain faith in the IRS and to repeal one of the most egregious applications of Tax Policy ever enacted: the dreaded and stealthy Alternative Minimum Tax (AMT).

This woefully outdated policy forced me and my family into a **2000% tax bracket** in 2000 and required us to provide an **interest free loan to Treasury** that will take us **433 years** to receive back!!

A little bit about us:

My family has lived and worked in California for 26 years. Our home is a 56-year-old, 1,245-sq-ft., 3-bedroom ranch home in Cupertino California. We have a 9-year-old son, Justin. My wife, Dawn, is a unionized Registered Nurse of 23 years who is currently working in the Stanford University Hospital Emergency Room. Both of us are approaching our fifties, and our living parents require our financial support, which we are unable to provide in our current situation. As you will easily understand, our experience with the AMT has been very stressful on our family and we have come close to divorce over this!

I started my career in the electronic manufacturing sector working on programs for the Department of Defense, the first MRI unit, and other dynamic technological areas of industry. I proceeded to Stanford University where I consulted on exciting projects such as the Hubble Telescope, Sun-Net, the Rel-Gyro project (Testing Einstein's Theories), and helped the founders of Cisco Systems. From there it was back into High-Tech in 1994–2001 at Synopsys, and Network Appliance. Both firms offered stock options, and were on growth paths of 50–100% growth year over year. I typically worked 10–14 hours per day, 5–6 days a week.

While I was a Customer Service Manager at Network Appliance, I was diagnosed with a life threatening disability and in December 2000, I started chemotherapy treatment. In spring 2001, while undergoing chemo, our accountant informed us that we were subject to a parallel tax called AMT and we were responsible for $2.1 million in tax to the IRS and California even though we didn't sell or have a gain.

I was shocked to learn that the tax imposed had absolutely no correlation to actual gains; and that it would actually be an **overpayment of $1.4 million!!!** How is it possible that a law that was enacted in 1969, to catch 155 wealthy people who didn't pay taxes, is now forcing tens of thousands of hard working citizens and entrepreneurs to legally **pre-pay a tax** and making it nearly **impossible** for them to recoup the overpayment in their, or their children's lifetime? To add insult to injury, the taxpayers who overpaid their taxes to the government do not earn interest on their own money even though Congress has established such safeguards for con-

sumers requiring banks, escrow companies, landlords and others to provide interest income even on funds held in trust for even just a short—term.

Many are being driven into bankruptcy over phantom gains. I am certain that Congress did not intend to drive people to bankruptcy when it created the AMT in 1969. Under the regular tax system if a taxpayer overpays, he or she receives a refund in a lump sum, not so under AMT.

Impact on Us and the U.S. economy by not having our tax credit returned:

Other than perhaps homeland security, there is no more important issue affecting my family than the AMT. Thankfully, my illness is now in remission. My wife and I had wanted to have more children, but we discovered we are medically unable. We then thought to adopt but we are financially unable to do so. I was laid-off during my disability in 2001 and have been out of work for three years. My unemployment ran out long ago and we need the money. For example, my wife's 1991 Nissan truck has 132,000 miles and needs replacing. It would help us tremendously even if all we received was the interest on our credit.

I've have drawn up few business plans for "start-ups," one a consumer wireless application, real estate venture and others. If I had my credit back I would put it to use to launch these businesses and help contribute to our economy-putting putting people back to work—people who would be paying income tax!!

Thank you for your time and consideration, I hope that with your leadership and help Congress can quickly enact a fair and principled reform to the ISO-AMT provisions and help us grow the economy.

D. Hasegawa & J. Cena

La Cañada, California 91011
June 18, 2005

To Honorable Chairman William M. Thomas and House Ways and Means Committee—Tax Reform Hearing

Dear Chairman Thomas and Committee Members,

I'm writing to beg you to change the tax code so that stories such as mine never happen again.

When eToys was started in 1997, its founders quickly realized that it would be difficult to know their market if everyone that worked for them was a childless, young male. So it wasn't surprising that they hired me as their 5th employee, a mid-thirties suburban mother with experience in marketing and website design. I initially worked part-time, as I wanted to spend time with my young children. When the company was low on cash, they offered to give me part of my compensation in stock options. I didn't know anything about stock options, but accepted, knowing that whatever happened, I was there primarily because I really enjoyed my job.

The company went public in May, 1999, but because of a lockout period and a blackout period, we weren't able to sell any of our stock until February, 2000. In the meantime, I exercised as many shares as I could, sometimes when the stock was trading as high as $68. I had also become a full-time employee, because the company decided it didn't want part-timers anymore.

Unfortunately, by February, 2000 I needed to sell my stock just to pay my tax bill. Even though my income for 1999 had been $85,500, I had to pay an Alternative Minimum Tax of $424,100 because I was taxed as if I'd had income as high as the price the stock was selling for each day I exercised my options.

Thankfully, the company's stock hadn't been de-listed yet, so I was able to sell my shares to pay my tax bill. I've been trying to get AMT overpayment back from the IRS, so far to no avail.

I implore you to do what you can to reform our nation's tax code so that this doesn't happen to anyone else, and so that I can recover the overpayments that have become a lifetime interest free loan to the government. I know that ReformAMT and the Coalition for Tax Fairness are working hard to support targeted ISO AMT legislation to bring immediate relief to ISO AMT victims, many of whom will be financially irretrievably destroyed if relief is not provided in the next few months.

Taxation without income is wrong. Thankfully, so is taxation without representation, and I'm relying upon you to do the right thing.

Sincerely,

Kathryn C. Hernandez

New York, New York 10024
June 21, 2005

Dear Chairman Thomas and Committee Members:

My name is Tony Kadillak. I was born and raised in Butte, Montana, and graduated from Montana State University in Bozeman. After college I moved to the Bay Area in California to get my career start, where I landed a job with a startup called Ariba, Inc. I worked there nearly four years before being laid off in a massive restructuring, a result of the economic downturn and the dot-com meltdown.

I am yet another unsuspecting victim of the **Alternative Minimum Tax.** Due to a stock options exercise, I'm being taxed over $1.2 Million on stock that yielded actual capital gains of approximately $125,000. I can't possibly afford to pay a tax on money I never received, yet the IRS seems unable or unwilling to work out a solution that is in line with the actual capital gain I realized.

Fours years on, I have experienced the following: My Offer in Compromise experience took almost a full year of my life, and in the end, the IRS rejected my offer. I decided to take my appeal to Tax Court in hopes it would provide some relief, but after 2+ years I still haven't seen any result. Last year my wife and I moved to New York, and decided to sell our condominium in San Francisco. Unbeknownst to us, the IRS had placed a lien on the property, and we were forced to surrender 100% of the equity in the sale. We were rejected for numerous apartment rentals in the New York area because of the federal lien. Only after begging a building owner and offering a 4-month security deposit were we able to find a place to live. We're expecting our first child in September, and I have no idea how we'll ever cover our basic costs if the IRS starts garnishing my wages.

Every day I live with this tax looming over me like a dark cloud. I would love to pay my fair share, but I simply can't fathom how I'm being taxed on money I never saw. Please act now to correct this injustice—tax people when they sell the stock, not on phantom gain they "receive" upon exercise. Thousands of us deserve the opportunity to piece our lives back together.

Thank you for your consideration.

Tony Kadillak

Statement of J. Michael Keeling, The ESOP Association

Summary:

1. The Ways and Means Committee (the Committee) should make recommendations that are consistent with President Bush's policy goal to encourage and promote an "Ownership Society".
2. If the Ways and Means Committee does not make recommendations for major changes in the current tax systems, there are several changes in current tax laws to encourage more employee ownership through ESOPs.
3. In studying the current tax laws encouraging employee ownership through ESOPs, the legislative history of ESOP law leads to conclusion that ESOP law may be reviewed in context of tax favored employer proved benefits, or in the context of tax laws encouraging entrepreneurship, productivity, and American competitiveness on both a corporate, and individual scale.

The ESOP Association's Written Statement for the Record of Ways and Means Committee's Hearing On Tax Reform

"To give every American a stake in the promise and future—we will—build an ownership society. We will widen the ownership of homes and businesses, retirement savings, and health insurance—preparing our people for the challenges of life in a free society.

By making every citizen an agenda of his or her own destiny, we will give our fellow Americans greater freedom from want and fear and make our society more prosperous and just and equal."

President George W. Bush, January 20, 2005.

Part I

General and Primary Position

The ESOP Association, on behalf of the employee ownership community, respectfully asks that the Committee on Ways and Means (the Committee) make it a goal of any work reforming tax laws that the Federal tax system continues to encourage

and promote an ownership society, where many average income citizens are owners, in addition to the goals of a more fair, simple, and efficient Federal tax system.

The ESOP Association recognizes that current Federal tax law encourages and promotes employee ownership through ESOPs, and that in the 30 plus years these laws have existed, employee ownership through ESOPs has in the overwhelming majority of instances provided significant wealth to employee owners, and has in the overwhelming majority of instances made the employee-owned companies high performing companies in comparison to their non-employee-owned competitors. (Summary of research data attached.)

The ESOP Association recognizes the Committee has many options to reform the Federal tax laws; for example, the Committee may recommend to the full House a major overhaul of the current Federal tax system, moving the current income tax based system to a so-called "flat-rate" system with few exceptions to the general rule that all income of whatever source and form is subject to tax, or to a consumption tax such as a national sales tax or value added tax, or to a hybrid system of both.

The ESOP Association notes to the Committee that no matter what the major structure of the Federal tax system may be, consumption or income, or both, there are many methods to be sure it contains provisions that encourages and promotes ownership by average income citizens.

Based on real world experience, a system that enables average income citizens to be "financed" into an ownership state is more effective in creating significant ownership than voluntary savings plans, which are most utilized by citizens with ample income.

Theories of how to expand ownership through finance were put to Congress by Senator Russell B. Long from 1974 through 1986, and resulted in the current laws for ESOPs, which do finance average pay employees into ownership positions. Since 1996, the House Ways and Means Committee has played a bigger role in protecting and expanding ownership through ESOPs than has the Senate.

A final point is that the one time that Congress made a major overhaul of the Federal tax system, coming very close to a pure flat tax system, was in 1986 under the leadership of President Ronald Reagan. He and Senator Long made sure the Tax Reform Act of 1986 not only maintained the tax laws favoring employee ownership through ESOPs, but enhanced those laws. A similar result is possible with any proposal by the Committee if it is agreed that promoting an ownership society is an important goal of any Federal tax system.

In summary, the ESOP community's general position towards the tax reform efforts is in alignment with the words spoken by President Bush in his Inaugural Address that an ownership society will build a more prosperous, more just, and more equal society. Therefore, the ESOP community urges the Committee to have as a goal whatever tax system it endorses, income or consumption, the recommended Federal tax system should encourage and promote an ownership society where ownership is widespread, among average income Americans.

To reach this goal in the context of the system that the Committee may endorse, The ESOP Association stands ready to provide input on any of the details of any tax system in order to be sure it promotes a true ownership society.

Part II

Specific Ideas to Promote Employee Ownership If Committee Does Not Recommend Major Changes in Current Federal Tax System

Assuming the Committee does not recommend significant, major restructuring of the current Federal income tax system, The ESOP Association recommends modest, but significant steps to create more employee owners through ESOP arrangements, and to permit better operation of existing ESOPs. The recommendations are particularly pointed to two areas: One, situations where an S corporation is partially owned by an ESOP, and two, in the universe of publicly-traded companies. Many may be characterized as "simplification" proposals of certain current ESOP related tax provisions.

Brief summary history is in order to understand these recommended positions. Under current law, Congress has established significant tax incentives for small to mid-sized privately owned businesses to establish employee ownership through ESOPs, primarily by encouraging the current shareholder[s] who are exiting the business to sell shares to the ESOP, if the business is a C corporation. For S corporations Congress has established a method of taxing the ESOPs share of an S corporations' income that encourages the creation of S corporations owned 100% by the ESOP. Current law does not necessarily encourage S corporations to establish employee ownership through ESOPs where the ESOP owns a minority of the S corporation, and even has somewhat of a barrier to the continued operation of an ESOP that owns a minority of an S corporation. Current law also does not directly

encourage publicly-traded companies to expand ownership to employees through an ESOP.

In essence, The ESOP Association would want to see an expansion of ownership through ESOPs with specific provisions of law that addresses the barriers to ESOP creation and operation, in both C and S corporations, and both private and public companies.

Here are some ideas for new law, but certainly not exhaustive, that assumes no major change in Federal tax law, as all ideas were developed in the context of current law. Many of these legislative ideas were included in HR 4796 and S 2298, introduced in the 108th Congress.

1. Repeal the punitive 10% penalty tax on S corporations' distributions from current earnings, also referred to as dividends, paid on ESOP stock that are passed through to ESOP participants in cash. (Participants will pay regular income tax on the cash received. Based on prior Joint Committee on Taxation revenue estimates of repeal of excise taxes, this revision should raise revenue.) Such a change would equalize treatment of cash dividends distributed between C corporations and S corporations as the treatment for C corporation dividends has no penalty tax imposed.
2. Permit sellers of stock to the ESOP on an S corporation to utilize the ESOP tax benefit referred to as the tax deferred rollover, or the 1042 treatment.
3. Clarify that dividends paid by C corporations on ESOP stock are not a preference item in calculating the corporate alternative minimum tax.
4. Permit proceeds received from a 1042 transaction to be invested in mutual funds consisting of operating U.S. corporation's securities.
5. Redefine what is a 25% owner for purposes of IRC 1042 to be 25% or more owner of voting stock, or 25% or more owner of all stock of the corporation, not 25% of any class of stock. IRC 1042 imposes restrictions on 25% owners' participation in a 1042 ESOP.
6. Permit early withdrawals from ESOP for first time home purchases, and college tuition under limited circumstances.
7. Increase de minimus amount in an ESOP account not subject to mandated diversification from $500 per account to $5,000 per account. There should be no revenue impact from this change. In 1986, Congress passed a law mandating that an ESOP participant be permitted to diversity his or her account from employer securities over a five year period up to 50% of the account balance if the account was over $500. The $500 level has never been altered in the past 20 years, whereas nearly all other de minimus amounts cited in ERISA law have increased either under a standard inflation adjuster, or by specific law. It is not reasonable to require the administrative headaches of diversifying accounts under $5,000 as that amount is not enough to ensure a secure retirement.
8. Allow a corporation selling a division or subsidiary to an ESOP company to utilize 1042 to defer the corporate capital gains tax.
9. Permit a tax deduction for transfer of stock at less than fair market value that equals the difference between the transfer price and the fair market value price. Under certain circumstances, transferring stock at less than fair market value triggers a favorable gift tax deduction. The contemplated provision would provide for an income tax deduction.
10. Clarify impact of 25%/5% ownership rule for allocations in a post-1042 transaction. Current law has a quirk that eliminates an exception to the 5% rule for lineal descendants but in the 25% ownership rule covers the same lineal descendants nullifying the 5% rule exception.
11. Permitting holders of "Section 83" stock to sell that stock, if not-publicly traded, to an ESOP and utilize the ESOP tax deferred rollover provision (Code Section 1042) if employees acquired stock at fair-market value. This provision arises from both a current law provision in 1042 that does not permit stock held by an employee because of the exercise of a stock option to utilize 1042, and from a series of IRS letter rulings in the late 80's that expanded the limit on 1042 utilization to all stock held by an employee because of his/her receiving it because of a program of the employer, even if the employee bought the stock at fair market value. The current law is not fair as employees who obtained stock paying fair market value because of employment do not have the same treatment as an owner-founder, or outside investor, who can sell stock to the ESOP and defer the cap gains tax under Section 1042.
12. In the estate and gift tax is maintained, and not totally repealed, consider these ideas:

A. Restoration of the shifting of the estate tax liability from an estate to the ESOP sponsor if estate transfers stock to the ESOP. This provision would be a restoration of a 1984 pro-ESOP law that was repealed in 1989 during a series of cutbacks in ESOP tax incentives. It was Code Section 2210. At no time from 1984 to1989 did the provision lose more than $5 million per year in revenue, and estimates made for a variety of pro-ESOP bills containing the provision since 1990 have always been less than $5million.
B. Treat non-corporate donations of company stock to ESOP as a charitable contribution for purposes of income, estate, and gift taxes.

Part III

Proper Input from Employee Ownership Community to the Committee

Given the hybrid nature of employee ownership in all of its various forms, it is possible for the Committee to slot a review of how employee ownership fits into any tax system in two different general areas.

One, it is clear, particularly for ESOP discussions, that employee ownership is tied to the compensation decisions of the employer, either current, or deferred. Two, nearly all employee ownership plans arise from deferred compensation schemes. Three, nearly all therefore fall into the generally accepted category of employer provided benefits. And four, within the general area of employer provided benefits, the major employee stock compensation schemes are part of the Federal retirement income security laws, or ERISA.

Thus, there is no doubt that any review of how our tax system might impact, or should impact the encouragement of broad ownership in our society, could be done in the context of how current law, and proposed law, might impact employers' actions to compensate employees as part of an employer provided benefits package.

On the other hand, most of the social research, and the justification for broad based employee ownership revolves not just around employee income security, but also on how ownership increases citizen responsibility, citizen entrepreneurship attitudes, self-esteem, community involvement, and the performance of companies with broad based ownership among its employees. These concepts are in sync with the views of President Bush, as expressed in his Inaugural Address cited above, and certainly are in sync with his expressions of why wide spread home ownership is important.

Thus, any review of employee ownership by the Committee could focus on whether the tax system of the United States should encourage employee ownership, in order to increase not just personal wealth, but also whether to encourage the ownership behavior that leads to high performing companies, better and more involved citizens, and employees who are more likely to approach their work in an entrepreneurial manner.

Or, of course, the Committee could measure the effectiveness of broad based employee ownership in the review of both areas of the tax laws—both as employer provided benefits, and as a way to make American companies and their employees more productive, entrepreneurial, and connected to the community.

In any manner, The ESOP Association stands ready to dig into both the macro and micro evidence of why the Committee should endorse a tax system that helps create the Ownership Society called for by President Bush.

Attachment

Employee Ownership and Corporate Performance

1. In 2004, the Employee Ownership Foundation, conducting its 13th Annual Economic Performance Survey, found that a very high percentage of companies, 88%, declared that creating employee ownership through an ESOP (employee stockownership plan) was "a good decision that has helped the company." In addition, the EPS asked companies to indicate their performance in 2003, relative to 2002. Approximately 65% of respondents indicated a better performance in 2003 than 2002, 12% indicated a nearly identical performance, and 23% indicated a worse performance. Around 70% indicated that revenue increased while 30% indicated revenue did not increase. In terms of profitability, 64% indicated that profitability did increase and 36% indicated that profitability did not increase in 2003. This survey was conducted in the summer of 2004 among corporate members of The ESOP Association.
2. The most comprehensive and significant study to date of ESOP performance in closely held companies was conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, and funded in part by the Employee Ownership Founda-

tion. The study, which paired *1,100 ESOP companies with 1,100 comparable non-ESOP companies* and followed the businesses for *over a decade,* reported overwhelmingly positive and remarkable results indicating that ESOPs appear to increase sales, employment, and sales/employee by about 2.3% to 2.4% over what would have been anticipated, absent an ESOP. In addition, Drs. Blasi and Kruse examined whether ESOP companies stayed in business longer than non-ESOP companies and found that 77.9% of the ESOP companies followed as part of the survey survived as compared to 62.3% of the comparable non-ESOP companies. According to Drs. Blasi and Kruse, ESOP companies are also more likely to continue operating as independent companies over the course of several years. Also, it is substantially more probable that ESOP companies have other retirement-oriented benefit plans than comparable non-ESOP companies, such as defined benefit plans, 401(k) plans, and profit sharing plans.

3. Research done by the Washington State Department of Community, Trade and Economic Development of over 100 Washington not publicly-traded ESOP companies compared to 500 not publicly-traded non-ESOP companies showed that the ESOP companies paid better benefits, had twice the retirement income for employees, and paid higher wages than their non-ESOP counterparts. Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State, Kardas, Peter A., Scharf, Adria L., Keogh, Jim, November, 1998.
4. Research conducted by Professor Hamid Mehran, while he served on the faculty of the J.L. Kellogg Graduate School of Management, Northwestern University, of nearly 400 publicly traded companies with significant ESOPs both before and after the adoption of the ESOP, compared to non-ESOP companies in similar lines of businesses, showed that the rate of return for the ESOP companies was 2.7% higher, 60% of the ESOP companies experienced share price increases upon announcement of the ESOP program, and 82% indicated that the ESOP had a positive impact on business results.
5. In 1995, Douglas Kruse of Rutgers University examined several different studies between ESOPs and productivity growth. Kruse found through an analysis of all studies that "positive and significant coefficients [are found] much more often than would be expected if there were no true relation between ESOPs and productivity." Kruse concludes that "the average estimated productivity difference between ESOP and non-ESOP firms is 5.3%, while the average estimated pre/post-adoption difference is 4.4% and the post-adoption growth rate is 0.6% higher in ESOP firms. Kruse cites two studies as part of his research: Kumbhakar and Dunbar's 1993 study of 123 public firms and Mitchell's 1990 study of 495 U.S. business units in public firms. Both reports found significant positive effects of greater productivity and profitability in the first few years after a company adopted an ESOP.
6. In 1995, the U.S. Department of Labor released a study entitled "The Financial and Non-Financial Returns to Innovative Workplace Practices: A Critical Review." This study found that companies that seek employee participation, give employees company stock, and train employees, can positively affect American corporations' bottom lines. In addition, the report cited three studies that analyzed "the market reaction to announcements of ESOPs which found significant positive returns to firms which implemented ESOPs as part of a broader employee benefit or wage concession plan." The three studies are: Chang's 1990 "Employee Stock Ownership Plans and Shareholder Wealth: An Empirical Investigation"; Dhillon and Ramirez' 1994 "Employee Stock Ownership and Corporate Control"; and Gordon and Pound's 1990 "ESOPs and Corporate Control." citation.

Westminster, Massachusetts 01473
June 22, 2005

Dear Chairman Thomas and Committee Members:

I was contacted yesterday via email by an organization I have been associated with for the last several years known as ReformAMT (www.reformat.org). I joined this organization sometime after being hit with a substantial tax bill in the form of AMT tax in the tax year 2000. They have informed me of your panel and you're looking for input on the following items regarding current tax laws:

- Headaches, unnecessary complexity, and burdens that taxpayers—both Individual's and businesses—face because of the existing system.

- Aspects of the tax system that are unfair.
- Specific examples of how the tax code distorts important business or personal decisions.
- Goals that the Panel should try to achieve as it evaluates the existing tax system and recommends options for reform.

In regards to the following item:

- Headaches, unnecessary complexity, and burdens that taxpayers—both individuals and businesses—face because of the existing system.

I have worked most of my adult life at start up high technical companies which commonly issued stock options as a form of compensation. One grant I received in 1997 was for ISO options, the rest were for Non-Qualified options. It is the ISO options that have created my headache. With the ISO options the general prevailing philosophy on the sales of these options was to exercise them and hold them for at least a year so that they would be taxed as long term capitol gains. This philosophy appears to have been a recipe for over taxation in the form of AMT tax when held in the context of the boom period of 1999–2001. While my employer held seminars on the implications that stock options had on potential tax burdens, we would be advised to consult with our own private tax consultant on our specific details. The problem is many tax consultants seemed to be inadequately informed on the matter of stock sales, ISO options and AMT tax implications. The result of attempting to do the correct thing for me to put myself in a tax situation where my ISO options would be taxable as long term gains resulted in being taxed on potential income that I have never made. Indeed four years later the stock my ISO's were granted in have still not approached the values that my AMT tax was based upon. I have since sold these shares to pay for my AMT obligation, but I am extremely disappointed at the opportunity lost. I am not an accountant and to this day still do not know what would have been the correct way to handle my ISO options.

I have continued to seek accounting help in this area several years after the fact, I have involved myself in the organization ReformAMT and hope that some day a clearer more representative taxation on my ISO sales will be implemented and I will have some restitution on my AMT taxes paid.

I am not a millionaire. I do not earn $200,000.00 every year. I had several exceptional earnings years based upon stock options in the late 90's and early 2000. I am not now nor have I ever been close to bankruptcy. I have paid all my tax bills. I do believe that due to the current tax laws and lack of correct advice I have been overtaxed in the form of AMT tax on ISO options for profits I will never earn. I also feel that the government has impacted my ability to provide greater stability in the form of financial security to both my children and my spouse and I as we get older. This seems shameful to me that taxation laws could have this kind of impact on a family.

In regards to the following item:

- Aspects of the tax system that are unfair.

Any tax law that taxes people on potential future earnings and then does not return those taxes if the earnings are not realized is just plain unfair.

In regards to the following item:

- Specific examples of how the tax code distorts important business or personal decisions.

For me my important decisions had to do with funding my children's educations and providing for my wife and I in retirement. Due to the complexity and lack of correct advice in ISO/AMT matters my ability to properly plan for these items have been adversely impacted.

In regards to the following item:

- Goals that the Panel should try to achieve as it evaluates the existing tax system and recommends options for reform.

My primary goal for this panel is to recover AMT taxes assessed in the year 2000 for exercise of ISO stock options. My secondary goal would be obviously for others who have been impacted similarly to have there AMT recovered as well. My third goal would be a review of the AMT tax laws to see if they make since and due whatever it is they were originally intended to do. If they do a new less complicated method of implementing these needs to be developed. Currently the AMT taxation rules are even to complicated for most accountants to properly explain to clients.

While I have not commented on specifics of my AMT impact other than the time frames and personal feelings towards the issue, I would be more than happy to meet with the panel to discuss any specific detail of my AMT experience. I am not comfortable providing more specific details in this letter, as I am told it would be public record.

Feel free to contact me.

Sincerely,

Todd Keen

Statement of Debra and John Kelly, San Leon, Texas

Dear Chairman Thomas and Committee Members,

I want to tell you my story to see if you can help by providing needed legislative Tax reform. Specifically the **AMT, (Alternate Minimum Tax).**

In 2002 I retired from a 20 year career in the pharmaceutical industry.

IDEC Pharmaceuticals did very well and I received some ISO's. All the hard work and sacrifice was going to pay off and more. I was not in management.

I wanted to be at home with my Husband and children.

When I retired IDEC stock was trading at $78 a share. My holdings were in ISO's (incentive stock options). When I retired, by company policy, I had to exercise my ISO's.

I purchased my ISO's and held my stock.

Now understand, I did not cash this stock, did not realize wealth from this stock.

In three months, summer of 2002, the ENRON collapse came. Its effect on the entire stock market was unbelievable. My share price went from $78 to $21. It would have been only troublesome, had I been able to wait out the recovery of the IDEC stock.

But I owed a tax on money I never received. How can this be??

April 15th of 2003 I was going to have a tax debt higher than the stock was worth and my ability to pay.

AMT tax was going to be due. AMT tax I owed for ISO's that were trading at $78 a share were now trading at $21a share. In addition I would owe capital gain tax by selling the stock to pay the AMT tax. Double taxation!

I can not begin to tell you my disbelief, sadness, shock! I am an honest hard working middle class citizen. How could my government do this and legally?? My dreams were destroyed.

When the stock crept back up to $40 a share I elected to sell my stock. I would have enough money to pay my tax debt and pay my bills. I had little money left.

I was getting advice to take an extension to pay the IRS, ride out the stock market. But in light of the world events and the volatile nature of the market my husband and I elected to sell the stock and cut our losses.

We did not want to risk loosing our home by incurring debt to the IRS.

April 15th, 2003 I paid my tax owed, in Full. I did not take an extension with the IRS.

Then the fall of 2003 the tax law changed.

Due to the changes in the tax law the IRS owed me money back.

I received some money back in June 2004.

Now the IRS owes me $239,000.

But the IRS doesn't have to pay me right now. I get a tax credit. The IRS doesn't have to give me penalties or interest on the amount.

I receive a benefit of about $11,000 credit back each year. I still have to pay money in to the IRS.

At that rate I'll get my money back in about 30 years.

If I owed the IRS that kind of money they would come take my home.

Garnish my wages.

It is not just.

It's not right.

IF I could have stayed in the stock market, sold my IDEC stock on an as needed basis and paid regular capital gain on the sell I would be in incredible financial shape today.

What if??

Now my story isn't as extreme as others I know.

I don't have any debt to the IRS and have not entered into court battles.

It has not financially devastated me.

But I have had to make decisions that have grossly affected my financial situation.

I went from $1.2 million in IDEC ISO stock to $40,000 in my Brokerage account. My Husband and I spend $4,000 a month in household expenses.

We both are working and saving for retirement.

I am not an extravagant person.

At present I have two children in College.

My mother is entering into assisted living.

My husband and I work to make the college payments and ends meet.

My husband is retired Military and my son is starting his second tour in Iraq.

I am an Oncology Nurse at MD Anderson.

What's done is done.

But why can't I have what the IRS owes us?

Not so much to ask.

We need to make our government live by real world standards.

We need to make the highly paid CEO's account for mistakes.

I know we all live in a complex world and simple answers are hard to find.

But enacting legislation that prohibits the IRS from owing money to tax payers is an easy fix. You have the power.

I cannot believe that this is what the government intended with Tax Laws.

We depend on you to protect us.

Please make the IRS pay me the money they owe us. So we can invest that money to rebuild our family's future.

Note. This is a simplified version. For answers to any tax questions contact me and I will put you in contact with my attorney Scott Mitchell or AMT TAX Reform organization.

Retail Industry Leaders Association
Arlington, Virginia 22209
June 21, 2005

Chairman William M. Thomas
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Thomas:

As President of the Retail Industry Leaders Association (RILA), I appreciate the opportunity to submit comments related to the committee's hearing on fundamental tax reform of June 8, 2005.

I commend you for undertaking such a Herculean task as fundamental tax reform. I understand you have made significant efforts to educate members of the committee on issues related to fundamental tax reform. The tutorials provided by the staff of the Joint Committee on Taxation have given members of the committee a broad understanding of the terms being used by proponents of the various proposals. I appreciate too, that you have urged Members of Congress and other interested parties not to cling too tightly to labels during consideration of the various proposals.

The Retail Industry Leaders Association (RILA) represents the nation's most successful and innovative retailer and supplier companies—the leaders of the retail industry. Retail is the second largest industry in the U.S., representing $3.8 trillion in annual sales and 12 percent of our nation's workforce. RILA member retailers and suppliers operate 100,000 stores, manufacturing facilities and distribution centers throughout every congressional district in every state, as well as internationally.

We have serious concerns about the effect of a national sales tax on retail sales and the economy at large. A 2000 letter from former Joint Committee on Taxation Chief of Staff Lindy Paull suggests a 59.5% national retail sales tax rate is needed for the tax to be revenue neutral over five years. This would have a significant depressing effect on retail sales, putting the cost of many basic commodities and other items out of reach for millions of Americans.

Many national sales tax advocates wish to repeal the current income tax system to eliminate the possibility of having a sales tax layered on top of the current federal income tax. Repeal of the income tax would require amending the United States Constitution. Given the difficultly and infrequency of a Constitutional amendment,

the possibility of both a national sales tax existing along with the federal income tax seems altogether possible.

RILA members are also concerned about the effect of a value added tax on consumer goods. We are concerned about the lack of transparency and the tendency of the tax to be ratcheted up over time without knowledge of the consumer. I understand that you are looking very closely at the "subtraction method" VAT, as used in Japan. While this plan does have some characteristics less onerous than the traditional European method VAT, concerns about transparency remain. Additionally, retailers are concerned about the complexity of the administration of the VAT.

Another proposal that has been floated by proponents of fundamental tax reform is a flat tax. A flat tax is similar to a national sales tax in that one rate is applied across the board, albeit one levied on income rather expenditures. Again, the rate needed to be revenue neutral would be unpalatable to most taxpayers, and the axiom "simpler isn't necessarily fairer" is well-proven by the innate unfairness of a such a high income tax rate on lower income Americans.

In conclusion, RILA respectfully requests that you keep the retail sector and the purchasing power of the American consumer in mind as you consider various tax proposals. We stand ready to assist you, the Committee and your staff with any additional information you may seek regarding the retail sector.

Thank you for your consideration of our views.

Sincerely,

Sandra L. Kennedy

Statement of David Koenig, American Forest & Paper Association

Summary

U.S. manufacturing is at the heart of a vibrant economy that has produced the highest living standards in the world. But today, manufacturing faces serious domestic and international challenges which, if not overcome, will lead to reduced economic growth and ultimately a decline in living standards for future generations of Americans.

The U.S. forest products industry is no exception to the challenges facing U.S. manufacturing industries. Today, the forest products industry is facing serious threats to its continued viability. U.S. paper mills and wood products mills are permanently closing their doors, resulting in a loss of American jobs. At the same time, our foreign competitors, facing generally lower taxes, are expanding their capacity.

An April 2005 report by PricewaterhouseCoopers on behalf of the American Forest & Paper Association examined the effect of the U.S. income tax system—both the individual income tax and the corporate income tax—on the competitiveness of corporations in the U.S. paper manufacturing and timber producing sectors.

As described in this submission, the report found that U.S. income taxes are the second-least favorable of the major competing nations. *U.S. tax rules consistently raise disadvantages for U.S. corporate investments* relative to the tax rules in most of the competing nations. The overall effect is that *U.S. companies cannot profitably undertake certain investments that foreign competitors can undertake* because U.S. investors would be left with too little after paying tax whereas foreign investors would enjoy a sufficient return after paying tax. Because U.S. companies compete against foreign companies in capital and product markets both at home and abroad, the U.S. tax disadvantage ultimately limits the degree to which U.S. companies may successfully challenge foreign competitors.

Significant reform of the U.S. tax system is necessary in order for the U.S. tax system to not excessively hinder U.S. competitiveness. Options that should be considered for reform include significant rate reduction at both the corporate and individual levels and more advantageous rules for recovering the costs of business investment. The United States should also consider fully exempting from tax the foreign income of U.S.-headquartered multinational corporations, as is the practice of many of our trading partners with respect to the foreign income of multinational corporations headquartered within their countries.

A competitive, reformed tax system holds significant promise for the American forest products industry and can provide the best opportunity for American workers to attain ever higher living standards.

Achieving Tax Competitiveness: Options for Tax Reform

U.S. manufacturing is at the heart of a vibrant economy that has produced the highest living standards in the world. But today, manufacturing faces serious do-

mestic and international challenges which, if not overcome, will lead to reduced economic growth and ultimately a decline in living standards for future generations of Americans.

The U.S. forest products industry is no exception to the challenges facing U.S. manufacturing industries. Today, the forest products industry is facing serious threats to its continued viability. Since 1998, 98 paper mills and 142 wood products mills have permanently closed their doors, resulting in the loss of nearly 140,000 jobs. At the same time, our foreign competitors, facing generally lower taxes, are expanding their capacity.

An April 2005 report by PricewaterhouseCoopers on behalf of the American Forest & Paper Association examined the effect of the U.S. income tax system—both the individual income tax and the corporate income tax—on the competitiveness of corporations in the U.S. paper manufacturing and timber producing sectors. The report, *Taxes in Competing Nations: Their Effects on Investments in Paper Manufacturing and Timber Production,* and a companion policy paper providing reform options, *Reducing Tax Disincentives for Corporate Investments in Paper Manufacturing and Timber Production,* are included in this submission. The report compared income taxes in the United States with income taxes in seven other competing countries in terms of facilitating or inhibiting investments in paper manufacturing and timber production. The seven foreign countries selected—Brazil, Canada, China, Finland, Germany, Indonesia, and Russia—compete aggressively with U.S. companies in paper manufacturing and timber production.

The report found that U.S. income taxes are the second-least favorable of the major competing nations. *U.S. tax rules consistently raise disadvantages for U.S. corporate investments* relative to the tax rules in most of the competing nations. The overall effect is that *U.S. companies cannot profitably undertake certain investments that foreign competitors can undertake* because U.S. investors would be left with too little after paying tax whereas foreign investors would enjoy a sufficient return after paying tax. Because U.S. companies compete against foreign companies in capital and product markets both at home and abroad, the U.S. tax disadvantage ultimately limits the degree to which U.S. companies may successfully challenge foreign competitors.

Significant reform of the U.S. tax system is necessary in order for the U.S. tax system to not excessively hinder U.S. competitiveness. Options that should be considered for reform include significant tax rate reduction for businesses at both the corporate and individual levels. Also, restoring a differential in the tax paid by corporations on capital gains income relative to ordinary income would help the competitive position of U.S. timber companies. While capital gains income is insignificant for many manufacturers, most income from the sale of timber qualifies as capital gain income.

More advantageous rules should be implemented for recovering the costs of business investment, including expensing for business assets. Furthermore, the corporate alternative minimum tax, an additional tax burden placed on corporations that mandates even slower depreciation allowances, should be repealed.

The United States should also consider exempting foreign income from the active conduct of a trade or business as is the practice of many of our trading partners. Further, U.S. companies may be currently disadvantaged with respect to their exports (and face heightened import competition) by the absence of border tax adjustments for U.S. income taxes, while border tax adjustments for value added taxes are made by our foreign competitors. A reformed system should be amenable to World Trade Organization rules permitting border tax adjustments.

The Competitiveness Rankings

The specific rankings of the competing nations are displayed in **Exhibits 1 and 2.** The rankings refer to income taxes levied on corporate income, first the tax paid by the corporation and second the tax paid by shareholders and lenders as a result of their financing the investments that generated the corporate income. The rankings are based on laws in effect for 2005, except for the United States where it was assumed the fully-phased in nine-percent deduction for qualified production activities applied.

In general, the United States and Canada have the least competitive income taxes, while Brazil, China, Indonesia, and Russia have the most competitive income taxes. Finland and Germany are closer to the least competitive pair.

As explained in more detail in the accompanying report, the rankings and conclusions are derived by computing effective tax rates in the competing countries. An effective tax rate is the percentage of income that is collected in income taxes over the life of a particular investment project—namely, the project that just barely gen-

erates the minimum rate of return required by investors, measured after taxes and inflation.

Other rankings included in the report show that U.S. multinational corporations in paper manufacturing operating abroad are similarly disadvantaged relative to multinational corporations headquartered in the competing nations.

As noted in the report, the analysis does not fully account for several features unique to the U.S. tax system that serve to further increase tax burdens on U.S. corporations. These include the corporate alternative minimum tax, which provides for slower recovery of the costs of business investments, rules requiring the capitalization of indirect costs in inventory, and rules which serve to reduce the crediting of foreign taxes.

Options for Reform

A number of options for reform are considered in the accompanying policy paper to reduce the U.S. effective tax rate to that of the median, or middle-ranked, of the competing nations. These reforms are indicative of the extent of change necessary to make the U.S. tax system simply *moderately* competitive with the tax systems of the competing nations in paper manufacturing and timber production.

For corporate paper manufacturing, as shown in **Exhibit 3,** these options include:

- A 40-percent reduction in all top rates (including rates on corporate income and individual income from interest, capital gains and dividends);
- Expensing for all equipment and structures;
- A 10-percent investment tax credit; and
- Various combinations of partial expensing or accelerated depreciation combined with rate reductions.

The reform options shown in Exhibit 3 would also make U.S. income taxes more favorable for U.S. investors who want to build a papermaking facility abroad—provided, of course, that the options were also fully applicable to foreign investments. In the past, the United States has not allowed investment tax credits or accelerated depreciation for equipment used outside the United States. The United States should also consider fully exempting from tax foreign income from the active conduct of a trade or business as is the practice of many of our major trading partners.

Exhibit 4 presents reform optionsto reduce the U.S. tax rate on corporate timber production income to that of the median of the competing nations. These reform options include:

- A 40-percent reduction in the corporate capital gain rate for timber gain;
- A more than 40-percent reduction in all top corporate and individual rates;
- Various combinations of rate reductions with expensing of reforestation expenditures or investment tax credits.

We urge the Advisory Panel to study these options and give great consideration to their adoption. It is important to understand the need for substantial reductions in the tax burdens on corporate income in order to provide a tax system that does not excessively hinder the ability of U.S. corporations and U.S. workers to compete in the global marketplace.

Exhibit 1

ISSUE: Where are the tax hurdles the highest for a corporation that would invest in papermaking in its own country?

DOMESTIC TAXATION OF DOMESTIC CORPORATE PAPER MANUFACTURING

*Image not available

CONCLUSION: The U.S. tax system raises very high hurdles compared to other countries. The effective tax rate of the United States is the Second Highest in the competing group and 17 percentage points higher than the median of the other countries.

Exhibit 2

ISSUE: Where are the tax hurdles the highest for a corporation that would invest in forestry and timer in its own country?

DOMESTIC TAXATION OF DOMESTIC CORPORATE FORESTRY PRODUCTION

*Image not available

CONCLUSION: The U.S. tax system raises very high hurdles compared to other countries. The effective tax rate of the United States is the second highest in the competing group and 16 percentage points higher than the median of the other countries.

Exhibit 3

Corporate Paper Manufacturing

WHAT IT TAKES TO BE COMPETITIVE

Current Status in 2005

U.S. effective tax rate = 51%

Median effective tax rate for competing nations = 34%

U.S. Alternatives for Change

1. Reduce the top individual and corporate income tax rates to 21 percent and to 9 percent for individual capital gains/dividends (a 40-percent reduction in all top rates)

- Makes the U.S. tax system moderately competitive.

2. Allow expensing in lieu of depreciation for new equipment and structures.

- Makes the U.S. tax system moderately competitive.

3. Adopt a 10-percent investment tax credit for new equipment.

- Makes the U.S. tax system moderately competitive.

4. Eliminate the individual income tax on capital gains and dividends.

- Falls short. Reduces U.S. effective tax rate to 39 percent.

5. Composite #1. Allow expensing in lieu of depreciation for new equipment (but not structures), and reduce the top individual and corporate rate to 30 percent and to 12.5 percent for individual capital gains/dividends (approximately a 15-percent reduction in all top rates).

- Makes the U.S. tax system moderately competitive.

6. Composite #2. Allow 50-percent bonus depreciation for new equipment, and reduce the top individual and corporate rate to 25 percent and to 10 percent for individual capital gains/dividends (approximately a 30-percent reduction in all top rates).

- Makes the U.S. tax system moderately competitive.

7. Composite #3. Reduce the depreciation period for new equipment from 7 years to 3 years (double declining balance) and for new structures from 39 years to 20 years (straight line); also, reduce the top individual and corporate rate to 27 percent and to 12 percent for individual capital gains/dividends (approximately a 20-percent reduction in all top rates).

- Makes the U.S. tax system moderately competitive.

Exhibit 4

Corporate Timber Production

WHAT IT TAKES TO BE COMPETITIVE

2Current Status in 2005

U.S. effective tax rate = 37%

Median effective tax rate for competing nations = 22%

U.S. Alternatives for Change

1. Allow 40 percent of long-term capital gain from the sale of timber to be excluded from taxable income (reducing the capital gain tax rate on corporate timber to 21 percent).

- Makes the U.S. tax system moderately competitive.

2. Reduce the top individual and corporate rate to 20 percent and to 8.5 percent for individual capital gains/dividends (a more than 40-percent reduction in all top rates).

- Makes the U.S. tax system moderately competitive.

3. Adopt a 10-percent investment tax credit (ITC) for all reforestation expenditures.

- Falls short. Reduces U.S. effective tax rate to 35 percent.

4. Allow expensing for all reforestation expenditures in lieu of amortization.

- Falls short. Reduces U.S. effective tax rate to 35 percent.

5. Composite #1. Allow expensing for all reforestation expenditures and reduce the top individual and corporate rate to 25 percent and to 10 percent for individual capital gains/dividends (approximately a 30-percent reduction in all top rates).

- Comes very close. Reduces U.S. effective tax rate to 24 percent.

6. Composite #2. 10-percent ITC for all reforestation expenditures and exclude 30 percent of long-term capital gain on timber sales from taxable income (reducing the tax rate on capital gain of corporate timber to 24.5 percent).

- Makes the U.S. tax system moderately competitive.

7. Composite #3. Allow expensing for all reforestation costs and exclude 50 percent of long-term capital gain on timber sales from taxable income (reducing the tax rate on capital gain of corporate timber to 17.5 percent).

- Makes the U.S. tax system moderately competitive.

Statement of Vivian Kramp, San Jose, California

I exercised 4600 shares of ISO stock at $61.0625 per share on 9/14/2000. If I had sold at that point, the total value of the stock would have been $212,827.90. But the stock tanked to $17 a share, for a value of $78,200.

On my 2000 tax return I had to pay $78,864 in Alternative Minimum tax, which is more than the stock was worth. My adjusted gross income for that year was $79,596. Virtually all of my income for the entire year went to pay the AMT. As a divorced woman I am receiving alimony that diminishes in amount every year. In 3 more years, that will drop to zero.

I was counting on the stock options to tide me over until I can work again. With a special needs child, it is difficult to return to work at this point. I can ill afford to pay almost $80K in AMT when the stock value dropped so much. The AMT is affecting many middle class people like myself, many in more dire straits than I. To pay my 2000 income tax bill I had to spend all of the profit from the sale of my house after the divorce. I have heard stories of people losing their homes and savings because of this tax.

To tax someone on paper profits is grossly unfair. If I had actually sold the stock options, then the tax would be fair. The AMT was supposed to target wealthy taxpayers, but the unintended consequence has been to hit middle and lower income wage earners. We are being destroyed by huge, unfair tax burdens. Please reform the AMT to eliminate this problem.

Los Gatos, California 95033
March 18, 2005

To Honorable Chairman William M. Thomas and the House Ways and Means Committee's Tax Reform Hearing:

My wife and I have paid an unfair tax. I am an individual engineer who took a job with a technology company in 1998. The company offered me incentive stock options. I exercised some of the options at a time when the stock's value had dramatically increased. Not being a well informed investor, I held the stock while its value dropped. I was finally forced to sell the stock when the company was acquired.I have gained nothing on this stock, but the U.S. and CA government have taxed me approximately $50000 because of the Alternative Minimum Tax. I've only received a fraction of the money back over the years since I paid that tax. This tax has deci-

mated my savings, and that has caused me and my wife a lot of frustration. My wife, an immigrant from Russia, says that her previous government was worthy of such an unfair practice, and she has lost her faith in the fairness of the U.S. government. I think the government owes me interest for holding so much of my money for so long.

My coworkers sold their stock when they saw the value was dropping, but I believed the hype that the Internet boom would continue and that technology stock prices would remain strong. Why should the government punish me for my lack of stock market savvy?

Regards,

Kirk Krauss

Mountain View, California 94040
June 19, 2005

Dear Chairman Thomas and Committee Members:

Thank you for the opportunity to voice my concerns regarding tax reform. The main point of this submission is to call attention to the "AMT/ISO problem" (alternative minimum tax treatment of "phantom gains" on incentive stock options), and to make a specific request for retroactive relief for those affected in the past by this severely unfair and inequitable tax burden. While the AMT system in general is widely regarded as problematic, and deserves attention and consideration of reform, this specific "AMT/ISO problem" is an especially severe problem for those affected, and therefore requires special attention. The reason is, while the typical effect of AMT may be to increase one's tax liability by a few percentage points (say, 25% of income instead of 20%), the "AMT/ISO problem" has, for numerous taxpayers, caused a tax liability of 200% or more of their annual income, ostensibly as a prepayment of tax on anticipated future capital gains. In theory, the AMT payment is recoverable in future years as "AMT credits" when the anticipated capital gains, or other similar amounts, are realized as actual income; in reality, if that income is never realized, the "excess" tax paid as AMT may not be recoverable as "AMT credits" within the lifetime of the taxpayer. The question is, is it fair to assess an income tax on income that will never be received, effectively imposing a tax rate of 200% or more when compared with actual income? I think reasonable persons would agree that the answer is "no." What follows is my own story, and a specific request for remedy.

Originally from Cincinnati, Ohio, I graduated in 1985 with a degree in engineering from Case Western Reserve University, and then began a career in Silicon Valley. I was fortunate to work with many creative and talented people. In 1996, I joined Netscape to work as an engineer and technical trainer. In 2001, I exercised incentive stock options and held the shares, due to my belief in the company. I paid an AMT of over $180,000, around twice my annual income, by liquidating a substantial portion of my savings. By 2004, I had sold off all of the stock, but my actual gains were far lower than the "phantom gains" I had paid tax on. Now, I find that I have a six-figure AMT credit balance that is probably not recoverable in my lifetime. Needless to say, this is very disappointing. Whereas I fully accept responsibility for any gains or losses in the stock that I held, I am at a loss to understand why many years worth of my hard-earned savings must be permanently forfeited to pay an outrageously high tax involving "phantom gains."

Therefore, I respectfully request relief from this unusual and unfair tax burden, in the form of being allowed to pay capital gains tax on my actual gains, while receiving a full refund of any tax on "phantom gains." The net fiscal impact of providing this relief is theoretically zero, because, as I understand, a refund of AMT credits takes a liability off of the government's books. I think everyone, including the government, should be happy with people paying taxes on their actual gains. I certainly would be happy to do so.

Thank you for your attention to this matter.

Hans Lachman

Ben Lomond, California 95005
June 17, 2005

I am writing this letter to add my testimony to those given by others who are suffering because the affect of the application of the complicated AMT provisions to

the exercise of incentive stock options in a down market was unknown. I have been devastated after losing all that I have saved to carry me through retirement and find myself in a dire position.

I am a software engineer and have worked for wages all my life. I've been continuously employed since I was twelve years old. I'm from a large (5 boys and a girl) poor family. We lived on one income from my father, who was a technician. I worked my way through high school and college at various jobs to provide me with clothes and transportation and to help supplement the family income.

I was fortunate enough to work for the Department of Energy (DOE), where I implemented operating systems on state of the art supercomputers. During my 22 years with DOE at various facilities, I was exempt me from FICA and when I left DOE to work in aerospace, I was quite behind my peers in acquiring Social Security credits. While at various positions in Silicon Valley, where I was again working on state of the art networking and computer security, I did not receive any real retirement benefits. The work was all consuming and most enjoyable and the years seemed to fly by.

When I reached fifty-five, I noticed that I quickly needed to amass a nest egg to carry me through my retirement years. The point was driven home when my grandmother could no longer take care of herself and had no support to help provide comfort until she died. I was her only support as the eldest child (my mother and father died at an early age). She had nothing but Social Security and that was just not sufficient to take care of her. While I had sufficient income to allow her the care she required, it made me aware of the state of risk that I was in. I had never given the fact that I may not be ABLE to work any significant thought and at the age of fifty-five, I did not have many years left to save for a time when I may have to stop working.

I took a position at Exodus Communications as an early employee for a reasonable, but not outstanding salary with stock options. I was told that if I worked hard and the company prospered, my stock options would become valuable. I liked that idea because I have always been an overachiever. During my tenure at Exodus, I worked harder than I ever have in my life. I worked days at a time and traveled constantly. I have never worked under such stress in my life, but I built a security managed services business for Exodus that was their most profitable service. Eleven group members generated over $15 million in annual revenue. We were the highest producers in the corporation and watched over a world wide network of security services for Exodus customers.

The five years at Exodus took a heavy toll on me and my family but we all supported each other and took pride in the fact that I was helping to build a business that anyone could be proud of. We were counting heavily on the value of the stock options to provide us with the retirement income necessary. We built a retirement home in Colorado and purchased a nice home here in Santa Cruz County that we hoped would provide a little estate for our two children after we passed away.

That was not to be. Shortly after the company went public, a new set of management was brought in as part of the process of becoming a large corporation. The new management team squandered all the value that all the hardworking staff had generated and drove the company into bankruptcy in a very short time. I was not sure what had happened, but as I learned about Enron, WorldCom, and other corporate criminals, it became obvious that I too was a victim of corporate greed. When it became obvious that all the stock options I had exercised had become worthless, I was most disappointed, but I comforted myself with the knowledge that we still had our two houses, an IRA, some savings and I still had a good reputation as a leading software development manager.

However, that also was not to be. In August, after filing two extensions, my CPA and financial adviser informed me that I had a $1.7 million dollar tax bill based on all that worthless Exodus stock. I thought, "That's just not possible, I paid over a half million dollars in taxes the year before, how could I owe another 1.7 million based on worthless stock?"

I can assure you that you have never experienced a shock like the one I got when I learned that I REALLY owed the State and Federal Government all that money—many times over what I had left from my time at Exodus or that I could make in my viable working years. Until that day, my biggest problem was finding a new job to replace the income I had at Exodus. Now that I was 60 and the market was tight, no one wanted to hire me even though I was still one of the best in the business.

So here I am at 61 and still telling myself that this just CAN'T happen to me. There must be some way this is incorrect. I've attempted to work out settlements with the IRS and California Franchise Tax Board and they now have all the cash and retirement savings I have accumulated during my 50 years of employment and it appears they are about to take the rest of my possessions. I never thought I'd

end up as one of those you see on a street corner with a cardboard sign, but I'm not far away from that today. I've been looking for work for nearly a year now and living on savings which the IRS has just taken. There are tax liens on both houses so I can't sell them to buy food and pay rent. There are zero balances in my bank accounts and all the monthly bills are coming due.

I feel really bad for my wife who depended on me to provide us with some sort of retirement. The frustrating thing is that with this job market, I can't just say "Oh well, I'll just work until I die." I can't even find a job with sufficient income to pay medical insurance or rent. I just don't know what I'm going to do. It's a mess.

Thanks for your attention. I do hope that you can make some equitable changes to the tax system before we lose our last remaining assets.

Leroy Lacy

Statement of Linda L. Lacy, Mogadore, Ohio

Dear Chairman Thomas and Committee Members:

After struggling with the words that might make my testimonial a significant statement in favor of reforming the AMT, I keep returning to the reality of the personal toll that the AMT has taken on my son . . . and so, I offer a Mother's intimate account:

After months of back-and-forth "conversations" with the IRS that finally resulted in their determination that they had zero interest in an "offer in compromise" and because my son was told by the IRS that the only monthly payment plan they were willing to offer him was a one-month plan for the entire amount "owed", I obtained a signature loan, maxed-out three credit cards, and most crushing of all . . . cashed-out my fifteen-years of retirement savings from my 401k, walked into our local IRS office and proceeded to hand the clerk a personal check approximating 95% of the "debt" my son "created" by exercising a portion of the stock options given him by a dot.com firm he was working for in California in 2000. After watching him struggle to figure out a way to support his wife and children and still pay the IRS for a phantom gain on those remaining stock options, I decided to utilize MY borrowing power and deliver him from the specter that is the IRS. I could ill-afford to do this for him, yet I must confess that I did it partially for selfish reasons . . . I was tired of the fear that kept me awake at night wondering if the "new, friendlier IRS" would put a lien on his bank account or encumber his employer by laying claim to his wages in order to satisfy the most insidious IRS tax regulation that exists.

What a ridiculously complicated system of taxation we live under! This young man has been sentenced to years of trying to climb out from under oppressive and illegitimate taxation debt. I'm appalled by what our own government is allowing to obscure the dreams of so many.

After considering the power the IRS wields, we determined it was better to owe almost anyone but the IRS (in fact, the IRS WEB site encourages that it would be more advantageous to take out a bank loan than subject oneself to the penalties and interest assessed by the IRS . . . *very helpful information*). As I am nearing retirement and need to direct my financial life toward that phase, I found myself in a rather precarious position . . . one of choosing to help my son or helping myself (what would most parents do?).

My children were raised with a respect for the United States government and all it represents. I led them on several occasions through the impressive buildings and beautiful monuments of Washington D.C. and extolled the virtues of living in such a privileged country. My husband and I managed to provide all three of our children with college educations and will gladly and appreciatively spend the rest of our lives repaying the loans that provided them with the excellent learning experiences they received. But, at least there are solid educations in exchange for those loans! My son received two engineering degrees in four years and we were certain that the culmination of his hard work would be financial reward compensatory to the effort he expended. That reward must now take a back-seat to the IRS to satisfy this caustic injustice.

Please give all of us a break . . . reform this tortuous tax and designate it RETROACTIVE to the 2000 Tax Year when so very many ambitious, spirited, and intelligent young people were caught completely off-guard and are now paying dearly for their naiveté (some in amounts reaching hundreds of thousands of dollars). In addition to those already mired in this mess, so many of us in the middle class without

accountants and lawyers to warn us of impending danger are indeed poised to be ensnarled also.

To close, I must add that those affected by the AMT extend beyond those whose social security numbers appear on the IRS debt ledgers. . . . Thank you for reading a Mother's testimonial.

Hutto, Texas 78634
June 20, 2005

Dear Chairman Thomas and Committee Members:

Thank you for looking into what is an extremely egregious situation. The AMT as it affected us due to ISO stock options has forced us into bankruptcy, and due to the extremely large amount of tax it calculates, it may cause us to lose everything we own, including our house. At a minimum, it is forcing us into a Chapter 11, preventing us from a Chapter 13 or Chapter 7, which means our Bankruptcy costs are about $15,000-$16,000 instead of $2000 to $3000. Our effective tax rate was over 600% and if nothing is done, it will take us over 70 years to utilize our tax credits. This happened at a Bio-Tech company not a telecom company, so there are some of us in many facets of U.S. industry, not just one.

How is this fair or right? We went from thinking we were on our way to having a decent retirement after struggling for 20 years to living the last 5 years under the constant stress of what is going to happen to us and how are we going to survive. There hasn't been a single day that we haven't had some issue, be it physical, emotional, stress, or depression to deal with. So far we have been able too stay married and sane, but it has not been easy. Instead of helping our children and parents they are having to help us. Is this the American Dream? Since finding out about the AMT repercussions, almost everything we do has been based on how to deal with it. All we did was exercise my ISO options. How can we owe taxes on something that we never realized? How can the U.S. government and its tax code be responsible for making thousands of people paupers?

For those of us that are either on the brink of ruin or over the edge, it would be a big help to us to be able to resolve this equitably. It will not put things right for us because we still will not have any retirement or funds and will have to try to rebuild, but it will at least help us to get started. If we can either take the credits that are due to us more quickly so that we can recover the credits that are due to us or if we can treat the exercise and final sale/resolution of ISO options/stock as a single year occurrence, we can at least have a fair way of dealing with this issue.

We have been a middle-income family since we were married almost 25 years ago. We have worked for everything we acquired, and have not been extravagant spenders. In fact since our 2 children started their activities, Ballet and Dance, Ice Hockey and Figure Skating, most of our expendable income has gone for them. I worked at a company, Luminex Corp. that I helped to be successful enough to go public, and was offered ISO stock options as a reward for my efforts. Due to management changes I left the company in July of 2000, and had to exercise my options, but was not aware of the tax implications of the AMT. Everyone including our stockbroker told us to hold on to the stock to get long term gain tax gains as well as I thought the company had a future. What we didn't realize is that the IRS wanted us to pay the taxes on the gain (AMT) even though we did not sell the stock. This would be like paying taxes for the increase (Gain) in value of your land, even though you never sold it. All we have left is the house we have been living in for the last 12 years, as we no longer have any savings or retirement, and both of our vehicles are over 6 years old. Also, since I came from the technology sector, I was out of a job in my industry for over 2.5 years, and worked at whatever jobs I was able to find. I am now working in industry again, but this burden of the AMT is having very serious consequences that are not only affecting ourselves, but is also affecting our children. Instead of being able to pass along some of the fruits of our sacrifices and hard work, we are not able to help our children start their own lives, and in fact are concerned for ours in our later years as our children (17 and 22) are having to help us now.

We had to exercise my ISO options in August 2000. The IRS says that due to the AMT, we owed almost $300,000 from that year even though we didn't sell them. Because of what happened with the stock value, if we could treat the exercise and the final result as a single transaction, or if we didn't have to consider the AMT, the amount would be more realistic and manageable. We currently are in bankruptcy and the IRS has put a lien on our house for over $400,000, that if we come out of Bankruptcy (the trustee is trying to say there is no outstanding question about the

validity of the AMT so is trying to get the case dismissed), they will seize it. We don't understand how we can owe taxes on a something we never had. The judge just ruled that the IRS claims are such that we cannot file Chapter 13 but have to file 11, which increase our costs to recover from $2000–3000 to $15,000-$16000. If we are already struggling to recover, how is adding $13,000 on top of our debt helping?

Your consideration in this issue is greatly appreciated. Please help to make the AMT law apply as it was supposed to, not against normal middle-income citizens.

Regards,

John Lapaglia

Mountain View, California 94043
June 17, 2005

Dear Chairman Thomas and Committee Members: My name is William Lazar and I am writing on behalf of my wife Vivian and myself. We appreciate the opportunity to discuss the hardships we are suffering due to an outdated and complicated portion of the tax code called Alternative Minimum Tax.

I moved to Silicon Valley before the dotcom era to work for a small software company. Like many such firms, our product was interesting and even innovative but our management was better with technology than business and nine months later I was out of a job.

Fortunately I hired on almost immediate with another startup in January, 1997, and this company was much more successful. The ISO options I earned as part of this work became very valuable when Sun Microsystems bought the company in 1998. I worked through an unbelievably difficult two and half years at Sun until my options were fully vested and decided to take a little time off.

I asked for a six month personal leave, which was granted, but when that time was up the tech market had crashed and there was no job for me to return to at Sun; their first major layoff was only three months later. Since I was no longer a Sun employee I had to exercise my vested options within 90 days or lose them.

Since I was fortunate enough not to need the money immediately I exercised and held. Unfortunately Sun's stock continued it's fall from a high of $64.50 to under $2.50. I had to pay $45,000 to the federal and California governments all due to AMT calculations. Of course I never saw a penny of this, the stock was sold for under $20,000.

Just as there was no job for me at Sun, there were no jobs in general. Since my separation from Sun on 17 Aug. 2001 I've worked 5 months for one company as a contractor (total income of $34,500 but self-employed so a huge tax bill) and now have worked three months for another small company at $20 per hour (though as an employee). Only through the good fortune that my wife has been able to help with the bills—she's a records clerk at a law firm making under$40,000 per year—have we been able to avoid serious financial trouble.

Meanwhile, I have an AMT tax credit of over $150,000 that I can hardly imagine ever being able to claim.

I could have been smarter and sold the stock sooner, I'm not trying to evade responsibility for my own decisions. But I cannot understand how a tax program that was intended to make sure very wealthy individuals didn't hide their good fortune and avoid contributing to our community can catch up people like myself, who've never made as much as $100,000 in a year. My story is probably one of the mildest you're receiving on this subject but I want to add my voice to those urging you and other members of Congress to change this illogical law.

William Lazar

Statement of Leo Linbeck, Americans for Fair Taxation, Houston, Texas

Mr. Chairman and Members of the Committee on Ways and Means:

The Americans for Fair Taxation (Fairtax.org) welcome the chance to submit this written testimony for the Committee's first tax reform hearing. We understand that this, initial hearing is limited to an overview of the principle objectives of reform—fairness, simplicity and growth—in anticipation of the recommendations from the President's Advisory Panel on Federal Tax Reform (which have been delayed until September 31, 2005). Fairtax.org submits this testimony in order to:

- offer its views on the criteria by which tax reform should be judged, the importance of defining those criteria and the relevance of holding hearings exploring those criteria;
- address two issues discussed by panelists, particularly the means of measuring fairness and as to the effect of tax reform on border adjustability;
- and, dispel two unfair myths that have been connected with the FairTax plan, namely the difficulty of compliance and the relevance of the tax-inclusive rate.

With more than 600,000 supporters, Fairtax.org is the nation's largest grass roots citizens' organization dedicated to fundamental tax reform. As a nonpartisan organization, we have engaged some of the nation's leading scholars and tax policy analysts to explore the infirmities of the existing system and the best means of correcting them. The product of our effort is the FairTax, which has been introduced by Representative John Linder as H.R. 25 and in the Senate as S. 25 by Senator Saxby Chambliss. The House bill now has 37 cosponsors. We have engaged and we continue to engage academic scholars to study the effects of the FairTax on economic growth, fairness, international trade and specific industries. With the benefit of our research and our efforts towards fundamental reform, we respectfully offer the following insights within the narrow scope of this hearing.

Relevant Criteria By Which Tax Reform Should be Measured—The Internal Revenue Code and the U.S. tax system in general are nearly universally derided. Although many Americans taxpayers share a visceral disdain for the tax system, they hold that view for diverse reasons. The Tax reform debate by necessity cannot focus on one problem. The debate will encompass a wide range of competing problems searching out competing solutions.

In light of the complexity of the issues demanding resolution, a consensus must emerge over the common issues tax reform is meant to address before the effectiveness of competing plans can be analyzed. The salient problems with the current system must be identified before we can determine which ideas best address those problems.

As the Committee takes this first step along its historic task, the Chairman is to be commended for noting three major priorities that should drive any tax reform we enact: simplicity, fairness and economic growth. However, we would ask the Committee expand upon those criteria by developing a methodology for measuring which system most effectiveness promotes these objectives. As the Committee begins the task of fact finding and deliberations, Fairtax.org offers what it considers to be the most important classifications of these problems. From our own analysis, from our evaluation of testimony and from the problems most commonly cited in our surveys and in the hearings, we suggest the Committee measure the success of tax reform alternatives against the following scorecard:

- How do the plans *affect economic growth and real incomes? Apart from lowering marginal rates, a system that eliminates the double taxation of income (is neutral as to savings and investment) will create more growth.*
- In a related inquiry, what is the base and therefore the required marginal rate to achieve revenue neutrality? *Not only is the marginal rate directly related to the base, but the marginal rate has a direct bearing on economic growth and evasion.*
- How do the plans *encourage savings and investment? Savings are responsive to a return on capital and consumption taxes remove the bias against savings.*
- How is *education treated under the plans? The cost of acquiring education is the cost of America's investment in its intellectual capital and the route to upward mobility.*
- How do the plans *ameliorate complexity and compliance costs? Not all plans are created equal in eliminating compliance costs long-term.*
- Does border adjustability really have no effect on international competitiveness or do the plans have vast differences in the way they *affect international competitiveness (the ability of domestic producers to compete against foreign produced goods)? Only destination-based consumption taxes are border adjustable.*
- How *fair is the distribution* of the burdens and benefits and how does it affect *upward mobility? Under a consumption tax, this question requires a multi-dimensional analysis.*
- How *reliable* is the plan as a *source of revenue? Under some plans, fluctuations in revenues present a problem.*
- How do the plans *expose hidden taxes? Plans can be distinguished by the ability of taxpayers to see what they truly pay for the cost of government.How do the plans respect privacy and other civil liberties? The tax laws need not be intrusive.*

- What effect will the plans have on charitable *giving? Plans differ as to the after-tax costs of giving.*
- What effect will the plans have on promoting *homeownership? Plans differ by raising or lowering the costs to the taxpayer of purchasing a home.*
- How will the plans affect tax *evasion and tax avoidance? Some tax reform proposals will do nothing to quell the swelling tax gap.*
- How *permanent* is the plan (i.e. how resistant is it to unraveling)? *The Committee should consider the staying power of the reforms it recommends.*
- How does each the plan affect *global tax competition, tax rates and reform? Some plans will encourage global tax reform (i.e. they are more contagious).*
- To what extent do the plans introduce and dispose of *transition* issues? *Many plans simply ignore the large transition issues they present.*

The FairTax plan best meets the criteria laid out before the Committee. We stand ready to offer the Committee more detailed testimony at future hearings to more fully address each of these issues. We would urge the Committee to review our web site, which contains a recent submission to the President's Panel on Tax Reform on these very points.

In identifying the tax reform alternative that is considered optimal, the inquiry begins with defining the public policy goals of tax reform. A more definitive level of agreement over those goals—if not the prioritization of them—is the political question that will better enable scholarly and objective analysis to analyze the plan that best succeeds in achieving those goals. Congress and the American people will be able to judge the effectiveness of proposals against these objective criteria without unnecessary political rhetoric. And as the Committee addresses the key questions, the true strengths and weaknesses of each plan will become evident.

The Distributional Methodology to Ensure "Fairness" Should be Measured in Ways that are Not Biased Against Pro-Growth Tax Policy. Fairtax.org views favorably recommendations made by Dr. William Beach of the Heritage Foundation, who focused much of his oral testimony to the Committee on the need to change the method of measuring distribution. Dr. Beach argued that as the tax reform debate commences, the Committee should avoid the trap of income-tax biases when measuring distributional burdens of consumption taxes. Fairtax.org agrees, taking Dr. Beach's testimony one step further. The Committee should recognize the flaws of current distributional methodologies when seeking to make the tax system more pro-growth and progressive.

The Chairman recognized the importance of fairness as a key priority of tax reform and defines it as "similarly situated taxpayers bear[ing] similar tax burdens." Whether any tax reform plan is more equitably distributed than another will simultaneously be the most influential and contentious value judgment of the coming reform debate. In the final analysis, the question of distributional equity boils down to three inquiries: (1) how much *should* people of varying wealth, income or consumption pay in taxes and on what basis?; (2) how much *do* people of varying wealth, income or consumption pay under today's structure or alternative tax structures?; and, (3) does the tax system curtail or improve prospects for upward mobility? In the absence of specific criteria to define and measure 'fairness' these relatively straightforward questions may lend themselves to rhetorical flourishes rather than economic analysis.

As the Committee approaches the pivotal issue of "fairness," the definition it ascribes to "fairness" and the means of measuring and presenting distributional data will mean the difference between informing the debate or constructing a monolith to stifle pro-growth reform. As the conventions for defining, measuring and portraying distribution now stand, the answer to the question of whether a consumption plan is "fair" is effectively pre-ordained by standards of distributional equity that frame the question through reference to an income tax. In short, the Committee must reevaluate and reconstruct the manner in which it chooses to measure and view distribution if the American people are to be given relevant information that can enable them to make informed decisions about distributional equity.

The centrality of this point is best understood by examining the narrow but conventional view that "fairness" equates to progressivity of tax burden relative to some measure of *annual income.* That is the view that may be shared, for example, by Dr. Joel Slemrod of your hearing panel, and for a reason. Taxes paid over *income* is the preferred quotient of analysis for those who support multiple taxation of savings and investment at accelerated rates (as opposed to consumption taxes). Since consumption taxes do not tax returns on investment multiple times (which under an income tax is considered a normal part of the income base), and since lower wage earners in the aggregate spend a disproportionate amount of their earning on consumption, the more a tax is based on consumption the more it is a foregone (and

incorrect) conclusion (based on such a methodology) that the tax is "regressive" or less "fair." Measuring fairness according to an *annual income* methodology will always show an unfair bias in favor of punishing savings and investment chiefly because it uses taxes paid over *income,* rather than *consumption,* as the unit of measurement, even though nearly all economists agree a system neutral as to savings and investment will result in higher real incomes. The biased nature of basing distributional tables on *annual income* would seem apparent.

In reality, measuring distribution as a quotient of taxes paid over *income* is only one possible method of portraying fairness, and neither the most objective nor best method. Income earned in any given period is, at best, an incomplete measure of one's ability to pay over a lifetime; and in the case of wealthy individuals, a poor measure. Proponents of a consumption tax argue instead that the best measurement of the equity of a tax system is what one individual consumes for his or her own personal well-being over the course of a lifetime, *i.e.* the private as opposed to public uses of capital. Under the FairTax, consumption at or below the poverty level is simply not taxed at all, in keeping with the principle that the government should not extract resources from citizens until they have met their own sustenance. This is accomplished by a "prebate." Income which is not consumed is either saved or invested or provided to charitable causes (or government) to fund the consumption of others. The return on savings and investment is either used to fund future consumption or reinvested to increase productivity and output. If income and savings are taxed, we have simply taxed deferred consumption. Individuals who defer consumption do so because they elect not to consume it for themselves immediately, but to make the resource available for others. For this reason, consumption tax supporters argue that measuring taxes paid over *consumption* is an equally valid distributional measure, and a more appropriate measure, of fairness. If one supports a consumption tax for pro-growth reasons, even if one supports certain aspects of a consumption tax (such as the taxation of income only once), then is it not equally valid to display the distribution as taxes paid as a function of *consumption* as opposed to *income*? Is this is not a decision that rightfully falls outside the learned realm of economics?

Using *income* as the denominator is a bias built into conventional distributional charts that favors the steeply progressive marginal rates with double or treble taxation of income, but it is far from the only bias. Another major bias exists if we adhere to the conventional wisdom of restricting the unit of analysis to *annual* income. *Annual* income wrongly assumes the taxpayers within an income category will remain financially frozen in perpetuity (i.e. their income will not change year-by-year and over the course of their lives). By making that assumption, we not only defy reality, we are often comparing a 45 year old father with the 18 year old daughter in order to argue that tax policy should require the father to redistribute more of his income to his daughter. If Congress is provided charts depicting distribution only on this basis, those charts will wrongly argue that flatter marginal rates hurt the poor and benefit the rich, even if they are the same people at different stages of life. Basing distribution on stagnation within income deciles not only yields a knowingly wrong result, but also yields a result knowingly biased against a flattening of rates that nearly all economists (and those on your panel) agree increases economic growth.

Rectifying these biases is not only desirable; it is imperative if we are to make economically sound analysis of competing proposals based on accepted economic principles. Rather than blindly measuring distribution on the basis of taxes paid over *annual income,* Fairtax.org contends that the proper approach is to examine distribution in the manner that has been recommended for several years by the President's Council of Economic Advisors; such as, measuring distribution as taxes paid over consumption, lifetime income, or by evaluating distribution on a dynamic basis by measuring *what people have after taxation.* Such means of measuring distribution was suggested by Dr. Beach. In considering distribution, the Committee should make clear the enormous and uncertain effect that conclusions over incidence of corporate and other taxes have on distribution. Sometimes these taxes are just ignored in distributional tables. The Committee should employ a methodology that requires the distribution tables include the compliance costs that are regressive under the current tax system and which have given rise to the need for reform (as well as assumption over differential compliance rates by income or consumption class since the $353 billion tax gap itself is not equitably distributed). The Committee should be aware that plans which seek to significantly lessen compliance costs should have a "simplicity dividend" a "growth dividend" and a "compliance dividend" that will also have distributional effects.

The Committee should also recognize distribution models underestimate the regressivity of the current system by failing to account for uncertain incidences of

corporate and personal income taxes, payroll taxes, self-employment taxes, and compliance costs that are embedded in the price of consumables or the cost of capital. The Committee should recognize that an important determinant of 'fairness' is whether a particular tax scheme affords greater or lesser upward mobility. In summary, as the Committee explores the key subject of fairness, it should resist viewing the distributional debate solely through the reference frame of an income tax. And it should understand why such a limited reference frame offers a skewed vantage point that flies in the face of the pro-growth policies the Committee recognizes as essential to reform.

The Unsettled Question Concerning Border Adjustability (and Territoriality.) The FairTax has many merits arguing for its enactment. These include, among others, the fact the FairTax stimulates economic growth, untaxes the poor, removes disincentives to work, save and invest, encourages home ownership, advances investment in human capital, makes the tax system simpler and more visible, lowers compliance costs, and honors the privacy and other civil liberties of taxpayers. Moreover these positive effects are supported by extensive research. But one often understated reason that deserves further explanation is that the FairTax is the most border adjusted tax plan that could be devised.

Allow me to explain further. Fairtax.org asserts that the U.S. government should not, as a matter of policy, accord a huge advantage to foreign companies competing in the U.S. market or impose a huge disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets. Regrettably the current tax system has this adverse consequence on the economy.

Today, the U.S. tax system harms the competitiveness of U.S. businesses. Heavy income and payroll taxes are imposed on U.S. workers and businesses producing goods in the U.S. whether those goods are sold in here or abroad. U.S. corporate taxes are the highest in the industrialized world; with a top corporate rate about nine percentage points higher than the OECD average. Our current tax system imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign value added taxes, a major component of the total revenue raised in most developed countries including every OECD country except the U.S., are rebated if foreign goods are exported. U.S. manufacturers selling abroad must pay foreign value added taxes at an average rate of nearly 18 percent in addition to U.S. income and payroll taxes, creating a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad.

Empirical evidence suggests that the U.S. inability to border adjust its taxes is of tremendous practical importance. With each passing year, manufacturing is a smaller and smaller part of the overall economy. The value of all goods manufactured in the United States was roughly 30 percent of the value of all goods and services in the economy in 1953, and fell below 15 percent in 2001. The U.S. trade deficit is now almost six percent of GDP and trade deficits exist in nearly every category of goods with nearly every country. Most importantly, there is an unsustainable "Production Gap." The U.S. now produces only about ⅔ of the goods it consumes. The reason is the tremendous price advantage we accord foreign producers and foreign workers when competing against American products sold in the domestic market or bound for overseas sales.

The largest single factor in the decline in U.S. manufacturing jobs is within our power to fix by reforming the tax code.Specifically, we need to eliminate those aspects of our tax system that artificially place U.S. production at a competitive disadvantage to foreign production. The most powerful tool to improve the international competitiveness of U.S. business is to move to a destination principle tax system (also known as a border adjusted tax system)—a tax system that taxes all goods consumed in the U.S. alike, whether the goods are produced in the U.S. or abroad.

The FairTax accomplishes this result. Foreign manufactured goods and U.S. manufactured goods will pay the same tax when the goods are sold at retail. U.S. businesses selling goods or services in foreign markets will not be subject to federal tax. By comparison, not all consumption taxes do so. The flat tax does not address this problem. The Flat Tax is an *origin* method value added tax. It taxes the consumption of U.S. value added, whether the consumption occurs in the U.S. or abroad. Foreign made goods consumed in the U.S. bear no tax under the Flat Tax. Thus, under the Flat Tax, American businesses and American workers would still be placed at a large tax disadvantage in international markets. Other destination based consumption taxes may be border adjustable, but they accomplish this result less effectively and efficiently because the entire taxes imposed are not border adjusted as they would be under the FairTax.

Fairtax.org recognizes that some of your distinguished panelists at this hearing, particularly, Dr. Alan Auerbach, disagree with us on the relevancy of border

adjustability. For instance, without much elaboration he asserted that "border adjustments will simply strengthen the dollar, putting importers and exporters in the same competitive positions no matter which approach is adopted." By contract, Fairtax.org contends that border adjustability matters greatly to U.S. competitiveness, and this view is shared by noted economists.

The fallacy of the 'border adjustability is irrelevant argument' can be seen most clearly with the FairTax. Advocates of the "irrelevancy position" incorrectly argue that if the FairTax were implemented, any relative price change will be eliminated by an immediate offsetting 23 percent appreciation in the dollar. This theory is based on the assumption that appreciation of the dollar will be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods. The greatest flaw in this analysis is that the demand for U.S. dollars is not limited to the traded goods market. Nearly $90 trillion in U.S. assets owned by households and non-financial businesses are denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and long and short term assumptions. Furthermore, the non-traded goods and services sector is also denominated in dollars and exceed the traded goods sector in size. The value of the traded assets alone cannot possibly adjust the value of all dollar denominated assets. Consider for a moment the treatment of commodities, where prices are established through international markets.

If, however, border adjustability is not relevant and there is no increase in the competitiveness of U.S. goods because of a 23 percent increase in the price of the dollar (more or less precisely) relative to foreign currency, then the FairTax will have succeeded in increasing the wealth of the American people by something on the order of $20 trillion (23 percent of $90 trillion) relative to the rest of the world, an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. If that were to happen, it would be reason enough to enact the FairTax. Unfortunately for American asset owners, it is impossible for the traded goods sector to dominate the currency movements since the dollar asset markets are perhaps 100 times as large as the annual traded goods market (net basis).[1] The argument collapses when one understands that currency fluctuations are influenced by a great deal more than just taxes on traded goods. An additional legitimate inquiry regarding the reliance of border adjustability would examine whether the U.S. wants to take the risk that it is imposing what amounts to a self-inflicted tariff on its domestic producers and workers when it recognizes the difficulty of providing direct trade incentives under the WTO?

The Tax-Inclusive Means of Measuring the FairTax is Not Disingenuous— Critics of the FairTax wrongfully contend that expressing the FairTax rate in tax-inclusive terms is disingenuous. For instance the Ways and Means Committee democratic staff state on their website that when the rate is quoted as '23 percent' it really means '30 percent' to the consumer." As the Committee proceeds with these hearings, it should clarify that the rates of various tax reform proposals must be compared on a uniform basis.

When considering the rate of a single stage consumption tax, or any tax for that matter, one must always decide which of two distinct means of portraying this rate—the "tax-inclusive rate" or "tax-exclusive rate"—best reflects the tax burden. Which one we employ changes absolutely nothing in terms of the taxes that are actually raised or paid by the taxpayer under the taxing regime examined any more than describing a hot day as 40 degrees centigrade or 104 Fahrenheit changes the level of discomfort. **But the metric used does change the perception of those who wish to compare the merits of competing tax proposals.** When making comparisons between alternative taxing systems, it is important to ensure that these comparisons are consistent, fair in terms of expectations, and are well explained. Fair comparisons eliminate rather than exacerbate confusion over a relatively critical point as the means of expressing the tax rate. The FairTax plan contends that the rate of the FairTax is properly measured through the use of the same scale as is used for all competing federal plans. We contend the only correct and accurate means of measurement is to compare the tax-inclusive income tax rate to a tax-inclusive sales tax rate. Therefore, in order to compare apples to apples the FairTax is, unlike most state sales taxes, imposed on a tax-inclusive basis.

Two examples may help clarify the use of these two rate calculation methods. Assume a worker earns $100 and uses the entire amount to pay for a CD player at Wal-Mart. Under the income tax, the worker would earn $100, pay $20 dollars in income tax, and have $80 left over to buy the CD player. We would say this tax

[1] See, Flow of Funds Accounts, United States of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

rate is 20 percent. In a typical sales tax we would say the worker earned $100, paid $80 for the CD player and paid $20 in sales tax. We would divide $20 by $80 and say the rate is 25 percent. Using this method, we would say the sales tax rate is 25 percent and the income tax rate is 20 percent even though the tax burden is precisely the same, i.e. $20. The problem of course is that representing the FairTax as 25 percent and the income tax as 20 percent would lead one to think the FairTax imposes more tax or has a smaller base, when both conclusions would be wrong. Thus, the FairTax uses the same method of stating its rate (the tax-inclusive rate) as does the current system it is designed to replace, and while the FairTax is agnostic about which method is chosen, it believes the methods should be consistent across tax plans.

The Ways and Means' Democratic staff observes that on a tax-exclusive basis, the FairTax would be imposed at a 29.9 percent rate. Nothing is wrong with that assertion in the abstract. However, on that basis, the current tax system would impose marginal tax rates on middle-class taxpayers of 76 percent, if you take into account the hidden employer payroll tax is borne by workers.[2] The Flat Tax would bear a maximum marginal rate of 47.7 percent. The FairTax is expressed on a tax-inclusive basis not because it shows a lower rate expressed differently than state sales taxes, but because the price of adherence to the way state sales taxes are expressed would be misrepresentation at the national level. Therefore, the FairTax quotes the rate as tax-inclusive, and explains where it has the chance, the difference between the two methods.

The Myth that a Single Stage Consumption Tax In Excess of 10 Percent Won't Work. Dr. Joel Slemrod testified that a national sales tax that would replace the entire tax system would suffer from a lack of compliance. He repeated an "urban myth" of income tax proponents that a sales tax in excess of 10 percent will create compliance issues. with a rate beyond 10 percent. This statement has been repeated so often and with such certainty by income tax proponents, that it must have academic substantiation or proof. This is not the case.

The author of this conjecture was Vito Tanzi, former Director of Fiscal Studies at the International Monetary who simply offered this opinion in a 1995 Brookings Institution publication.[3] Taxes are unpopular and breed resentment today—as they undoubtedly always have and to some degree probably always will. Accordingly, some people will evade taxes no matter what the governing tax system, but there is no evidence—empirical or analytical—to suggest that the sales tax would not be complied with at a national level, extant research and the empirical evidence suggests that the tax would increase voluntary compliance while reducing compliance costs. For example, much of the tax gap today is attributable to mistakes caused by the complexity of the law. Mistakes and confusion would be all but eliminated under a system that creates no exemptions, and dispenses with the complex issues present today. And the FairTax improves all the factors known to bear upon noncompliance, including reducing the rate and the number of collection points. The more than 60 years of practical experience in administering sales taxes at the state level supports the position that the FairTax would be administrable at higher compliance rates relative to administrative and compliance costs. Whether or not the plans can be complied with is also directly related to the costs and intrusions into privacy. The relative administrability of the various alternatives, including the single stage consumption tax, should be explored in a separate hearing devoted to that purpose and not dismissed by unsubstantiated opinion.

The Facts that Influence Pro-Growth Tax Policy. Fairtax.org has done extensive research on the economic effects of its plan. Economists estimate that the FairTax plan improves wages and the economic well-being of all Americans. For example, Boston University economist Laurence Kotlikoff estimates the shift to consumption taxation raises the stock of U.S. capital by at least 29 percent (potentially by as much as 49 percent) and U.S. living standards by at least seven percent and

[2] The way of looking at the income tax from a tax-exclusive point of view is to ask how much a worker must earn to spend $100. Today, a taxpayer in the 28% tax bracket (who pays 7.65 percent in payroll taxes) must earn $155 to pay for $100 in goods. If the employer's share of the payroll tax is considered, this worker must earn $176 to spend $100. A 15 percent income tax bracket taxpayer must earn $129 to spend $100. This figure would be $143 if the employer's share of payroll taxes is taken into account. If we were to apply a tax-exclusive metric to the income tax, the income tax with the payroll tax bears a maximum marginal rate that is 75.8 percent of the tax-exclusive rate. Even the Federal individual income tax alone reflects a maximum marginal tax-exclusive rate of 43.3 percent, and the FairTax plan bears a maximum marginal rate of 29.9 percent.

[3] Tanzi, Vito, 1995 "Taxation in an Integrating World." Washington: Brookings. 1995, pp. 50–51. For the opposite view, see Dan R. Mastromarco, "The 'Fair Tax' and Tax Compliance: An Analytical Perspective." *Tax Notes* 79 No. 3 (April 20, 1998): 379–87.

potentially by as much as 14 percent. Work by Gary Robbins, Ph.D. of Fiscal Associates shows that replacing the current tax system with a single-rate system that treats capital and labor income equally—such as the FairTax—increases the GDP 36.3 percent and private output by 48.4 percent over the long run. Higher investment levels increase the productivity of employees, demand for workers and real wages.

Even more important than the end result of the FairTax is an understanding what critical aspects of the various plans generate such positive effects. Certainly, the FairTax provides substantial benefits from the non-trivial savings from compliance costs, from greater compliance itself, from international competitiveness and from the elimination of the deadweight loss of special interest tax provisions. However, the Committee should recognize that the majority of the economic growth will come from lowering marginal rates (which results from broadening the base and flattening the rates) and the elimination of the multiple taxation of income (which results in neutrality as to savings and investment). Not all plans proposed will achieve these objectives to the same degree.

Conclusion. As the President's Advisory Panel on Federal Tax Reform noted: "History has taught us that although it is relatively easy to achieve consensus on the need for reform, it is much more difficult to devise a solution that satisfies all competing interests." The hard work of crafting of that solution will fall upon this Committee. As it undertakes this task, Fairtax.org urges the Committee to define the goals of reform in the most definitive terms possible and focus the debate around the type of reforms that best meets these goals. As it proceeds, Fairtax.org urges the Committee to separate the myth and rhetoric from the reality and efficiency of each reform plan it considers. Proponents of the FairTax eagerly await and welcome the opportunity to participate in such a debate.

Statement of Hendy Lund, Ben Lomond, California

Subject: California dreamin? Try California Nightmare thanks to AMT

Comments: In 2000, I was living a dream. I was working for Redback Networks in a job I loved, was married to a great guy, and had just bought a house thanks to stock options I'd been granted when I started at Redback. With the rest of the options, I'd done an "exercise and hold", with the intention of avoiding short term capital gains by holding the shares for a year, then selling them to pay the taxes on the shares I'd sold to buy the house.

Convoluted? Perhaps . . . but it was based on the "common wisdom" of the time. After all, "the shares aren't going to go down anytime soon, and this way you'll save a bunch on taxes!" Then the bubble burst. Come April 2001, when it was time to pay taxes, the shares were worth 1/50th of what they were in 2000. Still, if I sold those and took out a mortgage on the house, I could cover the regular income tax. I wouldn't have the luxury of owning a home free and clear, but a mortgage is "normal", and I still had a house, something that isn't easy to make happen in California.

Imagine my horror when my accountant presented me with a Federal tax bill of $1.2 million. Why? That "exercise and hold"—a transaction in which I received no actual money—was treated as income for AMT purposes. My accountant explained that it was a "prepayment", and that it would be applied as a credit when I actually sold the shares.

Excuse me? The government is taking my money before I even have it?!? And now that the stock is effectively worthless, they're taking money I'll *never* have? Now it's 2005. I've sold that home for ⅔ of what I paid for it. That "great guy" and I are divorced—and yes, the fights over money and the associated stress contributed. I still owe the IRS $1.2 million thanks to compounding interest and penalties. The only reason I'm not in collections with the IRS is that I hired a tax attorney. My financial future—my retirement, my daughter's education—is on hold until someone flinches and figures out what to do with my debt.

I think I'm a good citizen. I pay taxes on the money I earn with hardly a grumble, and I'm honest about how much I earn. But I'm screwed because AMT considers a "Monopoly money" gain to be cold hard cash . . . and that's just not right.

Boca Raton, Florida 33432
June 17, 2005

Dear Chairman Thomas and Committee Members:

I was an employee of Qtera, in South Florida, of one of the many acquisitions of Nortel Networks during the telecommunications boon of 1998 to 2000. I received incentive stock options and subsequently have paid to the U.S. Treasury department, Alternative Minimum Tax, in excess of $230,000.00.

I was hired as the 17th employee in 1998, three years after completing a Bachelors degree in Mechanical Engineering. Working for Qtera, in Boca Raton, FL was a fantastic experience. The team that was assembled was of the highest quality and some of the most motivated individuals I have ever worked with. Our devotion, hard work and technical expertise made us an acquisition target of both Cisco Systems and Nortel Networks in late 1999, Nortel Networks ultimately acquired us; seventy employees had achieved the impossible. Instantly, all our Qtera ISO's were converted to Nortel Networks ISO's at approximately $60 per share. Our success received a wealth of media coverage, from the Wall Street Journal to NPR.

Soon after the media broke the news of our success, the stockbrokers and investment bankers began courting our employees. As employees with much work ahead of us, we had little time or energy to learn about the Alternative Minimum Tax code. Some of the investment firms provided seminars on the Alternative Minimum Tax code but usually we were left with more questions than answers. AMT soon became the number one discussion topic, on the surface, we found ourselves quite versed in the subject, yet few of us really understood the dirty details.

My plan was to exercise and hold the shares as Congress had intended then after holding the stock for a year, sell enough shares to pay AMT and invest the rest. The first sign of trouble was the gradual decline in Lucent's stock price during 2000. We continued working incredible hours to meet our company milestones during our one-year transitional period.

By the middle of 2000 many employees had stockbrokers managing their investments. Not only brokers, but accountants, estate planners and life insurance brokers, everyone was after our potential wealth. I retained a local accounting firm to manage my tax liability and a nationwide brokerage house to manage my account. The accountants were confident they were experienced with Alternative Minimum Tax. Their experience turned out to be limited, but since they had fifteen of my coworkers on a yearly $4,000 retainer, they had no problem getting their hands dirty with the tax code. I reasoned that the Alternative Minimum Tax code was so complicated that I should have professional support, no mater the cost.

April 15th 2001. The year had gone so quickly and I exercised options twice during the previous year resulting in an Alternative Minimum tax on "Paper Gains" of $195,000.00. It was strongly suggested, by my investment broker, use margin to pay the tax bill. The margin loan sounded like a reasonable idea, the investment firm provided a low interest loan without liquidating the account, as long as the account value is not less than the loan. Little did I know the bottom was about to drop out.

I began to diversify my account, but the majority was still in Nortel stock. Meanwhile, while no one was watching, Nortel Stock fell below $20 per share. The Nortel management was positive on the company's growth and their overall market position, the low price was a just small correction in the overall market. (We now know these earnings were inflated.)

By summer of 2001, the margin debt was nerve-racking and I was forced to sell Nortel shares and diversify as the share price continued to slide. I began to exercise and sell, just to raise cash for the 2001 Alternative Minimum Tax. Nothing could stop the hemorrhaging stock price or margin calls. The tax models the accountant had prepared last year were useless. My only concern was having enough cash to pay the AMT and pay off the margin debt. By the end of 2001, we got word that Nortel would soon be downsizing their operations in Florida. Nortel Networks needed to reach the "break even point" and the cutbacks began. By the third quarter of 2001, the share price was under $10 and Nortel was laying off two thirds of their worldwide workforce.

April 15th 2002. I had paid estimated tax throughout the year, in hopes of making the April payment manageable and avoiding penalty fees. Each of those quarterly tax payments went on the margin loan. By April 2002, I reached my personal debt limit and liquidated my account to pay off my debt and pay the AMT. The 2001 tax bill was only $37,000.00, a few thousand less than my yearly salary! I ended my contract with my accountant, sold 90% of my investment account, and prepared myself for the possibility that I too would soon lose my job. My fears were realized and by the second quarter of 2002, I was unemployed.

I learned many valuable lessons through this experience and I am fortunate that I am not financially ruined like so many of my former colleagues. Many will have their wages garnished, or have filed for personal bankruptcy, some were fortunate enough to negotiate settlements with the IRS. The Alternative Minimum Tax code was implemented to prevent wealthiest 2% of Americans from using special tax benefits to pay little or no tax. For various reasons the Alternative Minimum Tax has reached many hardworking, middle class Americans in South Florida, some who don't have very high incomes or special tax benefits. I hope those in the United States Congress have the compassion and foresight to realize the growing negative effect of the Alternative Minimum Tax and bring change to the outdated tax code.

Timothy Masters

Fallbrook, California 92028
June 22, 2005

Dear Chairman Thomas and Committee Members:

My wife and I are among other Americans who have been hugely impacted by the Alternative Minimum Tax (AMT) and its treatment of Incentive Stock Options (ISOs).

In 1998, I joined a Silicon Valley startup. Within 18 months, I exercised incentive stock options and we were instantly "millionaires" on paper. Unfortunately, our stock value plummeted in 2001 with the rest of the NASDAQ. As a result of the AMT, however, we were still liable for nearly $300,000 in federal income taxes and approximately $75,000 in state taxes based on the value of the stock at exercise. Given the dramatic fall in the value of the stock, we were unable to pay the liability in full.

Over the next 2½ years, we tried to reach a reasonable compromise with the IRS on the remaining balance, but our offer in compromise (OIC) with the IRS was rejected, as was our appeal of the rejection. Most recently, at great family hardship, we did a cash-out refinance of our home and liquidated all of our remaining assets to come up with $262,000 (which included $187,000 in federal tax and $75,000 in penalties and interest) to pay the balance of our year 2000 taxes.

My wife and I are now starting over financially due to the AMT. I am 47 years old and the first of my two teenage children will enter college next year, which my wife and I are committed to fund. Given that the AMT has completed depleted all savings, investments, 401ks, college funds, etc, we plan to cash flow our children's education over the next 7 years and then at age 54, we will begin to re-save for retirement.

Please help us, and quickly. We are hopeful that our Leadership will recognize that the AMT and its impact on families like ours is unfair and distorted. We are also hopeful that new legislation will soon provide relief for families in our situation. **For example, the ability to apply our AMT credits against normal income and tax events would allow us to regain some of our financial security.**

Sincerely,

Steve Mazingo

Statement of Monica McGuire, AMT Coalition for Economic Growth

On behalf of the *AMT Coalition for Economic Growth,* a coalition of companies and associations representing small, medium and large businesses from different industries, we direct your attention to problems created today by the corporate alternative minimum tax (AMT). While the growing reach of the individual AMT is a major area of focus in the tax reform debate, any serious reform effort also must address the adverse effects of the corporate AMT.

Regarding the Ways and Means Committee hearing on Tax Reform June 8, 2005, we submit these comments to highlight aspects of the corporate AMT that are unfair, including the growing problem companies face of not being able to recover AMT credits on a timely basis if at all; ways in which the corporate AMT distorts business investment decisions; and the complexities and administrative burdens needlessly imposed by the AMT. In light of these concerns, we urge the Committee to advance the goals of repealing the corporate AMT and allowing taxpayers to utilize existing AMT credits (i.e. prepaid taxes) on an expedited basis.

Unfair Impact of the Corporate AMT

One of the most punitive aspects of the AMT system today is the inability of many taxpayers to utilize AMT credits[1] within a reasonable period of time. Companies with unused AMT credits essentially are making interest-free loans to the Federal Government, to be repaid only when the company has sufficient regular income tax liability in the future. Many past AMT taxpayers have significant amounts of AMT credits that are now older than 10 years. The longer AMT credits go unused (i.e., the longer the interest-free loan to the government remains outstanding), the less value they have. Congress intended for the AMT to serve only as a pre-payment of tax, not as a permanent tax increase, which effectively becomes the case the longer taxpayers cannot use AMT credits.

IRS data show that AMT credit utilization has declined in recent years, down from more than $5 billion in 2000 to $2 billion in 2002.[2] While usage has slowed, more than $26 billion of AMT credits remained outstanding in 2002.[3]

Many reasons explain why a taxpayer may be unable to recover AMT credits on a timely basis. The decline in AMT credit usage over the 2000–02 period was in part the result of the recession, which left many companies with little or no regular tax liability against which to apply AMT credits. Indeed, a perverse aspect of the corporate AMT is the fact that the economic benefit of AMT credits is denied at precisely the time companies are in greatest financial need. For many past AMT taxpayers, deductions for mounting health care benefit and pension costs, use of net operating loss (NOL) carryforwards, and other factors may limit credit utilization significantly for years to come.

In recognition of these systemic problems, Congress in the past has considered legislation to allow faster use of AMT credits. The AMT Coalition would be pleased to work with the Committee this year to suggest other means by which taxpayers can better utilize AMT credits.

Interestingly, fewer and fewer corporations are actually incurring AMT today.[4] In 2002, fewer than 7,000 corporations incurred AMT liability, down from more than 30,000 that paid AMT in 1990 and more than 25,000 that paid it in 1995.[5] Looked at another way, only about 0.3 percent of corporations that filed a return in 2002 incurred an AMT liability. The amount of AMT collected in 2002 was $2.45 billion compared to more than $8 billion in 1990 and more than $4 billion in 1995. Accordingly, the revenue lost by repealing the corporate AMT, standing alone, would be far less today than in years past.

Where the corporate AMT does continue to be paid today, its imposition can be viewed as wholly unfair. For example, the AMT's limitation on the use of net operating losses (NOLs) prevents companies from being able to carry back fully a current-year loss to offset taxes paid in prior years. This limitation only exacerbates the problems many companies face in struggling through business cycle troughs.

Ironically, "fairness" considerations partly drove Congress to enact the AMT at the outset. Concerns had arisen that companies were "zeroing out" their tax liability prior to the Tax Reform Act of 1986 through use of investment tax credits, the "accelerated cost recovery system" of depreciation, "safe harbor" leasing, and other tax-favorable items that have since been repealed or scaled back. The corporate tax landscape looks far different today, as the Joint Committee on Taxation staff noted in recommending repeal of the corporate AMT:

The corporate alternative minimum tax does not necessarily produce a more accurate measurement of income after the depreciation, inventory and accounting provisions of the Tax Reform Act of 1986, and subsequent legislation, have become fully effective. Thus, the Joint Committee staff believes that the original purpose of the

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[1] Under present law, every dollar of corporate AMT paid results in an AMT credit that may be carried forward to offset regular tax liability in future years, but only to the extent regular tax exceeds tentative minimum tax.

[2] IRS Statistics of Income, Table 13—Corporate Income Tax Returns: Balance Sheet, Income Statement, and Tax Items for Specified Income Years, 1990–2002.

[3] In 2002, there were $26.4 billion minimum tax credits carried forward to 2003, U.S. Dept. of Treasury.

[4] The decline in the incidence of the corporate AMT, not all of which is yet reflected in available statistical information, is attributable in large part to recent legislation. The Taxpayer Relief Act of 1997, for example, modified the AMT depreciation adjustment to reduce the likelihood that investments in plant and equipment would cause a business to incur AMT liability. Most recently, the American Jobs Creation Act of 2004 repealed the AMT's 90-percent limit on the use of foreign tax credits, an inappropriate restriction that had resulted in double taxation of income earned in the global marketplace by U.S. companies.

[5] IRS Statistics of Income, *op cit.*

corporate alternative minimum tax is no longer served in any meaningful way. . . .[6]

The Coalition would challenge anyone to argue how the corporate AMT system today advances the objective of fairness, or any other tax policy goal for that matter.

Negative Impact on Investment Decisions

The corporate AMT operates as a significant disincentive for companies to make productive investments. For example, the AMT blocks the incentive effect of tax credits like the R&D credit. The AMT does not allow the R&D credit to offset AMT liability. The AMT also blocks utilization of R&D credits for many companies that do not incur AMT liability, since tentative minimum tax liability forms a "floor" that limits the amount of credits a company may claim against regular tax liability. Accordingly, for many taxpayers, the AMT thwarts the incentive to invest in U.S.-based R&D that Congress has long sought to provide. Meanwhile, remaining AMT limitations on depreciation operate as another disincentive, at the margins discouraging companies from investing in new plant and equipment.

These investment disincentives kick in just when businesses most need to be retooling and investing for future growth. That is, a recession increases AMT liabilities, a counter-cyclical impact that is not disputed.[7] For example, AMT liabilities jumped from $1.8 billion in 2001 to $2.45 billion in 2002.[8]

Compliance, Administrative Burdens

The corporate AMT imposes extremely onerous—and well documented—compliance and recordkeeping burdens.[9] The AMT requires a calculation of a second income tax base and computation of a tax on that base. The result is that the AMT adds an additional layer of administrative burdens and complexity to the regular corporate tax system.

One study has found that calculating the corporate AMT adds 16.9 percent to a corporation's tax compliance costs.[10] Moreover, these AMT compliance costs are incurred regardless of whether a corporation actually ends up paying any AMT. Companies first must undertake the AMT calculation to determine whether they are liable. All but the very smallest firms are required to perform the separate calculations. While most of the tax paid under the AMT comes from large firms, about 75 percent of all AMT returns have come from small and medium-sized businesses.[11]

The Joint Committee on Taxation staff recommendation that the corporate AMT should be repealed was based in part on the premise that Congress should "relieve corporations from computing their tax base using two different methods and complying with burdensome recordkeeping requirements."[12]

Conclusion

Consequently, the AMT Coalition urges the House Ways and Means Committee to include as part of any tax reform legislation repeal of the corporate AMT and allowing taxpayers to utilize existing AMT credits on an expedited basis. Of course, the means by which taxpayers may recover AMT credits in a post-tax reform world may depend in part on what the new system looks like. That said, mechanisms easily could be developed in connection with any type of reform framework that would preserve, and quickly unlock, the value of these long-accumulated prepaid taxes. We look forward to working with the Committee to address this important issue.

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[6] Joint Committee on Taxation, *"Study of the Overall State of the Federal Tax System and Recommendations for Simplification"* (JCS–3–01), April 2001 at II–16.

[7] See, e.g., Joint Committee on Taxation, *"Background Materials on Alternative Minimum Tax and Capital Cost Recovery Prepared for the House Committee on Ways and Means Tax Policy Discussion Series,"* (JCX–14–02), March 2002 at 7.

[8] IRS Statistics of Income, *op cit.*

[9] See, e.g., General Accounting Office, *Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers* (GAO/T–GGD–95–42, Dec. 9, 1994); Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, D.C.: The Brookings Institution), 1997.

[10] Joel Slemrod and Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," *Public Finance Quarterly,* 24 (October 1996), pp. 411–438.

[11] General Accounting Office, Experience with the Corporate Alternative Minimum Tax (GAO/GGD–95–88, April 1995), p. 35.

[12] Joint Committee on Taxation, *"Study of the Overall State of the Federal Tax System and Recommendations for Simplification"* (JCS–3–01), April 2001 at II–16.

Statement of Arthur and Rita Miller, Reform AMT, Catonsville, Maryland

Dear Chairman Thomas and Committee Members: My name is Rita Miller and I am writing on behalf of my husband, Arthur W. Miller, Jr and myself. It is regarding a huge tax debt that we incurred on phantom gains that were created by the application of the Alternative Minimum Tax (AMT).

In November 1997, I took a job in Linthicum, Maryland as an Administrative Assistant for a start-up Internet security company, VeriSign, Inc. We incurred a huge tax debt starting in the year 1999 by exercising Incentive Stock Options (ISOs) I received while working for VeriSign, Inc. We read everything we could about stocks and taxes and everything pointed to exercising and holding the stock for long term capital gains. We enlisted the help of a reputable financial advisor. The advice from the financial advisor was to exercise and hold the stock so as not to incur the higher short-term capital gains rate. But unbeknownst to everyone, if you exercise and hold onto stock for the long term and carry it over a tax year, a tax called AMT (alternative minimum tax) can apply, and it did.

All other assets, like real estate and stock purchased on the open market, are taxed based on the value at the time of the sale, when you actually receive a profit, not at the time of the purchase. Why aren't we just taxed when, and if, we sell the stock? That then would be a *legitimate profit made* and a *legitimate tax due.*

Our total federal taxes due from the years 1999 through 2002 were $448,873. We managed to pay $314,784 by selling whatever shares of stock we had. This is not even to mention the amount that we owed to the state. We negotiated with the IRS and went on a payment plan to pay the remaining $134,089, likewise with the State. We never missed a payment until both my husband and I lost our jobs within a few months of each other in the year 2002. I was unemployed for over a year, my husband is still unemployed. I'll be 58 this year and my husband will be 60.

We submitted several OICs and Appeals and the IRS rejected them all—stating that we had a house, a car and some retirement money and if we sold the house, the car or turned in the retirement, we could pay the "phantom taxes" we owed. We came to realize that after filing subsequent years taxes, that the IRS now "**owes us**" over $125,000 in credits. We owe them $124,000. We filed an OIC asking the IRS to accept our credit as payment. It was rejected. The last OIC we offered $30,000 (provided by a family member) and our credit to bring our tax debt to a "paid-in-full" status. Can you imagine our disbelief when we received the notice that the IRS is rejecting this offer too? They accused us of using "delay tactics". The IRS wants us to pay them in full, **first.** Then they want to give us back the $125,000 by allowing us to recover a small portion, approximately $3,000, of the credit per year! It is highly unlikely that my husband and I will live to recover all the credit due us. We would have to live to approximately 99and 97 respectively to recover the entire amount. While awaiting a court hearing, they have put a lien on all our assets.

A travesty occurred in our lives that added additional hardship. My husband, who has been unemployed since August 2002and spent more than a year of processing for employment with the Department of Defense, was notified that the DoD was withdrawing their offer of employment due to the outstanding IRS debt. They said that the tax issue "brought into question his credibility and trustworthiness". That he didn't meet their suitability criteria. At almost 60 years old where is he going to find another opportunity like the one with the DoD? We are hardworking, trustworthy and honest people. We have never avoided paying taxes and have always engaged in honest financial practices. We understand the AMT was put into place to make sure that the very wealthy people paid their fair share of taxes, but it's not working the way it was intended. There has to be some consideration for people like us, those of us that were caught in the AMT trap.

This year we celebrated our 40th wedding anniversary, but for the past 5 years we have been living a nightmare. We fear that one day when we open our mailbox there's going to be a letter from the IRS stating that they are taking our home or making us liquidate our retirement to pay them taxes that are unjust and unfair.

We respectfully seek the understanding of this Committee and plead with you to help rectify this wrong.

Marietta, Georgia 30066
June 12, 2005

To Whom It May Concern:

I will keep this brief. I just want it to be known that as a tax-paying (yes I pay and do not get a "refund"), law abiding voter that I am in full support of H.R. 25. As a working mother of two, as well as financially supporting parents, I see how social security and Medicare fall down financially in caring for those over the age of sixty-five. Even with other savings, it is still not enough to cover the external costs of insurance, medicines, general upkeep of a home, etc. The current system is perpetuating the current, causing aging parents to become a financial burden to their children and taking away their children's choice of wanting to work vs. having to work, in order to care for a family.

I believe government spending should be audited and downsized as well in order for us to reap the FULL benefits of H.R. 25.

Please do not take this bill lightly. It is time for change and the time is now so that we do not have to continue to force citizens to become financial burdens to the Federal Government.

Thank you for your time and reading this email.

Ashlyn Montague-Hill

Statement of Nield Montgomery, Las Vegas, Nevada

Dear Chairman Thomas and Committee Members:

My name is Nield Montgomery. I very much appreciate the opportunity to tell my story of suffering and hardship brought on by the application of the out of date and destructive rules for the treatment of Incentive Stock Options under the Alternative Minimum Tax (AMT) code.

My difficulties and those of thousands of others were brought about by events never contemplated when the AMT was devised, i.e., the significant negative tax impact that happens with stock options when a company's stock price experiences a dramatic decline. At the risk of being too basic, please allow me a brief explanation of stock options. A stock option is the right to buy a share of stock at its current price (the strike price) at some time in the future. Non-Qualified Options (NQOs) and Incentive Stock Options (ISOs) differ in their tax treatment. I'll talk first to ISOs. When the option holder exercises the right to buy (obviously the current market price exceeds the strike price), they create an Alternative Minimum Tax (AMT) taxable event. The AMT treats the spread between the option strike price and the stock price when the option is exercised as income (otherwise called "phantom" income). That is, even though there's no tangible income, a tax consequence occurs non-the-less. Now to be fair, when the AMT exceeds the regular tax owed calculation, the taxpayer gets a credit against taxes in future years (the credit's application is complex and can take years if ever to recover). A subsequent sharp decline in stock price does not alter the tax owed even if the stock price goes to zero.

When the tech bubble burst, huge numbers of share owners were left with tax bills resulting from the AMT treatment of ISOs while their shares had become nearly or even totally worthless. Remember, the real value of the stock has nothing to do with taxes owed. What was supposed to be an "incentive" and accepted in lieu of cash compensation turned into a tax nightmare (an obligation to pay taxes where no income/gain was realized). People were forced to mortgage/sell their homes, take out loans, or sell what ever they could to pay these absurd tax bills. It seems *incomprehensible the IRS would enforce such harsh collection measures for tax dollars that become a* ***credit*** *in the taxpayers account.* This AMT tax treatment is complex and unfair and has caused untold financial hardship, ruin, and heartbreak. Side note: how does the government account for these prepaid taxes?

The tax treatment for NQOs is even worse. Tax law requires the treatment of the NQO as an income event at the time of grant. The income results from the difference between the strike price of the option and the stock price on the grant date. This is without regard as to whether the NQOs are even exercised and, if they were, whether or not the shares were sold. Again, in a market such as we've experienced, a decline in the price of the stock is just a personal misfortune. The tax is owed even if the stock price goes to zero.

Looking at the larger picture, I'm not sure anyone can assess the positive impact the awarding of stock options has had on our economy. I know their use has been wide spread and it's my opinion they've been a significant factor in holding down wages and inflation. Thousands of employees had been willing to accept below market wages in exchange for options. The belief was that by working hard and making their company a success, they'd have a share of that success. Unfortunately, for

many, it didn't work out that way. If the negative tax treatment of stock options isn't fixed, their use as an incentive and benefit on holding down wages will be lost.

Now for my story. By way of background, I worked 31 years in the telephone industry starting at the lowest entry level job and working my way to General Manager. In 1993, I left a good paying job to become and "entrepreneur". Two years later, I founded MGC Communications. Having worked my entire career in large impersonal corporations, I thought it was important that our employees be owners as well. We accomplished that goal by granting stock options to everyone who joined the Company. At the most senior level, we were able to hire very qualified people at compensation levels below market rates by sweetening employment packages with stock options. As a young Company, it was essential we conserve our cash. Since salaries and bonuses represented such a significant portion of on-going cost, the use of ISOs was an effective way to do that. ISOs also incented our employees, as owners of the Company, to really apply their talents to building the business.

As the most senior officer/leader of the Company, I was committed to and embodied these goals. In lieu of a salary more typical of my position (my successor's annual salary was $500,000), mine was $150,000 with ISOs as additional compensation. In lieu of cash bonuses (my successor's annual bonus was $500,000), I took ISOs. Little did I know of the tax nightmare lying ahead.

Unlike many victims of this cruel conspiracy of events, I had access good tax planning help. My personal banker was with one of the largest public stock firms in New York. When he didn't have answers, he had the best talent available to him in the corporate offices. My accounting firm was one of the big five national firms. Like my banker, when they needed help, they turned to specific experts on their corporate staff. Yet with all this knowledge and talent, none of them really understood the complex treatment of options within the AMT.

Here's what happened in my case. When I exercised my options in early 2000, the stock priced was $66 per share. Since the options had been granted in the early days of the business, the strike price for the options was very low. When the spread was calculated and the AMT rules were applied, I owed an additional tax of $4,400,000. Within six months of exercising my options, the stock had lost 90% of its value (the Company eventually declared bankruptcy). While the intended holding period for ISOs is one year, I was forced to sell shares sooner to raise the money to pay the taxes. To further compound the situation, I owed taxes on the shares being sold. In the end, I sold all the shares acquired thru options to pay the AMT and still ended up $200,000 short. I have said many times jokingly, if the IRS would have accepted everything I owned in the Company in exchange for the AMT owed, I would have been money ahead.

All I have to show for the experience is a substantial tax bill; a tax bill that resulted from a purchase event. I understand and accept the tax consequences when there's a purchase and sale which results in a net gain. What I reel at is the application of a 28 percent tax on the purchase of stock as though some form of gain had been realized. This is a virtual sales tax! And, as noted earlier, the tax code is so complex it was/is impossible to find anyone sufficiently knowledgeable to provide accurate tax planning.

As I've talk to other people similarly situated, I've realized how pervasive this problem is. I also discovered there are three ways in which taxpayers deal with this issue. The first group, like me, reported the exercise event and faced the tax consequences. The second group knew they should report but chose not to. Since there's no reporting/tracking mechanism, the IRS doesn't know there's been a taxable event. The third group just didn't realize they had to report. Of the three groups, I believe those who reported were in the minority. One of the fundamentals in our tax code is the uniform application of the law. Clearly that did not happen here.

As for reform, here are some ideas. Change the AMT formulas so this kind of injustice doesn't happen in the future. Those of us who have credits, at a minimum, make the credit directly applicable to *all* future taxes owed and not just a factor in the AMT calculation as it is now. At the extreme, send us a check equal to the credit (that would be a real "rebate"; these are real dollars we've paid in excess of what we would have otherwise owed). And if you must hold our money, at least pay us interest at the rate the IRS charges us for late payments. Finally, if the AMT must continue, please insure it is indexed down proportionate to the regular tax rate schedule.

As for the tax treatment of NQOs, stop treating the event as income at the time of grant. Taxes should be owed when income/gain is realized. That means determining taxes owed when the stock is sold. I would agree a portion could be treated as income and the change in subsequent stock price as a long/short term gain/loss.

If I sound like a tax professional, I'm not. I'm one of the thousands of people granted options only to have this tax nightmare. I've become knowledgeable by de-

fault! I just couldn't believe I'd owe taxes for options granted when I hadn't received income or realized a gain. In hindsight, I would have been so much better off to have taken the pay instead of the options. I know thousands of others feel the same way (not a scenario that bodes well for business and our economy). At least I'd have the income to pay the related taxes. We need your help; fix this injustice!

Statement of David W. Moyle, Beaverton, Oregon

Dear Chairman Thomas and Committee Members:

Thank you for the opportunity to express my views on this important matter. I am a hard-working upper middle class citizen who has experienced what I believe are unintended consequences of the Alternative Minimum Tax. Below are my views:

The Alternative Minimum Tax is bad government policy on a number of fronts:

- It is unfair
- It has stifled economic recovery
- It is difficult to understand and creates taxpayer resentment

My situation is this: I am a mid-level manager at Intel Corporation where I've worked for over 20 years. During my first 10 plus years at Intel I received incentive stock options. During the late 1990s and early 2000, the value of these options soared about the same time they were set to expire. Believing in Intel's long-term future, and the under the assumption that long-term gains would be taxed more favorably than short-term gains, I purchased the shares and held them. As a result, I began to trigger the AMT.

For the year 2000, in particular, I generated more than $400,000 in AMT based on paper gains from the purchase of incentive stock options. This amount was over *four times* my base salary. When the price of Intel stock fell before my taxes were due, going from a high of $75 to an eventual low of under $13 per share, my alternatives were to sell my shares to pay my taxes and have very little left, or take out a loan and hold onto the shares in the hope that Intel would rise again someday. I chose to borrow. The stock has never fully recovered, and to this day, I still carry a loan. I now have about $575,000 in AMT "credit," much of which I will probably not get back. The AMT tax I paid was based on phantom profits . . . in other words, money I never made.

Below is why I believe the AMT is unfair, has stifled economic recovery, is very difficult to understand, and has created taxpayer resentment.

The AMT is Unfair:

Phantom gains and Enron-style accounting: In calculating the AMT, taxpayers must calculate paper gains on stock option shares purchased, but not sold, and treat the phantom gain as if it were real income. In other words, no profit has yet been made. The regulations practically require us to do Enron-style accounting to show phantom profits as if they were real, and then pay taxes on them.

It's not really a credit: As I began to pay AMT taxes and build a "credit," I naively assumed I would get this back once I finally sold the stock. Theoretically, this could happen if the stock reached the former lofty heights of the dotcom era and if I were able to wait that long. Most of us get only a portion of this "credit" back, at a rate of only $3000 per year. At this rate, I would have to live to be well over 200 years old to recoup the credit.

Interest free loan to the government: If we under-pay taxes, the IRS assesses interest on taxpayer accounts until we pay in full. In the case of AMT, I have grossly overpaid my taxes, and rather than receiving interest from the government for my pre-payment of taxes, I had to take out a loan to pay taxes on money I never made. In essence, I have given a $575,000 interest free loan to the government . . . and the government will in all likelihood return only a fraction of the loan.

The MAT Has Stifled Economic Recovery:

Discretionary Income Has Gone to Payoff Loans Used to Pay Taxes: Because AMT taxes on ISOs were based on phantom profits, many of us did not have the cash to pay our huge tax bills when the stock market crashed. In my case, I had to take out a $375,000 loan to pay taxes. Interest payments on my loan were double my house payments, and my loan size grew because my income was insufficient to pay the interest. Prior to having the huge tax bill, I was shopping for a mountain cabin to enjoy with my kids while they're still living at home. We scrapped this plan. We were planning an international vacation. We scrapped this, too. We planned to make

some upgrades to our home. We scrapped this plan as well. Basically, all our discretionary income went to pay interest on our loan to pay taxes ON PROFITS WE NEVER MADE.

The AMT is Very Difficult to Understand:

Confusing and Contrary to Existing Tax Incentives: The AMT requires us to calculate our returns two ways. A "credit" is not really a credit. A paper profit is treated as a real profit. It is very difficult to do financial planning because many tax incentives and normally wise investment strategies, such has holding investments for the long term, actually put us at great risk with AMT. Rather than encouraging long-term investment and ownership in our companies, the AMT encourages us to "cash out" for short-term gains.

Taxpayer Resentment: Although I can't say I have always enjoyed paying my taxes, I had always viewed it as a necessary responsibility of citizenship. The AMT, however, has left me very confused and frustrated and quite frankly resentful of our tax policy. I feel that the government has taken advantage of me. I feel "robbed." The U.S. Government as been the beneficiary of my stock options; by contrast, I've paid a penalty. After years of growing my equity, I am now in worse financial shape than I was 5 years ago because I was taxed on profits I never made. To date, little of consequence has been done to address this unfair and complex tax. My hope is that your Committee will be able to do something. In priority order, I would have you:

- Refund "credits" . . . or let us use the credit against all taxes owed, not just future AMT taxes. If this is not done, at least pay fair market interest on the "loan" and speed up the process of giving our money back.
- Eliminate the AMT altogether . . . or go back to the drawing board and address the reasons it was created in the first place.

Bozeman Granite Works
Bozeman, Montana 59715
June 7, 2005

Dear Sir or Madam:

I respectively request that you support the end item retail taxation method known as FAIR TAX and elimination of the 16th amendment and all income taxes on USA labor.

I am a small businessman that runs a manufacturing and retail business with a storefront on a major retail avenue. My operation requires three full time employees and two part time people. As all businesses adding value to a product through manufacture, stocking an inventory, sales or any number of activities requiring labor I am confronted at least weekly with the taxes on the labor we politely call "income tax". I, as all businessmen, am required to add all taxes that are paid, to the price of the end product. What I'm trying to convey here is that all taxes, and specifically income tax, is just an added value tax. The person, company or corporation that digs the raw materials adds income tax to the price of the raw materials, the person, company or corporation that transports the raw materials pays income tax and adds the tax(s) the transported raw materials, and on and on and on, until the product is sold at the retail store. The point I'm making is, income tax is added to the price of the completed product at all levels of production making it simply an added value tax. In other words at any time during the manufacturing, distribution and sales of product that value is added to a product we tax it in the form of income taxes.

Added value is not that bad? Yes it is. We only tax our domestic production and tax it and tax it. The tune of 50,60,70,80% and some products that are heavy in labor 120+% of actual value (untaxed costs). We are forced to compete with foreign products that are not taxed in the country of origin nor here. Import dudies or taxes of 1, 2, or even 10% on the untaxed costs of foreign production is basically nothing.

I am lucky. The vast majority of raw materials, semi finished products and finished products that I either add value by finishing the production or retail directly are made in USA. They fall in the heavy labor category, I manufacture granite monuments. Foreign materials and semi finished production is on it's way to displace the domestic. The commercial market for natural stone 10 year ago was completely USA and now is completely foreign, the handwriting is on the wall; I'll be forced to purchase foreign production to stay in business within the next 5 years. The loss to our economy will be thousands and thousands of 20, 30, and 40 dollar/hour jobs. These highly skilled craftsmen will be shoveling burgers for the importers

and retail owners. These people won't be paid enough to pay taxes, they won't have high paying jobs. Please understand the rich aren't getting richer and poor aren't getting poorer. The middle class is shifting from high paying production jobs to low paying service jobs due to foreign markets caused by added value taxation on our production.

Fairtax is the only way out of this. We need to shift the taxation to the end item retail. It's there on domestic production anyway. It's about time we placed the same tax burden on the foreign retail here in the USA. Please understand that we already add the taxes to the domestic production and pay whatever that is at the retail end. Please understand that prices on domestic production will not change. Food, housing, clothes and all other "necessities" are still being produced domestically and will not change in price. The beauty of end item retail taxation will allow domestic production to expand and even take some of the current foreign markets and even compete internationally with like products. This will create vast quantities of high paying production jobs. In other words more money in the hands of more people resulting in more consumption and more tax dollars.

There are three civilized ways to collect taxes. Fees, the USA constitution established a fee system. If you wanted to be a citizen you paid an equal share of federal taxes (consult the body of the constitution). Fees are color blind, sex blind, handicapped blind, anyone who wished could pay the tax and have say in the country. Bill gates and a hobo would have the same opportunity. Our country operated for more than half it's life on the fee principle of taxation and is probably the best system. Number 2, value added is the current system. The worst of the three. Value added can tax only domestic production. Any changes in production such as imports will displace domestic production causing low tax basis and loss of tax revenues. Worse yet added value through income taxes results in imports taking high paying jobs, poverty and no tax basis. The third is consumption tax (retail end sales tax) or Fairtax. Basically put, no taxes are added to domestic production until they are retailed. Foreign production burdens the same tax, underground economies burden the same tax, collection is at a small number of locations, consumption is more consistent than income. High paying jobs come back to our country. I can see no down side.

Please support the Fairtax.

Thank You,

Thomas M. Olson

Cupertino, California 95014
June 20, 2005

Dear Chairman Thomas and Committee Members:

I am writing to ask for your support and would appreciate your taking a moment to read this letter.

My name is Kimhoe Pang. I am a software engineer of Network Appliance. I exercised some stock option in year 2000 under the Incentive Stock Options (ISO) scheme. I did not sell any of the exercised stock to get profits. The ISO exercise created a huge AMT tax. I have $367,684.00 tax due in 2000. It amount is more than 3 time of my annual salary. This tax payment actually becomes a credit and can never be recovered by me. In essence, I can lose all the investment money, and also other assets, simply to create a tax credit in my IRS account.

Due to the stock crises in 2000, I did not have enough money to pay tax. I filed an Offer in Compromise (OIC) and the OIC was denied after two and half years. IRS has started the collection process and has put a lien on all my properties. I am the only one who brings income to my family. My family (five people) still live in a two bedrooms rented apartment. However, the IRS officers told us that they only concern about the tax we have not paid. They are regardless about the fairness of the tax.

We are still facing financial crisis. IRS already starts collection process. We have to pay the huge tax that is base on the profit we never make.

We need your help to have the IRS to stop the collection activities. We respectfully ask that you further investigate the disastrous consequences of the Alternative Minimum Tax and please support all efforts towards reform.

Sincerely,

Kimhoe Pang

Issaquah, Washington 98027
June 17, 2005

Dear Chairman Thomas and Committee Members:

In 1997 I went to work for a new internet company, Exodus Communications, who granted sales employees pre IPO stock shares upon hiring. After the IPO and some time of employment I hired a financial planning firm to advise me on how to best handle these options. I was advised to exercise the options as they became available and then hold for one year from that date before diversification. I took this advice. During this time between 2000 and 2001 (within several months) the stock fell from the high $100s per share to landing at less than $10. I was laid off in May of 2001 when we finally sold our shares at $.10 after Exodus's bankruptcy.

I was laid off just before Exodus declared bankruptcy and found myself unemployed for 7 months. Meanwhile, we had to sell our house and all other valuables to make it through this period financially. My husband had quadruple bypass surgery unexpectedly in 2001 causing further financial difficulty and personal stress. We have not recovered from the financial challenges that losing my job, stock value and medical bills caused our family, not to speak of the outstanding balance expected by the IRS for AMT fees.

Since 2001 we have been attempting to work with the IRS as the amount they calculated we owed them based on the AMT value is over $600,000. As you can tell from this writing we incurred a huge loss on the "ownership" of these granted shares. The IRS denied our Offer In Compromise and has not proactively worked with us. We have retained counsel to help us try to avoid all collection issues with the IRS and had to borrow money exceeding $15,000 to gain representation.

We have no means to pay the IRS and, of course, feel there is no real debt to re-pay. This has been going on for nearly 5 years with a lien on our credit and ongoing fees to attorneys to keep collection at bay. The next step is the IRS waves our fees or we must declare personal bankruptcy. This AMT situation seems completely unfair and not the proper application for its original intention. We join AMT Reform in asking Congress to instruct the IRS to hold off on current collection efforts until new legislation can be addressed.

Bob and Susan Pessemier

Sunnyvale, California 94086
June 17, 2005

Dear Chairman Thomas and Committee Members:

Thank you for taking on the very important task of investigating the tangled web of our current tax system with the goal of implementing a simpler, more equitable system.

We respectfully ask that the committee examine the current tax system's shortcomings with respect to individual taxpayers' ability to recover AMT credits. We are a two-income household (both with full-time jobs as individual contributors—not managers or company officers) with three young children living in California—a high-tax state, as you well know.

As a result of exercising and holding (to qualify for the long-term capital gains tax rate) Incentive Stock Option (ISO) shares in 2000, we incurred a Federal AMT bill of several times our normal annual income. Luckily, in that year we sought and received sound advice on the AMT implications of that plan. Between doing same-day-sales in 2000 on remaining ISO shares and taking out a loan against a 401(k) retirement account, we were able to meet our AMT obligation on April 15, 2001. Thus, we have not run afoul of the IRS and have not had to worry about losing our home, unlike many others who exercised and held ISOs during that time period.

With the large decline in the stock markets since 2000, the shares we still hold are worth a small fraction of their value upon exercise. So, at this point the government is holding our entire gain (representing many years of hard work) from the ISOs in the form of a large AMT credit. Please also note that for tax year 2000 we paid (on shares that we purchased then, but have held for five years now) at the AMT rate of 28%, while under the current law our long-term capital gains rate upon sale would be 15%. The mandatory pre-payment of tax under AMT was at almost double the rate that the regular tax system requires!

When we first saw the size of our AMT credit, we thought we would be lucky to finish recovering it before we both died of old age. After filing our last four tax returns, though, we see that unless something changes we will never recover the vast majority of that credit during our lifetimes.

Here is how much we've been able to recover, on a percentage basis, for the 2001–2004 tax years. (Note that our tax returns for these years have included no other extraordinary events.)

Tax Year	*% of AMT credit recovered*
2001	0.56%
2002	0.17%
2003	0.13%
2004	0.00%
Total	0.86%

Less than one percent of our AMT credit has been recovered in the four tax years since the credit was established! And the trend down to zero in 2004 does not bode well for future years.

Under the current tax law we have very little hope of recovering this interest-free loan to the government. These funds would go a long way toward ensuring that we will be able to afford college educations for our three children.

Please find a way to accelerate individual taxpayers' ability to recover AMT credits!

Thank you very much for your consideration.

Sincerely,

S. Pintner
D. Pintner

Statement of Philip Priddy, Baton Rouge, Lousiana

Alternative Minimum Tax effects spreading

Filers must pay extra to the IRS

Friday, April 15, 2005

By Bill Walsh

Washington Bureau

WASHINGTON—Every April 15, Americans are reminded just how much they dislike paying taxes on their income. Philip Priddy is still paying off a $220,000 tax bill on money he never made.

Priddy, a Baton Rouge sales manager for Nortel, was forced to liquidate his savings, sell his boat and his wages are still being garnisheed by the Internal Revenue Service to pay off his debt. Although an extreme example, he is among a fast-growing segment of Americans who are feeling the pinch of the Alternative Minimum Tax, or AMT.

The tax originated in the late 1960s to target super-rich people who employed clever accountants to shield their income from the long arm of the IRS. But because it hasn't kept pace with wage inflation, the U.S. Treasury estimates that 3.8 million Americans this year will have to pay an AMT on top of their regular income taxes.

Most are upper-middle-class people making a comfortable living, but that will soon change, according to the Congressional Budget Office. By 2010, the agency said, nearly 30 million Americans—20 percent of all taxpayers and 40 percent of married couples—will have to pay the extra tax. By then, it will hit two-thirds of taxpayers with adjusted gross income between $50,000 and $100,000, the agency projected.

"It is growing every year and taking in people who were never intended to be hit by the AMT," said Rep. Jim McCrery, R–Shreveport, who has filed a bill to repeal the AMT. "It is already too pervasive in our tax system."

Most taxpayers probably skip right over the line on their 1040F.

Network Appliance Inc.
Barrington, Illinois 60010
June 20, 2005

Dear Chairman Thomas and Committee Members,

I am a sales manager in Illinois and work for a high tech company in Sunnyvale, CA., Network Appliance. I have paid my federal and state taxes every year since the age of 16 until 2000 & 2001 when AMT took over my families' life.

I obtained both a blessing and a curse when Network Appliance stock options became valuable and eligible to exercise. I followed expert guidance on tax issues in regards to ISO options and exercised and held all vested ISO options in 2000 & early 2001. The market collapsed, the AMT tax bill came due and subsequent loan cover calls collapsed any value left from the options. These events created a $900,000, and growing, tax liability with no shares or share value left to pay the tax bills of 2000 and 2001.

The tax bill was more than my family was worth by a factor of three. We are on a payment plan with the IRS but it does not allow us to cover monthly bills eight of the 12 months a year.

It has put a tremendous emotional strain on our family, especially my wife. From her perspective we were taxed on something we never had.

We have paid our taxes every year after and expect to for the rest of our lives.

The AMT ISO tax laws should have been written to treat vested ISO options as standard common stock with standard short term or long term capital gains to be applied based on vesting periods. If the law had been written as such in 2000 and 2001, we would have paid 5X the amount in taxes to the IRS and the state of Illinois. Our family would also have had several millions to both invest as well as contribute to various previously identified charities.

The U.S. treasury, the state of Illinois, the economy, several charities, and my family would all in better shape if the tax laws were written in better balance with today's stock option equity employment situation.

Michael T. Pritchett
District Sales Manager

Statement of Gregory Ralph, San Diego, California

My name is Gregory Ralph and I am writing on behalf of myself, my wife Nikki, and our four pre-school/elementary school age children. We appreciate the opportunity to discuss the inequities we have encountered due to the application of the Alternative Minimum Tax (AMT) on Incentive Stock Options (ISOs).

In the late 1990s, I was working as an electronic design engineer. As a co-founder of JNI Inc., I was granted Incentive Stock Options (ISOs). As was Congress's intent, the ISOs encouraged the founders to hold their stock and build a thriving and profitable company, which we grew from an initial 11 person staff in 1997, through an IPO in late 1999, to a company employing over 200 people and generating annual revenues of over $100M in 2000.

In my case, and similar to many others, as a result of the AMT treatment on the exercise of those ISOs that subsequently declined in value from the date of exercise, I ended up being taxed at a federal tax rate of over 60%. The reward for creating a successful company should never be that the IRS gets more out of it than the entrepreneur (in some cases more than 100% of it), as this is a clear disincentive to starting and growing a business. I know this result is clearly contrary to the intent of Congress in creating the ISOs, and is rather due to an unanticipated flaw in the complicated AMT treatment of ISOs that decline in value, resulting in huge taxes on phantom paper gains that were never realized.

This tax might also be known as the "Honest Hardworking Entrepreneur Tax", since it only affects those dedicated hardworking employees who hold on to their stock options after exercise (as the 'Incentive' in 'ISO' implies) and who are honest enough to report their option exercises to the IRS after market loses leave them owing more AMT than their stock may be worth. After paying my unfair share of tax, I have since found out that anyone who simply did not report the options exercises on their tax forms probably got away with not paying the tax, since there is

no employer reporting of ISO option exercises to the IRS. This is clearly not fair and needs to be rectified.

Another clearly unfair and confusing aspect of this complex and stealthy part of the tax code is the AMT credit. My understanding was that the AMT ISO tax is a prepayment of future taxes owed such that when the stock is sold, the credit can be recouped. To my dismay, I found out after selling all my stock that this credit was very difficult to recoup if the stock price had not appreciated since the time of exercise. Unlike a true credit in the common understanding of the term, this credit is not immediately refundable to the taxpayer upon sale of the stock as one would reasonably assume it should be. The result is that in addition to staggering market losses on my company stock over a period of only a couple months (during which I was locked out of trading by insider trading rules and could not sell to prevent the AMT tax prior to the end of the calendar year), the IRS is also keeping my huge tax overpayment "credit" indefinitely.

My "credit" has essentially become a long term interest free loan to the government of around $700,000 that I am not likely to fully recover even over the next 50-years or more, even by applying a portion of the credit each year to 100% of my annual tax bill. To compound matters further, the IRS has arbitrarily decided to further limit the amount of credit a taxpayer can use against regular income. The IRS has imposed this change in the law by a change in the form 1040 instructions with no clear legislative authority.

Legislative action is clearly needed to restore fairness, increase compliance, and bring the AMT treatment of ISOs in line with original congressional intent of encouraging long-term ownership of company stock without unduly and severely punishing those who do. I urge this committee to work toward implementing a swift and fair solution to this ISO AMT problem. The fix should include prompt return of prior excess AMT credits after the sale of the stock that generated the AMT, realignment of the valuation date for AMT to correspond with the one year long term gain holding period of ISOs to restore the initial intent of ISO AMT while eliminating the AMT "trap", and mandatory ISO exercise reporting to ensure future compliance.

We need this committees help today to correct the injustices caused by the ISO AMT. I ask not only for my own family which has been harmed by the ISO AMT's effects, but also for the many others who have lost everything to this man made disaster that has washed away their retirement funds, college funds, their homes, even garnished portions of their future livelihoods. If this were a result of a natural disaster anywhere in the world, this compassionate country would come to their aid. The reality is that hard working entrepreneurs right here in the USA are being destroyed by this ISO AMT disaster, and the only relief they need is the return or abatement of their tax overpayments such that they are only taxed on income they actually receive. It is not too much to ask. It is the fair and just thing to do. We have faith that this committee will act swiftly and appropriately to enact a fair and equitable solution. Thank you.

Statement of ReformAMT.org

To the Honorable Chairman Thomas and the Honorable Members of the Ways and Means Committee:

Thank-you for allowing ReformAMT the opportunity to communicate the urgent need for legislation addressing the life-destroying impact of the Alternative Minimum Tax (AMT) and its treatment of Incentive Stock Options (ISO). The average individual in our organization faces tax rates that exceed 300% of their income.

Introduction

Formed in April 2001, ReformAMT is a national grass roots organization whose mission is to educate, correct, and prevent the injustices created by the ISO AMT and its inappropriate means of taxing Incentive Stock Options, which are intended to be a form of compensation. We have members in 48 different states, plus Puerto Rico and the District of Columbia.

Through ReformAMT, we plead with Congress to correct this flawed tax code that has resulted in financial devastation for not only our members but also thousands of others across the country who are too embarrassed or discouraged to publicize their dilemma. Originally intended to "ensure that a very small group of high-in-

come individuals who paid no income tax would pay at least some income tax",[1] the AMT has hit hardest those honest, hard-working employees who traded longer work hours, lower salaries, fewer benefits, and job security for stock options that might someday provide for their children's education, assist in purchasing a home, or help fund their retirement. Unfortunately, caught in the AMT trap, these workers were forced to pay taxes on money they never received and never will receive. Consequently, they are losing or have lost their homes, education funds, and retirement funds.

These people were committed, dedicated, and loyal to their companies. "Hold for the long term", "be a part of the company", and "don't dump and cash in" was the advice of brokers, Certified Public Accountants, financial advisors, and the companies themselves. However, as we all now know, the Incentive Stock Option AMT provisions tax when you *buy,* NOT when you sell, forcing these workers to pre-pay taxes on stock gains they never realized. To add insult to injury, these taxpayers have honestly complied with this self-reported tax. While the IRS machine destroys their lives, they have watched many of their fellow coworkers go unharmed by simply omitting the reporting of the stock option transaction.

Demographics

These are the results of a recent survey of our members in April 2005:

- 65% of our members affected by AMT are secretaries, engineers, lower level managers and other rank & file employees (as opposed to Managers, Executives and Founders).
- Our members owe or owed an average of $322,428 in ISO AMT over and above what they would owe under the regular tax code for income received (that is *100 times* what the average taxpayer hit with AMT pays in additional taxes, according to testimony by the GAO at a recent Senate Hearing).
- Our members' average tax rate was 355% of their income.
- Our members have an average outstanding AMT credit of $213,620 due to their overpayment of taxes. With the current annual deduction for AMT credits of $3,000 per year, it will take 71.2 years—more than a lifetime—to finally recover their overpayment credit. Also, this credit does not accrue interest—on the flip side—individuals who still have outstanding liabilities are expected to pay interest and penalties on this tax prepayment.
- Because of the extreme difficulty/impossibility of paying huge taxes on money never received, about 3% of ReformAMT members have filed bankruptcy, with another 18% admitting they are considering bankruptcy.
- For every 2 people who complied with the AMT regulations, there were 3 people who did not, taking advantage of the fact that no independent reporting exists.
- For every 4 people who complied, there was 1 person who expatriated rather than have their lives destroyed by working the rest of their lives to pay taxes on income they never received.
- We know of 2 members who committed suicide due to the horrendous effects this ISO AMT tax had on their lives.

Flaws of the AMT Treatment on ISOs that Distort Business and Personal Decisions and Create Unfair and Unjust Results for Hardworking Americans.

Tax Date Flaw—The regular tax code provides significant incentives to hold on to the stock and grow the company. However, the AMT imposes tax on the purchase date, not the sale date, making the tax rational only in a bull market. In a down market, the AMT can result in unreasonable and totally disproportionate tax rates, easily exceeding an individual's income or even exceeding an individual's entire net worth.

- Complexity Flaw—Due to the complexity of the AMT, investment counselors and "tax experts" are frequently unable or unwilling to give proper advice to constituents about the consequences of the ISO AMT. Many people were completely bind-sided by the AMT despite getting professional advice on how to treat their stock options.
- Reporting Flaw—The exercise of incentive stock options is not reported to the IRS by the company or by the broker—it is only reported by the individual, making it a self-reported tax. Thus, the ISO AMT provisions punish those who

[1] Robert Carroll, Deputy Assistant Secretary (Tax Analysis), submitted a paper to the President's Advisory Panel on Federal Tax Reform on March 7, 2005, entitled: "The Fact Sheet: The Alternative Minimum Tax"

are honest and reward those who fail to accurately report their taxes under the AMT code (either through ignorance or intent).

- Credit Flaw
  - ISO AMT credit can easily outlive a taxpayer, since it can be applied only to the difference between the AMT and regular income tax. For those who are ready to retire and who have responsibly saved their entire lives to provide for a proper retirement, the ability to recoup the credit can be impossible.
  - The credit that is generated does not pass along to your family or estate.
  - The government does not pay interest on the credit.
- Tax Rate Flaw—Taxpayers exercise and hold stock options in order to pay 15% long-term capital gains tax at sale, but AMT forces them to instead pay 26 to 28% tax in advance. Thus, the AMT drastically exacerbates the risk of holding for long-term capital gains and discourages the economically beneficial practice of holding stock.
- Encouraging the Wrong Behavior Flaw
  - The combination of the Tax Rate Flaw and Tax Date Flaw results in encouraging behavior that is at odds with the goals of the company and the country (ie—forcing people to buy and sell short term and relinquish ownership in their own companies).
  - The combination of the Reporting Flaw along with the horror stories of IRS enforcement has discouraged compliance and undermines confidence in the government.

Unintended Consequences

In order to pay their AMT bills, taxpayers have been forced to liquidate much or all of their assets, including savings, retirement accounts, and children's college funds. Many have lost their homes. Some are forced to take out second mortgages and loans in order to comply with this pre-payment of tax. Others are forced into bankruptcy or expatriation.

Those who have attempted to resolve their outstanding liabilities through the IRS's Offer in Compromise (OIC) program have faced rejection after rejection. The offers often take years to resolve and result in unrealistic IRS demands, requiring the taxpayers to live at or below the poverty line. According to Nina Olsen's (TAS) 2004 report to Congress, only one OIC submission under the use of Effect Tax Administration (ETA) was accepted that year. The Tax Court recently upheld the IRS position on its refusal to consider the Section 7122 "equity and public policy" considerations of the offer in compromise process for ISO AMT, stating that while it sympathized with the taxpayers, the remedy rests solely with Congress.

The emotional and financial hardship caused by the AMT's treatment of ISOs has taken its toll on thousands. Marriages and families have suffered under the daily stress of dealing with the IRS; they have divorced, decided not to have children or to adopt children; their friends and parents watch in horror as their loved ones lose an entire life's work because of how the AMT can force them into pre-paying taxes on stock for which they never received gains (for individual stories, visit www.reformamt.org). Meanwhile, those who did not comply with the law are leading their normal lives.

Aside from the obvious "un-American" treatment of imposing taxes based on no realized gain, the effects also reach beyond individuals and families. The ISO AMT provisions are destroying and stifling the productivity, innovation, and companies that contribute greatly to America's economic success and growth. It undermines confidence in the tax system, encouraging non-compliance. These effects cannot be what Congress intended.

Request for Relief

Now, with the new bankruptcy laws going into effect in a few months, ReformAMT respectfully asks the Ways and Means Committee to consider an immediate and critical solution that will:

- Put a "stay" on IRS enforcement of this excessive tax prepayment and abate the liabilities, interest, and penalties based on phantom gain; and
- Restore taxpayers ISO AMT prepayment credits as quickly as possible.

The law as related to the AMT treatment of ISOs is fundamentally unfair and flawed, and comes at a tremendous cost to taxpayers. Our members are struggling with huge tax bills and IRS collections. They have pre-paid taxes from stock compensation for which they never received economic gain. Some of the companies whose stock was affected are now out of business. Our members are on the brink of financial ruin, suffering anxiety and depression that is so severe, it is destroying their daily lives. Please help us.

Thank you for your time. We hope that you will take our voices into consideration.
Sincerely and gratefully,

ReformAMT.org

Cedar Rapids, Iowa 52403
June 18, 2005

Dear Chairman Thomas and Committee Members:

The Alternative Minimum Tax Law currently requires citizens to pay huge amounts of taxes on imagined gain that the taxpayer may never realize.

When my husband and I exercised stock options through his employer as a portion of our retirement fund in 2000, we did not know about the Alternative Minimum Tax. There was a large difference between what we paid for the stock and the stock's value at the time of exercising. Unfortunately, as complicated as the law is, it does not account for the possibility that stock might decline substantially before the taxpayer could sell it, so we had to pay over $40,000 in Alternative Minimum Tax on stock that has a current value of under $1000.

We paid half our entire income for one year! We, in effect, prepaid taxes on income we never received to generate credits we may never receive. This tax on phantom income is unjust and must be reformed.

Thank you for your help.

Floyd and Robbin Rekemeyer

June 8, 2005

Dear Sir, Madam,

I am an American expatriate living on very modest income and concerned by proposals which could result in double-taxation for the 5 million Americans living abroad, with no true representation in Congress on matters of concern to expatriates.

We are the only nation which subjects its citizens and green card holders living abroad to extraterritorial taxation. This is an infringement upon the freedom of Americans to choose their place of residence, as compared to the freedom enjoyed by the people of every other free industrialized nation. It is detrimental to the U.S. economy by depriving U.S. products of the American salesmen and buyers employed in foreign countries who can best promote and import these products.

Thank you.

Rebecca Reynaud

Statement of Garth Rieman, National Council of State Housing Agencies

Mr. Chairman, Representative Rangel, and members of the Committee, thank you for the opportunity to submit testimony on the importance of preserving the Low Income Housing Tax Credit (Housing Credit) and tax-exempt private activity housing bond (Housing Bond) programs in any tax reform you undertake. The National Council of State Housing Agencies (NCSHA) provides this testimony on behalf of the housing finance agencies (HFA) of the 50 states, Puerto Rico, the U.S. Virgin Islands, and the District of Columbia and the tens of thousands of lower-income families these agencies house each year with the help of Housing Credits and Bonds. HFAs administer the Housing Credit and issue Housing Bonds in every state to finance affordable ownership and rental housing.

NCSHA is deeply grateful to this Committee and the Congress for its steadfast support of the Housing Credit and Bonds. Over 85 percent of the Congress, including most members of this Committee, cosponsored legislation enacted in 2000 to increase Housing Credit and Bond authority by nearly 50 percent annually.

The Housing Credit and Bond programs are by far the most effective tools states have to respond to their enormous affordable housing need. With these programs, HFAs have provided millions of working families affordable ownership and rental housing and improved the quality of neighborhoods across the country.

NCSHA also recommends Congress make the already successful Housing Bond and Credit programs work even harder for America with a few changes, many at

low or no cost to the Federal Government, to make them even more flexible and responsive to state housing needs.

The Nation's Affordable Housing Crisis

America's need for affordable housing is great and growing. More than 14 million working families of modest means in this country spend at least 50 percent of their income on housing. Hundreds of thousands more live in substandard housing or are homeless. Meanwhile, we are losing more low-cost housing annually to conversion, disrepair, and abandonment than we can replace with existing resources.

Federal funding for housing programs is insufficient to make headway against these problems. Three quarters of those eligible for federal housing assistance today do not receive it. Even the scare housing resources we have are in jeopardy. The Administration has proposed a 12 percent HUD funding cut in FY 2006, the largest reduction proposed for any federal agency.

Housing Credits—An Efficient Supplier of Affordable Rental Housing

Congress created the Housing Credit program as part of the Federal Government's last major tax reform effort, the Tax Reform Act of 1986. At the time, Congress took a remarkable, bold new approach to dealing with the low-income housing shortages that afflict almost all parts of our country, recognizing that apartments simply cost too much to build to rent at rates affordable to low-income families without some form of tax incentive or subsidy. Congress eliminated previous tax incentives in favor of a more effective, efficient, and tightly drawn program that places development and investment responsibility in the hands of the private sector with strong government oversight.

The Housing Credit program provides a ten-year reduction in tax liability for owners of low-income rental housing based exclusively on the development cost of the low-income apartments produced. Credit-financed apartments are dedicated for 30 years or more at restricted rents to families with incomes of 60 percent of median area income—on average, families earning $34,800 or less.

The program authorizes each state to allocate Housing Credits in proportion to its population. For-profit and nonprofit developers compete for Credits in an open, transparent process. Successful applicants exchange Credits for equity that investors supply to help fund properties' development cost.

States put each proposed development through three separate, rigorous financial evaluations to make sure it receives only enough Credit to make it viable as low-income housing for the long-term. Only investors in properties that pass all three financial reviews, complete their developments, rent them to eligible low-income families, and keep them in good condition can claim Housing Credits.

The price investors are willing to pay for Credits and the return they are willing to accept demonstrate the efficiency of the program. Over the last ten years, the average price per dollar for Housing Credits has increased over 50 percent. In some cases today, investors are paying more than a dollar for a dollar's worth of Housing Credits.

HFAs also finance the acquisition, construction, and rehabilitation of rental housing with tax-exempt Housing Bonds. Multifamily Housing Bonds provide debt financing for more than 40 percent of apartments that receive Housing Credits and other low-cost rental housing.

The Housing Credit and Bond programs have financed over 2.7 million apartments to respond to the severe shortage of decent, safe, and affordable housing for low-income families—working families, seniors, homeless families and individuals, and people with special needs all across the country. The two programs finance 160,000 apartments each year and are the only significant producers of affordable rental housing.

Creating Homeowners With Tax-Exempt Bonds

To help make homeownership affordable to tens of thousands of working families each year, the Federal Government allows state and local governments to use tax-exempt mortgage revenue bonds (MRBs) to finance low-interest mortgages for lower-income first-time homebuyers. Investors purchase MRBs at low interest rates because the income from them is tax-free. The interest savings made possible by the tax-exemption is passed on to homebuyers by lowering their mortgage interest rates.

MRBs have made first-time homeownership possible for more than 2.5 million lower-income families—more than 100,000 every year. The average MRB homebuyer earns $38,900—less than three-quarters of the national median family income.

Each state's annual issuance of Housing Bonds and other so-called private activity bonds, including industrial development, redevelopment, and student loan bonds, is capped. Congress in 2000 increased the private activity bond cap by 50 percent and

indexed it to inflation. The 2005 limit is $80 times state population, with a minimum of $239,180,000.

Congress limits MRB mortgages to first-time homebuyers who earn no more than the greater of area or statewide median income. Larger families can earn up to 115 percent of the greater of area or statewide median income. Congress limits the price of homes purchased with MRB mortgages to 90 percent of the average area purchase price.

Promoting Economic Growth and Job Creation

The Housing Credit and Bond programs are not just good for housing; they are good for the economy. In 2003, the construction and operation of Housing Credit properties generated approximately 76,000 jobs, $2.5 billion in wages and salaries, and $1.3 billion in government revenue. The MRB program the same year generated over 64,000 jobs, $2.5 billion in wages and salaries, $465 million in consumer spending, and over $1.3 billion in government revenue, while multifamily bond issuance generated nearly 89,000 jobs, $2.9 billion in wages and salaries, and $1.5 billion in government revenue.

Impact of Tax Reform Proposals

Several tax reform proposals put forward by members of Congress this year and under consideration by the President's Advisory Panel on Federal Tax Reform would eliminate or diminish the impact of the Housing Credit and Bond programs. The private market would not make up for these losses.

The Housing Credit and Bond programs help finance affordable housing production that would not otherwise occur. Rental development and operating costs outstrip lower-income renters' ability to pay in most areas. Conventional mortgages are not as affordable as MRB-financed mortgages.

Importantly, direct spending programs cannot replicate what the Housing Credit and Bond programs achieve through their private-sector discipline. Housing Credit and Bond investors risk losing the primary economic benefit of their investments (i.e., through Credit recapture or the loss of the Bonds' tax-exempt status) if the programs fail to achieve their public purposes. This threat provides a performance incentive unmatched by direct spending programs that has helped make the Housing Credit and Bond programs the most effective and efficient federal mechanisms for providing affordable housing.

Other seemingly benign changes to the existing tax code could have significant unintended negative effects on the Housing Credit and Bond programs. The Administration's 2003 proposal to eliminate taxation on dividends already taxed at the corporate level, for example, threatened to reduce annual Housing Credit production by as much as 35 percent. This estimate did not even take into account the impact the proposal would have had on Housing Bonds, which finance many Housing Credit apartments.

On the other hand, tax reform could greatly enhance these programs by eliminating tax code provisions that inhibit their effectiveness. For example, proposals to eliminate the Alternative Minimum Tax (AMT), or at least exempt Housing Bonds and Credits from it, would lower bond and Credit yields, increasing affordability.

Since 1986, the interest income on new money private activity bonds, unlike general obligation and 501(c)(3) bonds, has not been exempt from the AMT. As a result, demand for private activity bonds is weakening. To the extent potential Housing Bond investors are or fear becoming subject to the AMT, they either demand higher yields on the Housing Bonds they buy, reducing the dollars available for housing, or decline to buy Housing Bonds. Higher bond yields lead to higher mortgage rates, decreasing affordability for lower-income homebuyers and renters. AMT relief will lower bond yields and improve housing affordability.

Similarly, Housing Credit investors are increasingly subject to the AMT. To the extent potential Credit investors are or fear becoming subject to the AMT, they will either pay less for the Credits they buy, reducing the dollars available for housing, or decline to buy Credits.

An Opportunity to Strengthen the Housing Credit and Bond Programs

NCSHA also calls on Congress to seize the opportunity tax reform presents to strengthen the Housing Credit and Bond programs and make them even more responsive to today's affordable housing needs. Despite their success, Housing Bonds and Credits could fulfill the objectives Congress created them to meet even more effectively and make them even more efficient and responsive to state housing needs if it enacted a handful of changes, many at low or no cost to the Federal Government.

Though the Housing Bond and Credit programs are extraordinarily effective, over the years NCSHA and others have contemplated legislative and regulatory changes that would make them even better. In 2004, NCSHA undertook a year-long effort to identify what changes, if any, would improve the programs' operations and results. An 18-member HFA working group conducted a comprehensive review of the programs in consultation with all state HFAs and housing industry groups. That review produced the following recommendations:

- Exempt Housing Bond and Credit investments from the alternative minimum tax (AMT) to attract investors and generate increased proceeds to pass on to homebuyers and renters in lower housing costs;
- Exempt displaced homemakers, single parents, and families whose homes are destroyed or made uninhabitable by presidentially declared natural disasters from the single-family Housing Bond—Mortgage Revenue Bond (MRB)—program's first-time homebuyer requirement;
- Provide relief from the MRB Ten-Year Rule so states can recycle more MRB mortgage payments into new mortgages for first-time homebuyers;
- Allow states to provide greater Housing Credit amounts to properties that achieve state-determined goals, such as deeper income targeting and location in rural and other difficult-to-develop areas;
- Encourage mixed-income housing by changing the Housing Credit rule that requires all scattered-site properties to be 100 percent occupied by low-income families;
- Rename the Low Income Housing Tax Credit the Affordable Housing Tax Credit to encourage community acceptance; and
- Make technical changes to the Housing Bond and Credit programs to simplify their administration.

We would be happy to provide you more information on the rationale for and details of these recommendations.

Thank you for your attention. NCSHA is available to assist you in any way.

Aptos, California 95003
June 17, 2005

Dear Chairman Thomas and Committee Members: My name is Marile Robinson and I am writing you as a hardworking taxpaying citizen that has been devastated by the unintended consequences of the AMT law. I appreciate the opportunity to discuss the hardships I have suffered due to an outdated and complicated portion of the tax code called Alternative Minimum Tax.

I am a 27 year employee of Intel Corporation and as a Human Resources middle manager I was awarded ISO stock options as a compensation award for outstanding performance for many years of service. I choose not to exercise those options but to save them for my retirement, which I became eligible for in 2001.

In 1999 and 2000 the bulk of those ISO shares needed to either be purchased and held or face expiration. I could have just exercised them as Intel stock was between $59.00—$92.00/share in that timeframe. But I was advised by my tax consultant and Intel Stock benefits to purchase them and hold for one year. I purchased thousands of shares and held them only to painfully find out, literally on the afternoon of April 14th 2001 my tax preparer called me and said "are you setting down" YOU OWE $290,000 to the IRS.

I was a part time employee with an annual salary of $60,000/year less that a year away from retirement.

In order to meet that tax liability I barrowed from a margin account and paid 6% interest while I tried to figure out a way of sorting this out. For the next year I wrote letters, appealed to Intel Corporate Officers, supported Zoe Loftgren and others in their attempt to reform the AMT law, even sought legal advice. Total expenses including the initial tax payment totaled $320,000. I then sold my home of 19 years and the total proceeds went to paying off this phantom gains tax. I lost my nest egg home, all of saving and postponed my retirement. It's still painful to even talk about this financial devastation.

Most people have no idea how this could possibly happen. The way I explain it is: imagine you paid a dollar for a lottery ticket with a possible payout of $1,000,000. Well, your numbers didn't come up—However, the IRS says you could have won $1,000,000 so that's what we are going to tax you on.

The issue boils down to doing the right thing. I'll never live long enough to use my AMT credits. Please restore my faith in this nation, and in this committee. Fix it.

Respectfully,

Marile Robinson

Dayton, Ohio 45440
June 20, 2005

Dear Chairman Thomas and Committee Members:

I started working for a California based company in November 1998. I live and work from my home in Dayton, Ohio. As part of my compensation package, I received incentive stock options (ISOs) in the company. In March 2000, I exercised my vested ISOs (2,455 shares) by paying $30,000. The market value was $370,000. I planned to hold the stock for a year and complete the holding period.

By March 2001, the stock price had dropped from $159 to $60 per share. You can only image the horror as I did my taxes. Our joint Federal AGI was $100,000 and we owed an AMT of $121,000! **Thanks to outdated tax laws, we were in the 121% Tax bracket!**

To pay the tax, I had to sell all the stock by March 2001 (at $60.00 a share). This was just enough to cover the AMT taxes and pay off the loan I used to exercise the stock. The gain to my family was zero!

In April 2001, I sent the IRS a check for $102,000. This was the entire net proceeds from the sale of the ISOs plus my life savings. We survived paycheck to paycheck for the remainder of 2001. For my 2001 tax, I had an $82,000 non-refundable tax credit and I owed the IRS $8,000! The reason for this imbalance is that although I carry a $215,000 dollar loss on the tax treatment of the ISOs, I am limited to claiming a $3,000 dollar loss per year on the AMT side!

Now for the best part: the $102,000 check I sent the IRS in 2001 is treated as income, which places me in the AMT tax bracket. I had to pay AMT in 2001 on the money I used to pay the AMT in 2000! This is wrong! The government taxed me on income that I didn't receive! The next year, I not only don't get a refund, but I can't use the tax credit and I have to pay taxes on the money used to create the tax credit.

Meanwhile, our government has an interest free loan on my money. Based on my calculations, I have close to a $90,000 tax credit and $140,000 loss that I won't be able to fully recover until 2049.

I am 44 years old and a father of two (9 and 12 years of age). I was planning on using the ISOs to build a college fund for my children. But thanks to a complex, antiquated tax law, those dreams have vanished and my family sits on the edge of financial ruin.

Please forgive my sarcasm, but during the past 5 years, AMT has dominated our finical life. There is no way out under current tax laws. I spoken with dozens of CPA's and countless Certified Finical Planners, their only advice has been to seek legislative change.

I written and called my Congressman (Mike Turner). The last verbal response from his aid was to seek a tax attorney. A tax attorney wants $60,000 to take the case, sounds like a losing proposition to me.

I have written and called my Senators (George Voinovich and Mike DeWine). They sent me to Tax Payer Advocate Office. The Tax Payer Advocates Office could not help. They can not negotiate with the IRS on matters of un-fair tax laws.

My wife and I wrote letters the President and Vice President in 2001. In August of 2003, my wife received a letter from the department of the Treasury stating our case has been transferred to the Accounts Management Center. A few weeks later she received a call from the IRS. They apologized for the length of time it's taken to respond to her letter, however, the IRS can only enforce the laws, they can not change them.

I keep hearing "tax the rich", but from my experience, the tax laws are designed to prevent you from becoming "rich". Please help!

God Bless America,

Monte A. Simmons

June 22, 2005

Ask not: "What can my country do for me?"—Ask: "What can I do for my country?" This concept expressed in President John F. Kennedy, Jr.'s 1961 presidential inaugural address at the height of the Cold War was an invitation for young Americans to become unofficial ambassadors of the U.S. by joining the Peace Corps and taking our republican and democratic ideals to the poor nations of the world. Many Peace Corps workers later joined our esteemed Foreign Service and were in part responsible for the fall of the Iron Curtain some 30 years later, assisting on the ground the great political leaders, notably President Ronald Reagan.

It was also in the 1960's that many American companies ventured abroad, eventually leading up to the creation of many of the America-based multinational corporations we know today. Those companies sent U.S. citizens abroad to build these businesses and train foreign workers. This is still being done today, for the mutual enrichment of America and its trading partners including the peaceful economic development of poor countries in the world.

In other words, pro-active international business and economic development has enriched all concerned. This is simply a reflection of the American Way already naturally practiced in the United States since its inception.

The U.S. has also had taxation from its founding and even before—the hated tax on tea led to our independence from Great Britain. Our diplomats and Peace Corps workers have not had to worry about double taxation because international law allows government personnel to remain taxable in their home countries. Likewise, when most non-American private citizens who go abroad to promote their private sector economies: they leave their country's sphere of taxation and become taxable where they settle; the foreign country where they settle claims tax jurisdiction over them, as, by the way, does the U.S. for foreigners arriving on its shores. The home country gives up taxing rights levied with respect to residence. Not so, however, for private sector U.S. citizens moving abroad. None except the U.S. taxes on the basis of citizenship alone.

Among the beauties of the generally-used system is a much simplified compliance system. These non-U.S. expatriates may in fact remain taxable as nonresidents in their home countries with respect to income sourced there: most countries, including the U.S., tax nonresidents via withholding tax on investment income derived from that country. Double taxation issues are dealt with via bilateral tax treaties.

U.S. lawmakers have in the past rejected a residence-based tax system because of potential abuse, or exaggerated reports of abuse—

A wealthy American can already live in the U.S. income tax-free, or nearly so, by investing in tax-free municipal bonds, land or works of art, etc. He can already give up his citizenship and move to tax havens to avoid future tax. Expatriation to more clement taxation is thus already possible and legal—However, this sort of situation is (very) minor in the U.S. tax landscape because most Americans are patriotic and are not willing to go that far.

America has grown not via the wealthy, but via its vast population at all levels. For the few who might leave the U.S. for tax purposes, many talented foreigners are waiting to immigrate to the U.S. When tax rates were reduced from 70 % to 28 %, under President Reagan, individual tax collections climbed (!) because investors felt free to realize latent capital gains without punitive taxation. The economy soared. Recent economic reports suggest a similar effect is taking place at this time following the recent U.S. tax cuts.

The American Way is to believe in its people, to let our own magic mixture of free enterprise and basic social welfare thrive in an almost undirected economic system. We trust Americans to build our economy.

Lawmakers, you should unleash those adventurous Americans who are willing to work and trade abroad from undue taxation burdens by letting them go abroad and promote international business! To do this, stop citizenship-based taxation!

Stephanie H. Simonard
Tax Committee Chairman, AARO

Ely, Iowa 52227
June 15, 2005

Dear Chairman Thomas and Committee Members:

I am writing to you on behalf of my family because we desperately need your help. We are suffering under tremendous stress because of a flaw in the tax code, and we need your help to save our family. In the year 2000 our taxable income was

$105,461. That same year we were required to pay an Alternative Minimum Tax of $206,191 from Federal and $46,792 from the State of Iowa. The additional AMT tax was based on stock that we sold *for a loss* when our company nearly went bankrupt. We were **taxed $252,893** for a gain that we **never made.**

In December of 1992 I joined a small telecommunications start up in Iowa called McLeodUSA. The company provided incentive stock options as part of its compensation. This is what we were using to plan our future. We saved all the options we received to use on building a home, providing for our three daughters education, and providing for our retirement.

In 2000 we were ready to start building our home so we spoke to our financial and tax advisers to determine the best way to use the stock. Based on the current tax laws, they told us to exercise the options and hold them for a year so we could benefit from long-term capital gains on the income. We followed that advice, and exercised the stock and held on to it consistent with these strong tax incentives. As the home was nearing completion we had our taxes done by an accountant and received this tax bill which was totally disproportionate to any gain we received. The stock value had plummeted so we borrowed money from a local bank to try to pay the tax. We paid the State tax and $94,484 of the Federal in several payments. Our local IRS collections agent reviewed our case and told us there was no way we could pay the remainder off and instructed us to enter into the IRS's Offer In Compromise program. They said the OIC program was put in place to solve impossible situations just like ours.

After waiting for 8 months we were finally assigned to an OIC Specialist. The OIC Specialist utilized the formulas and guidance and informed us that we were rejected from the OIC program. He told our attorney that I have three things going against me; I am not old, I am not disabled, and I have been too consistent. I have been too consistent because I've been employed and paying income tax since I was fourteen years old. I've never filed bankruptcy. I've never defaulted on a loan. According to the archaic computations the IRS used our family should only have housing and utility costs of $1,067 per month, but our actual is over $3,700. Based on their allotment we are supposed to be able to pay $2,366 per month to pay even more unfair taxes, and a lien has been placed on our home. There is no way we will be able to pay this amount because we never received the money on which the tax is theoretically based. We have appealed our case to the U.S. Tax Court but the Tax Court upheld the IRS position.

Both the IRS and the Court say it's up to Congress to fix this.

Please use the powers you possess to right this inconceivable injustice. I beg of you to help. I have been nothing but honest to the letter of the law in paying taxes my entire life. It seems incredible to me that I should be financially destroyed by a tax that is so unjust and certainly not fulfilling the purposes that Congress intended.

Ron Speltz

Flossmoor, Illinois 60422
June 18, 2005

Dear Chairman Thomas,

Thank you for the opportunity to submit this letter to detail the hardships my family has faced as a result of the Alternative Minimum Tax. My name is Dan Taylor and I am writing on behalf of my wife Vicki and my children Trent and Stephanie. I write to you today to beseech you to provide a remedy to taxpayers and families who have been financially blindsided by the antiquated tax code that is the Alternative Minimum Tax, especially as it applies to Incentive Stock Options (ISOs).

In January 1998, I was hired by GeoTel Communications in a sales position to sell telecommunications software. As an incentive to work for this small company, I was granted ISOs as part of my compensation package. These options would vest over time and I would have the opportunity to receive additional grants for meeting performance goals, which I did. This was the first position that I held in my career where I received any form of stock option with my only investment experience being through personal IRAs and company sponsored 401Ks, so I would consider myself an unsophisticated investor. I did not know one type of stock option from another which, would prove to be catastrophic to me and my family later.

In June 1999, GeoTel, with revenues of approximately $40 Million, was purchased by Cisco Systems for $2 Billion, or 50 times sales. I received a bit more than one share of Cisco stock for every share of GeoTel that I was holding an option on, so this made my accruing options very valuable. In June 2000, I left Cisco Systems

to pursue other interests and was required to exercise the options and purchase Cisco stock or lose all the options at no value. I used some options granted while I was a Cisco employee, Non-qualified (NQs), to purchase the ISOs that I originally received from GeoTel. The NQs were taxed as I bought and sold them as ordinary income and the proceeds from the sale were used to purchase and hold the ISOs. I purchased 28,000 shares of Cisco stock for $4/share on a day that it was selling in the open market for $62.

All of these transactions were made with the help of a professionally licensed financial consultant. Every effort was made on the part of my wife and me to handle this financial blessing properly with regard to income taxes. We were advised that we would be taxed when we sold the ISO-based shares. The resulting tax would be at the long-term capital gains rate if we held the stock for one year. We were never advised that we had created a taxable event on the day that I purchased the stock with a tax liability of approximately $500,000 triggered by the AMT as it is applied to the exercise of ISOs.

Through late 2000 and Spring 2001, the value of the stock plummeted. Vicki and I filed our taxes using the accountant recommended by our financial consultant for the 2000 tax year. We were not asked any questions about our stock transactions other than to provide the 1099 for the exercise of the NQ based options. We were not asked to provide any records for the ISO based options despite the fact that we revealed to the accountant that I had exercised the options in June 2000.

In May 2001, I learned through a colleague from GeoTel that he had paid a tremendous tax bill centered on the exercise of his ISO shares. We both agreed that our situations were similar enough that I needed to research and confirm that my taxes had been filed properly. Much to my horror, I learned that Vicki and I had indeed filed our return improperly. Though we had paid over $125,000 in Federal taxes, we owed an additional $438,000 on W–2 income of approximately $350,000. The additional tax was generated solely by the AMT associated with the ISO stock purchase. I had not sold one share of that stock during 2000. The value of the stock was now less than $125,000.

We did not have the money to pay the taxes, but I was confident that if we came forward voluntarily that we would be treated fairly and equitably by the Internal Revenue Service. There was no audit trail, but I wanted my children to see that we should do the right thing even when no one is watching. I expected the outcome to be painful, but nothing like what we have experienced.

Everyone that we have come in contact with at the IRS has expressed sympathy for our plight, but very quickly made the point that they have no latitude in how the collection process is enforced. The guidelines are the guidelines. There are no allowances for anything, only formulas that are something out of the 1950s. After two and one-half years, we were able to reach an agreement on an Offer in Compromise in October, 2004. My family and I will pay $372,000 over two years or about $14,500 per month. This will require us to sell our home, use all of our savings and tax deferred retirement accounts, and my son will have to leave a four year university and attend junior college.

Is this how the tax laws are supposed to work? Are they to be a snare that catches unsuspecting citizens and devastates them financially? If financial professionals do not understand how the AMT applies to stock options, how can the average citizen be expected to understand and comply with this law?

Thousands of Americans have been caught in this snare, not just my family. Only Congress can provide a remedy that will insure that more families will not face similar circumstances. I believe and have faith that you will enact legislation to abolish the current AMT tax law and replace it with more straightforward tax code that the general public can understand. I believe and have faith that you will provide a remedy and relief to families such as mine with some type of retroactive abatement of taxes from ISO triggered tax bills. Why do I believe and have faith that you will do this? The U.S. Congress has the authority to do so, and it is the right thing to do. Thank you.

Daniel Taylor

Redwood City, California 94062
June 21, 2005

Dear Chairman Thomas and Committee Members,

My family was severely impacted by the Alternative Minimum Tax (AMT) law. In 2000, I purchased my employee ISO stock shares from my company. Rather than sell my shares, I held on to them through the high tech stock crash of 2001. Those

purchased shares dropped in value from $1,500,000 to approximately $400,000. Nevertheless, based on AMT rules, I owed more than $400,000 in tax. I was sure this was a mistake. **How can an asset be taxed more than it's worth?** I had to sell all my stock, and re-mortgage my home to pay the AMT tax. The mental anguish in this situation led me to thoughts of suicide and months of therapy. I have a huge AMT tax credit that I can never hope to regain, based on current tax laws, and the size of the credit shrinks annually.

I have to believe that Congress, when it drafted the original AMT tax laws, did not intend for the consequences above. I am not a rich man (I work as an artist now, and make less than $30,000 annually). When I tell others about what happened to me, they scarcely believe how unfair my situation—and many like me—is. The reason I held my shares to begin with, was because I'm an optimist at heart. I still strive for that, in the face of this incredible injustice. My hope is that the committee will do the right thing, and right this wrong.

Best,

Ed Terpening

Southfield, Michigan 48069
June 22, 2005

Dear Chairman Thomas and Committee Members:

AMT has financially devastated me and ended my marriage. Making $50,000 I now owe the government $500,000—including $200,000 of interest and penalties. The IRS has requested that I liquidate my 401K and pay ALL BUT $300 per month of income for the next 11 years, asking for an extra 3 years past the statute of limitations for income taxes. The stress of this situation has wrecked my marriage and will make raising two children nearly impossible. How will $300 of income each month pay for daycare let alone a car to get to a job, food to feed my children, and a place to live? I don't owe anyone else, nor am I living a lavish lifestyle while trying to avoid paying taxes! I am an honest, hard working contributor to society. I've been on the board of a non-profit volunteering time and energy to make life better for others.

How can it be that this PREPAYMENT on EXPECTED capital gains doesn't change if the EXPECTED capital gain is not achieved? The purpose of AMT—to make sure the rich pay their taxes—does not hold in a situation such as a stock plummeting 140 points in 6 months! An unintended consequence of the AMT, I am told, with no leniency possible. Aren't we a civilized nation that should be able to apply some logic and situational change to 'procedure'?

Please understand that a realistic outcome of not fixing this situation is that a hard working American could end up being forced to quit her job. Would I have to go on welfare to support my children? How can that be? Somehow I just can't believe that this was the intended meaning of the 'American dream.'

Christy Thaxton

June 8, 2005

Mr. Chairman,

Thank you for holding this important hearing on tax reform. The American people are eager for Congress to reform the overly-complicated, regressive and inequitable tax code.

When President Bush established The Advisory Panel on Federal Tax Reform earlier this year, he articulated his key principle that any solution must be revenue-neutral. Democrats' bedrock principle is that tax reform should not lead to tax increases on middle-class families.

Millions of working families are already paying more than their fair share due to the President's tax cuts and widespread tax avoidance by the wealthy and corporations. As a result of rampant underreporting of income by those who refuse to abide by the law, the Nation faces a $311 billion tax gap, leaving middle-class families to pick up the slack.

We can reform the tax code, restore progressivity and strengthen our economy without raising taxes on the middle-class. The last major tax reform legislation was enacted in 1986, at a time when the code was replete with shelters, loopholes, complexity and inequities. We face similar circumstances today.

The tax code now spans more than 60,000 pages, with thousands added in the last few years in the name of "tax reform." The IRS prints 1,000 publications, forms and instruction booklets in an attempt to assist taxpayers. This complexity is taking a toll on middle-class families in the form of wasted time, effort, money and productivity.

It takes the average family 7½ hours longer to complete its tax return than it did just ten years ago. Many spend nearly 24 hours annually completing their forms, and nearly 60 percent now use professional tax preparers at an average cost of $150, a full day's pay for millions of individuals.

These burdens will only increase as more middle-class families are ensnared by the Alternative Minimum Tax. By 2010, the AMT is expected to hit 33 million taxpayers, up from just 1 million in 1999. Tax reform must include a long-term solution to protect middle-class taxpayers from the AMT's unintended consequences.

While the code's complexity-by-design benefits those who can take advantage of its loopholes, middle-class families are left holding the bag. Americans recognize this inequity and are losing faith in the fairness of the tax system. The IRS found in 2003 that 17 percent of taxpayers believe it is acceptable to cheat, up from 11 percent just four years earlier. This is an ominous sign for a system built on voluntary compliance.

One example of needless complexity is in the higher education area. Parents with children in college have to decipher between five different education tax incentives and a series of confusing forms and definitions. We should consolidate these five tax breaks into one fully refundable $3,000 college tax credit available for four years of college and two years of graduate school.

We should also address the overlapping and confusing incentives for families with children. To that end, I have proposed a Simplified Family Credit collapsing the Earned Income Tax Credit, the Child Credit and the Dependent Exemption into one easy-to-use credit for working families with children. The Simplified Family Credit reduces 200 pages of the code down to a postcard-sized form with 12 questions.

Another area ripe for change is in tax incentives for homeownership. The mortgage interest deduction is currently available only to itemizers, effectively denying the benefit to millions of middle-class families. To add progressivity to the code and encourage greater homeownership, we should extend the mortgage interest deduction to non-itemizers.

We must also simplify and consolidate the "alphabet soup" of sixteen different tax-advantaged retirement accounts. The multitude of accounts is confusing to employers and employees alike, and acts as a disincentive to saving for retirement. That is why I support a Universal 401(k) that incorporates the best aspects of the various plans into one account that is portable from job-to-job.

In the last four years, the code has become filled with special breaks for special interests. It is time to make middle-class families the interests we serve. I look forward to working with my colleagues and with the Administration to that end.

The Honorable Rahm Emanuel

Shoreview, Minnesota 55126
June 20, 2005

Dear Chairman Thomas and Committee Members:

My name is Phil Thompson, and I am 44 years old. In 1997 I accepted a position as a software engineer with a software company located in Roseville, Minnesota. In addition to salary, I was given a one-time grant of 3,000 incentive stock options (ISOs) when I started. **This was the first time I had ever received stock options in my life.** Between 1997 and 2000, the company grew rapidly, and the stock split a few times, and the increasing stock price ended up making those options very valuable. Before the year 2000, I had exercised and sold some of the options that had vested, mainly to get a down-payment for my first house. But in the year 2000, because more than half of my options had vested, I decided to accelerate exercising many of these options.

I knew very little about the tax ramifications of exercising and holding ISOs, so I hired a professional tax advisor who had been recommended to me by several co-workers (who were in situations similar to mine). My tax advisor recommended an on-going, well-timed exercise-and-hold strategy, which would allow me to best benefit from the tax laws over the next several years. This seemed logical to me. **Unfortunately, he did not warn me of the risks involved with exercising and holding ISOs, should the stock price decline dramatically.** And because until

that point I had only done same-day sales of my options, I was not familiar with the different tax treatments.

During the year 2000, I exercised and held approximately 4500 options, worth approximately $470,000 on the purchase date. And for most of the year 2000, the stock price continued to trade considerably higher than my purchase price. My trading window for the year closed in mid-December of 2000, and even in early December the stock price was still above my purchase price. Of course, the stock price declined dramatically thereafter. I didn't realize there was a problem until **my tax advisor told me in March of 2001 that I owed approximately $165,000 in combined federal and state tax. I was shocked and amazed, because my gross annual salary at that time was only about $85,000.** Frankly, I didn't think it was possible that a taxpayer could be required to pay more in taxes than he/she actually earned.

After my tax advisor explained that I would not be able to discharge the AMT by selling the shares (because the AMT is an immediate tax on **potential** earnings, not on real money), I was forced to exercise and sell even more options in order to cover my tax liability. I was luckier than most, in that my company's stock price decline was less rapid than most tech stocks at that time.

As of this writing in June, 2005, the federal and state governments still hold over $108,000 of my money in so-called "AMT credits." This is money that I could use to pay off my house, invest in my future, and prepare for retirement.

After being victimized by the AMT treatment of incentive stock options, I have the following observations:

1. **The alternative minimum tax can be an unfair tax on phantom gains that may never be realized.** For incentive stock options, because the AMT is based on the tax that would be owed on the day of exercise, it does not take into account the possibility of a dramatic drop in the stock price. It also does not seem to take into account that for various reasons (holding periods, blackouts, complexity of the rules, etc.) a taxpayer may be unable to sell the shares in response to such a dramatic drop.
2. **The AMT rules are very difficult to understand.** Even with the assistance of a professional tax advisor, I encountered a situation that could have easily bankrupted me. And since the year 2000, I have read 2 books on the AMT, and done much internet research on the AMT. I still don't feel like I understand the AMT rules very well. Each rule seems to have multiple "except if" clauses. Thanks to the complexity of the AMT rules, I am forced to hire a professional tax advisor every year to prepare my tax return. I also find it very difficult to plan future financial moves because I am unsure of how they will affect my tax liability and the return of my AMT "credits."
3. **Current tax laws allow no solution to easily recovering the AMT taxes pre-paid on phantom profits.** Even if a citizen like me is able to meet the tremendous burden of the AMT, the rules for returning the AMT "credits" are designed to make it a very long and arduous process, in some cases requiring many decades. Recovery of "credit" is hastened only by dramatically increasing your earnings and/or by creating capital gains. And both of those solutions are not generally easy to do! **In my personal opinion, speeding up the return of the AMT "credits" is the most important part of AMT reform.**
4. **AMT "credits" (prepaid taxes) are lost forever if the citizen dies.** If I was to die in an accident tomorrow, the $108,000 of mine that the government holds in AMT "credits" would be lost to me and my heirs forever.

Although the tax rules claim to provide a benefit for investors who exercise stock options and hold onto the stock, I will never again exercise and hold any incentive stock options. Because of the AMT, it's just too much of a gamble.

Please fix the AMT and return the credits!

Thank you for your attention.

Phil Thompson

Statement of Sunnye Tiedemann, Overland Park, Kansas

Mr. Chairman and Distinguished Committee Members:

First, thank you for the opportunity to speak to you of my concerns. It is a humbling experience for an average taxpayer to appear before you, even if it is just via

e-mail. Please give me your attention while I tell you why you must repeal the current income tax system and install the FairTax.

President Franklin D. Roosevelt might well have been describing the present income tax code when he said, in 1944, "It is not a tax bill but a tax relief bill providing relief not for the needy but for the greedy." That's a perfect description of the situation we have today.

According to the IRS, $350 BILLION a year is lost to tax evaders. The IRS recovers $50 billion of that through intimidation, coercion and even illegal measures, leaving $300 BILLION out there in neverland, every year. Meanwhile there's a $6 TRILLION illegal drug industry that does not pay taxes.

While all of this money is out there, owed but untouched by the IRS, it costs the Federal Government $140 BILLION a year just to run the tax system, adding $850 to the tax bill for every man, woman and child in the U.S. That's enough money to the Department of Homeland Security, the State Department, NASA, HUD, the United States Congress, all our Federal courts and all foreign aid.

The American consumer, in addition, pays a conservatively estimated $225 BILLION annually taxes that are embedded in the prices of the goods and services we buy. That's because companies and corporations simply pass their tax burden along to the customer in their pricing.

Those are huge numbers so let's bring it down to specifics, if you don't mind. Every taxpayer—you, me, every honest person who pays an honest tax—pays $2000 a year just to make up for tax evaders. Add that to the $850 we pay for compliance costs annually and you have $2850 each of us pays BEFORE we get to our tax liability (and that's not counting the 20% to 30% embedded tax in everything we buy). And on top of that, many of us must pay tax preparers hundreds of dollars a year, mainly for the assurance that we would have support if the IRS should decide to question our tax returns.

As if the financial burden wasn't bad enough, we have the emotional burden of the IRS, as well. The following story is true, and can is a verbatim quote from an e-mail received by one of the FairTax volunteers in Florida and shared with the rest of us yesterday:

"Sorry I didn't answer right away; I was out of town for awhile. "Let me tell you a brief story about something that just happened to me. This year the IRS sent me a nasty letter, saying that I failed to pay a penalty in 1995 for the 1994 tax year, and now I owed that penalty with 10 years' worth of interest! Of course, there were all the usual threats and admonitions about how they'd seize my property, throw me in jail, and that just because I'm a disabled veteran military retiree, I =still= have an obligation to pay my taxes. (Duh! I'm obviously a low-life tax cheat in their view.)

"How did I get the penalty in the first place? Basically, I paid my taxes in time in April 1995. In June, some moron at the IRS said I paid too much tax and sent me a refund check. I went to the IRS office in Virginia where I lived at that time, told them that, No, I =do= owe this amount of tax. The helpful IRS agent said, "Don't send the check back. Cash it, and write me a new check for the amount." We put the money back in, and supposedly everything was fixed. "Three months later—you guessed it—the IRS sends me a refund check. I stormed back to the IRS office. They said, No, you DO owe that money. I told them to take their check back. They couldn't do that. Cash it and write us another one. Fine.

"The next month, I get a BILL from the IRS. I paid my taxes too late!!! They were due on April 15th, and I didn't pay until September. Back to the IRS office I went, fit to be tied. I explained to yet another IRS agent that I =DID= pay my taxes, ON TIME and IN FULL. They kept sending me refund checks. The error was theirs! THREE trips to the IRS office ensued over the next few months. They decided to forgive the penalty, but not the interest, so I wrote them a final check, and got a senior supervisor to write and sign a statement for me saying my 1994 taxes were fully paid. "Fast forward to 2005. The FEDERAL IRS office in Philadelphia decided to overturn the decision of the STATE IRS office in Virginia. Not only did I owe the penalty, but now the penalty had accrued 10 years' worth of interest! I was livid, to say the least.

"Armed with a thick folder of documentation, I went to the IRS office here in Jacksonville. The IRS agent here wasn't interested in looking at my documentation. He peered at his computer screen and dismissed me, saying, "It's your choice, sir. You can get a tax attorney ($$$) and fight this, meanwhile accumulating further interest and possible penalties, or you can just pay it, stop the clock on the interest, and write a letter of complaint about it. You MIGHT get something back, but probably not." (He said the Federal IRS office has a right to overturn the decisions of the State office. It made no sense to me, since we were talking about my Federal Income Tax return. How can one IRS office overturn another?)

"Let me tell you, I was tempted to spend hundreds of dollars and drag this into a public battle. After cooling down, I realized the gesture would not only be expensive, but would also be futile. I'd end up wasting time, money, and aggravation just to prove what everyone already knows—that the IRS is a crooked, incompetent, beast which threatens and preys on the lives of honest, hard-working, law-abiding Americans. I sent them their check. "I am more determined than ever to rid this country of the utterly contemptible system of revenue gathering we've been saddled with. I want the IRS out of my life forever."

His estimate of hundreds of dollars to defend his position is, I'm afraid, massively conservative. His story is typical of many, many others I encounter when I talk to people about the FairTax. The IRS is a travesty in a country dedicated to" life, liberty and the pursuit of happiness."

The best solution to this problem is, without a doubt, the FairTax. This is true not only because it is the only proposal that calls for repeal of the income tax but because it would fund the government without adding to or redistributing the tax burden.

With the FairTax everyone, rich or poor, would keep 100% of his or her paycheck or pension check to spend, save or invest as they choose. By repealing the income tax, the FairTax removes the 20% to 30% embedded taxes in goods, which means that when they pay the FairTax, people pay essentially the same they do now.

The FairTax funds the U.S. government at present levels—saving the taxpayer the aforementioned compliance costs and the annual $2000 s/he pays to compensate for tax evaders. That's a significant savings for everyone, wealthy or poor.

The FairTax, since it is a consumption tax, retrieves those funds from tax evaders, the drug, criminal and porn industries (which numbers in the $6 TRILLION plus range), and in addition adds to the tax rolls illegal immigrants and 40 million foreign tourists annually. Imagine the increase in the tax base.

With that kind of boost to the economy, imagine what Congress could do: fix the national highway system, pay our troops what they really deserve and give each family a $100,000 life insurance policy when a member deploys to a war theatre, and more.

The FairTax would free everyone to be as productive as s/he chooses. Today families with two paychecks often watch their income carefully to avoid earning enough to kick in higher taxes or the AMT. In America the sky should be the limit. It's not. In America the tax ceiling is the limit. I know that is so because that is my personal experience.

That, by the way, is why the FairTax is better than any other consumption tax proposal. Britain, France, Germany and other European countries have tried adding consumption taxes to income taxes and discovered, to their collective chagrin, that it is a fatal combination. Repealing the income tax and ridding us of it entirely is the only safe way to go in tax reform.

Another proposal before you is the flat tax. That's where we began. The flat tax, like Topsy, grows. And the flat tax taxes production. Can you imagine the advantage the U.S. would have if it were the only country in the world that did not tax productivity? The FairTax would make that a reality and our international status as a country welcoming foreign investment would soar.

The FairTax is a progressive tax. Everyone is taxed evenly. The wealthy pay more because they buy more expensive goods—mansions instead of houses, Jaguars and limousines instead of Fords and Toyotas, Kate Spade handbags at $260 instead of Coach handbags at $30, Versace, Chanel and Vera Wang gowns instead of off the rack. That's fair.

As for the poor, everyone with a social security card (wealthy, middle-class and poor) gets a "prebate" (a rebate before they pay) to assure that no one pays tax on necessities up to the poverty level. Only the FairTax evens the playing field like that for everyone.

May I respectfully submit that ALL exceptions, exemptions and so-called "incentives" should be removed from any taxation you approve. Tax credits are NOT powerful and important—they are cynical. They tell the American people that they are too dumb to make decisions for themselves concerning their retirement, home buying, etc. In the early years of this country citizens made great decisions. They will do it again, given the freedom to do so. The FairTax offers no restrictions, exemptions, or controls of any kind.

In addition to repealing the income tax, the FairTax repeals social security taxes, personal, estate, gift, employment, capital gains, alternative minimum, Social Security, Medicare, self-employment and corporate taxes. It is a replacement tax rather than tax reform. And, as I said before, it funds the U.S. government.

Under the current system, investments are taxed. Under FairTax, they would not be taxed at all. Investors prosper under the FairTax plan, since corporations have lower operating costs and people have more money to save and invest.

Charities and churches will profit immensely with the FairTax. With the repeal of the income tax, they will be free to speak as they please without feat of losing their "tax exempt status." When the Tax Reform Act of 1986 lowered marginal income and transfer tax rates, charitable giving *rose* by $6.4 billion dollars. Also, most charitable contributions now come from non-itemizers. My own view on this is that if I get a reward for my giving, I am not giving at all, but investing. I prefer to give where there is need.

In conclusion, the FairTax is not a plan that was developed without intensive research not only in considering economics but considering also the concerns of the taxpayer. It is the only proposal before you wherein some of the best economic minds of our age (from Harvard, Stanford, Rice, MIT and more) actually considered the practical needs of government and the U.S. citizen. In this, alone, the FairTax rises far above its competitors.

The argument that it is so hard to change the Constitution is fallacious. Only a few years ago we saw how easy it is to change the constitution when Congress decided to raise the voting age to 18. It took less than a year. How much more quickly could Congress get rid of the income tax when 80% of voters want to be rid of it! There's an old Chinese proverb that fits here: "Those who say it can't be done should get out of the way of those who are doing it."

In conclusion, I respectfully ask you to send HR 25 to the floor for a vote. There is a huge grassroots effort extant that supports the FairTax. Americans want 100% of our paychecks to spend, save and invest. We are happy to pay a consumption tax that funds the U.S. government and broadens the tax base while taxing everyone evenly and exempting the poor from taxation.

We are thrilled that the FairTax will tax the criminal, drug and porn elements of our society as well as the illegal immigrant and foreign tourists. We look forward to increasing our savings and investments and buying with pretax dollars.

As retirees living on social security benefits and a government pension, my husband and I will enjoy, along with others, a 24% increase in our income if the FairTax is passed. And we will delight in seeing the prosperity and growth it will bring to our nation.

Ruth Fulton (nickname/penname Sunnye) Tiedemann is a retired a writer, teacher and author who has worked in both the real estate industry and at law as a paralegal. Her accomplishments are in the fields of real estate, law, disabilities and publishing and are not relevant to the subject at hand. Her extensive political advocacy has been in the field of disabilities. Sunnye's husband, Herb Tiedemann, also retired was an initiator of the space photography program with NASA during the Gemini and Apollo programs.

A native Tennessean, Sunnye studied liberal arts and education at the University of Tennessee, real estate and appraising at the University of Maryland, and law at the University of Oklahoma. She and Herb celebrate their 50 th anniversary this year. Sunnye was an at-home mom for their four children until the mid-1970s. They have four children: daughter Teena and husband Dewey with grandson Ted; son Keene and wife Kathy with their six children; son Ted who died of an aneurysm in 1979; and son Allen, who is severely retarded with autistic tendencies and temporal lobe epilepsy.

Thank you again for the opportunity to present my thoughts on tax reform. I will be most grateful if you will send HR 25 to the floor for a vote as soon as possible.

Tewksbury, Massachusetts 01876
June 20, 2005

Dear Chairman Thomas and Committee Members:

In 2000 my husband and I purchased some of my options from Nortel Networks. I had been there for over 8 years so the options were fairly low priced. Our goal was to start acquiring shares to sell at some point to put towards our kids education, we figured if we bought and held for a year we would have 20% more to put down, but not having to pay the short-term capital gains. Logical, until we learned that next April 15th that we owed the government approximately $75,000 for shares that we paid approximately $8000 for.

I left my accountants office is tears. And since my accountant is my Dad, he felt pretty bad about it. We didn't have $75,000 available; we had to take it out of our home equity loan. I was physically sick for a month thinking about it.

It is now 2005 and we finally did get to recuperate some of our AMT tax when we sold some shares in 2003, but it is going to take us 3–4 years to get it all back. So our kids got whacked in the end with us not being able to put as much money into their college savings funds. I am lucky that my husband makes over $100,000 a year and it won't take us 20 years to get back all the money. I can't imagine all of the people out there that don't make a lot of money and just were trying to get ahead and their lives were ruined financially.

Some of the stories of the people who are a member of ReformAMT are heart wrenching. People lost their homes, declared bankruptcy—etc. I am only thankful that I was not one of those people and was fortunate enough to have the financial means to deal with the loss.

Please contact me if you need any more information.

Susan Timmons

Indianapolis, Indiana 46236
June 7, 2005

House Ways and Means Committee
United States House of Representatives
Washington, D.C.

The following can be found on the Internet, by doing a search for "IRS Abuse." On Yahoo it is the third Web Site and is entitled "IRS Abuse Reports prepared for the United States Congress." The following report I typed in, before things became even worse. Notice the date and the number of the report. I just looked today. The number has risen to 645. "TT" are my husband's initials. Our case looks mild here compared to many others. Reading them is true life horror or in the word understood today, "terrorism."

This is terrorism of the home grown kind. It may not come from overseas and is not bred in Madrasa Ciurriculum Schools, but this terrorism is just as effective. I copied and pasted it right from the Website.

IRS Abuse Report #171

Our lives have been ruined by the IRS. We have been accused of not filing income taxes and being govt. protesters. The IRS wants nearly $200,000 and will not tell us why. We did not make even close to what they say we owe. They levied our salaries, put liens on our property and have demanded we pay them over $800/mo. for the rest of our lives, We do not make enough money to do this. I have two choices: suicide or fleeing the country. We have three children so leaving is definitely difficult. There is no point to working anymore. Why is this happening? We have committed no crime, yet the IRS has definitely threatened jail. No one believes us and there is no help. If we had committed murder we would at least have an attorney. Our Congressman has not even helped as he could.

We are considered guilty. We have not had a day in court. The IRS has all our money if we do not pay them all and more of our money. I am angry and want to do something.

House Bill 25 is FairTax Bill. The Bill has many features. I will address only one feature in this letter or I must certainly exceed my allotment of pages. I wish to address why we need to eliminate the I.R.S.

Nothing is this country has the power of the I.R.S. With our court system one is considered innocent, until proven to be guilty. Not so with The Internal Revenue Service.

Our case began because of a vendetta a prior employer and his girlfriend had against me. What did I do to incur such wrath? Rather than go into the sordid details, let's just say I "blew the whistle" on them. They were breaking so many laws, and I refused to do as I was told. The first time, I only refused to lie to his automobile insurance company. You see, he had told me to tell them he was a dead man . . . but all became worse. He was a talk show host, took in money by advertising . . . I put my foot down at the time I learned he was advertising for a candidate for Congress and their deal was to split their proceeds. Not legal. There is so much more; however, it would only be window dressing to tell you more about Stan and Jessica. You are smart enough to get the picture.

It was in July of 1995 when we received our first notice from the IRS. At the time, I was assisting the FBI put Stan's girlfriend back into prison for breaking her Federal probation. I asked the FBI personnel involved if the letter I had looked to be written by the IRS. You see, It would appear in 1995, the IRS might have their own envelopes and letterhead. The typewriter was obviously not electric. It was the opin-

ion of the FBI the letter was bogus. Besides, in the letter, it was stated I had not filed my taxes since 1992. I knew that was wrong.

Then one day I received a call from someone, who stated they were calling from the IRS. We did not have caller ID. The caller sort of framed his request for money as a bribe. I still ignored the call, because I knew I had done everything as the law required . . . until the supposed IRS agent come to our house to peep into the windows. Then one day, I received a letter from Cincinnati IRS Office. The demand for payment was approximately three quarters of a million dollars. Well, drop me dead. That deserved a call back to the name and number on the paper. I spoke to a very nice gentleman and it was soon agreed I would send in all the taxes I was told had never been filed. That was easy to do. I had to find them, but that did not take so long. All seemed settled, fixed, satisfied, until this nice gentleman called me to relay to me, he was no longer handling the case. He could not understand just why, but my case was being moved to Indianapolis.

This is where I lost all perspective. The Indianapolis Office made it impossible to live. Neither my husband nor I were really allowed to earn a living. Huge liens were put on our junky house. I do mean really junky. No plumbing, no air conditioning, the septic was flooding, the roof was leaking, the electric was sparking, black mold was growing everywhere, as the Radon levels rose higher and higher. One evening my son came to me to ask whether I wanted the good news or the bad news first. I told him I wanted to hear the good news first. The good news was we were the owners of two swimming pools. The bad news was the second one was located in the basement. Some pipe broke and water was pouring in like crazy. The one outside did not work.

To help matters, I checked all the books out of the Indianapolis Public Library that had anything to do with the IRS. I learned they could not take your money (we had three children to feed and clothe) if bankruptcy were filed. Temporarily, they were stopped dead in their tracks. I contacted some IRS TAX helpers and they just took all the last money we had and did not one thing.

One day I watched a Montel William's show. A man had been through hell. He was flying his plane and it crashed, leaving him paralyzed and burned beyond recognition. This man fought and finally was able to have his company once again. He was flying in a small plane with his best friend, when that plane also crashed, killing his friend, burning the man even more, and leaving him a quadriplegic and totally blind. Montel had pictures. It might have been Maury Povich, I could be wrong. The point was this man had never given up. That show allowed me to think long and hard. I had all my body parts, could see very well, could walk, and I even looked good. Should I have been a happy person? NO! I would have traded places with that man, because my ability to earn a living had been taken away. I was living in terror. Nightmares containing government agents still haunt me to this day. I am afraid to sleep. The will to live has been taken away, EXCEPT for just one tiny thing: I discovered the idea of the FairTax. I got involved and have been for nearly eight years, I guess.

Congress was holding hearings on the IRS. Did I watch? You bet I did. My congressmen did little. Now we were being audited. We even had to prove our children belonged to us, show grocery bills, proving we even fed them, they asked for a copy of every check we had written for over four years. We had the free checking account, the one you have to pay a dollar for copies of your checks. We did not have four thousand dollars for checks, much less for anything else. By this time I think I lost my mind. My memory is a bit hazy. My husband did not help me with any of this. Meeting with someone from Dan Burton's Office, and Lugar's office, and some other people come to mind. I know I wrote to Senator Moynihan before he passed away. No doubt this great and wonderful man is now in heaven. My only connection to New York is my mother was born there, yet he was the only one who did help me. He got someone's attention. Heck, Lugar, my own Senator, for whom I voted, and ran for president on the promise of ridding this country of the IRS. I was pretty much kicked out of his office. Not by him. He was not there.

So now I was certifiably nuts, depressed and without any effort really, was able to get on Social Security Disability. No lawyer was needed. Something inside of me wants to work. I am not yet dead.I am pretty intelligent, too. I tried it, but the IRS keeps coming and coming, no matter what I do. The Social Security psychiatrist suggested I use my art to develop into a business. I have been trying. One evening as I was preparing to go to a "juried" art show, I was in the bath tub, when my husband called to me. I was naked at the time. A few minutes before my bath, I had called the IRS in New York State. The lady was not nice. She made some pretty ugly threats, enough to make me cry. I did not get a real chance to answer my husband, because into my bedroom, without knocking, walked some Marion County Sheriffs. How many I do not remember. I just remember trying to cover my-

self. Does this come close to Abu Ghraib? The sheriffs stood there and told a story of how someone had called from the IRS to their office from New York, gave our address, and said there was a sick woman with several guns, "hold up" in the bedroom of the home. Sir, Madam, whoever is on your Committee, we do not even own a gun. There was not a gun in the house. I hate guns and am scared of them, yet I am not against some guns and realize, they are necessary evils. I will never forget the humiliation of that evening, not long ago.

Never have I failed to file a tax return. The IRS sends out letters: "We have changed your return." How and why they never say. Try to call to ask a question, a simple one and one will get several different answers. The answers on the tax software is different from the IRS and the tax software people tell you, they don't know the answer. Call the IRS. I had this problem just this year when trying to get an answer to a question I thought was simple. The law was a new law and I imagined someone could answer it. You see, my daughter lives in a state where they have no income tax. The new law allowed one to use the sales tax deduction instead . . . yet there was no table, based upon income to use. No one could tell me the answer, so we just let it pass. Even the IRS does not know how their system works. Now I live in fear of doing taxes.

Well, I suppose I have written enough. I have much more to say and have the documents to support my letter. I had planned to attach them, but all will not work as Word files, because some are IRS forms with lines in them.

Please seriously take a look at the FairTax Bill #25. Provision need be made for owning a home and for charitable giving, but it will be good for the country. All 645 of the people who took the time to write of Internal Revenue Service Abuse will be pleased. I know there are many more citizens and taxpayers who will be pleased . . . more who will sleep better at night. If you on the Committee are able to effect change, you will sleep better, also.

For a moment, please think of what you can do,

Or even dream you can do. Then begin. PLEASE!

Have courage, because courage is a mixture of genius, power and even a bit of magic.

Engage yourselves, heat up those neurons,

and the work will be concluded or resolved in some manner.

Sincerely,

Claudia B. Treacy

Statement of Christopher Trowell, Palm Coast, Florida

The FairTax Act (HR 25 / S25): Clean out America's Economic Arteries.

Forty years and 56,000+ pages of trying to repair the present tax code and we are definitely far worse off than we were 40 years ago. The so-called flat tax is what our grandfathers instituted in 1913 to redistribute wealth. From a 2-page tax code we have put ourselves into a situation that has produced the present unwieldy unfair system we have today.

The single most often used words to describe a sales tax by its critics is that it would be unfair to those least able to afford it. However, if they were to look carefully at the FairTax bill (H.R. 25 and S. 1493 in the Senate) they would see that with the Family Consumption Allowance (FCA) monthly rebate it is actually a progressive tax that distributes the tax burden among individuals in proportion to their ability to pay. I would like to know why you don't put that bit if information from its supporters in your commentary of the proposed sales tax.

The second most important fact about the proposed FairTax is the fact that under the president's plan to privatize Social Security he doesn't tell us that within 30 years the number of retirees will increase by 100% while the number of workers supporting them will only increase by 15% in that time. Under that scenario the Social Security system will only survive by dramatically reducing benefits or increasing income taxes on all Americans. Under an income tax, by whatever name, Social Security will collapse within thirty years.

By repealing the entire income tax code—the AMT, withholding, personal and corporate income tax, capital gains and the gift and estate tax and replacing it with a single rate, revenue neutral 23% national sales tax you achieve simplicity, protect seniors and the poor, and make the system transparent. But most importantly you solve the long-term solvency problem of Social Security.

How? First it will be collected from 300 million Americans and 40 million visitors to our shores. According to Professor Dale Jorgenson of Harvard University's School

of Economics who participated in the four years and $20 million of research that went into the FairTax, revenues to Social Security and Medicare would double as the size of the economy doubles within fifteen years after the installation of the FairTax.

I would further point out that we are actually paying a value added tax under the present system because we pay America's corporation's share of the income tax, the employer payroll tax along and their compliance costs. These taxes are imbedded in everything we buy (a hidden tax that actually hurts the poorest among us the most). The FairTax only taxes products and services at the retail level and does not tax used products such as automobiles. Nor does it tax business-to-business products or services.

According to the National Bureau of Economic Research that participated in the study of the FairTax GDP would increase almost 10.5% in the first year after it goes into effect. Real investments could increase by as much as 76% and the incentive to work would increase by as much as 20%. Further, studies of the FairTax at Boston and Rice Universities suggest that replacing the income tax with the FairTax will bring long-term interest rates down to bond rates reducing interest by as much as 30%. Without the income tax and its associated costs imbedded in products going overseas exports would increase by 26% initially and remain more than 13% above present levels under the income tax. And, imports would carry the same tax burden at retail as our domestic product leveling the playing field.

Think about it, if all of the world's investors could invest in our markets with no tax consequences, we would become the world's "tax haven." Our $6 trillion off shore corporations would come home increasing values in the American market even more. And with the FairTax we would eliminate the complicated depreciation schedules, AMTs, credit and deduction schedules and their associated compliance costs that only confuse investors. In a nation without the income tax (flat or otherwise) only three numbers would have meaning in corporate America: earnings, expenditures and dividends.

All wage earners would keep 100% of their income to spend or save without penalty. They would receive a monthly prebate for sales taxes paid up to the poverty level virtually un-taxing the poorest among us and seniors would keep their entire Social Security checks. The cost of goods and services would be cut by up to 30% without the corporate income tax, employer tax and their compliance costs being imbedded in the pricing system.

And finally, with all of the above factors combined the FairTax would make the long-term solvency problem of Social Security possible while making privatization of the system viable without hurting seniors collecting it now.

Winnetka, Illinois 60093
June 17, 2005

Dear Chairman Thomas and Committee Members,

My name is Ron Vasaturo and I am writing on behalf of the Vasaturo family.

We're writing to ask that you help change the Alternative Minimum Tax (AMT) provisions which have caused a great hardship to our family, unfairly. We ask that you recommend reform to the Alternative Minimum Tax provisions to allow the AMT credit for the Prior Year Minimum Tax to be applied up to 100% of the taxpayer's ordinary income tax. We are middle income taxpayers in our 50's that have a large AMT credit we will take to our grave unless the AMT provisions are revised to allow use of the credit towards ordinary income tax.

In 2001 we had to pay an extremely large alternative minimum tax—$250,000—for money we never received and never will receive. The $250,000 AMT tax was on top of the taxes we paid on our earned income. In 2000, I worked for a high technology company that provided me with incentive stock options each month, in lieu of any annual salary increases. Because my wife and I were in our 50s we decided to exercise the stock options each month and set aside the stock for retirement purposes. The company encouraged this, emphasizing the benefit of long-term capital gains if we held onto the stock. We had no idea that the difference between the exercise price and the market value of the stock at the time of exercise would be considered income for alternative minimum tax purposes. We had never experienced stock options before. We thought we were to pay any taxes owed when we sold the stock, if we realized a gain. Having worked hard our entire lives and saved conservatively for a hoped-for retirement, we have always paid our fair share of taxes as part of what it means to be citizens of this country. So we expected that any real gain from stock options would be appropriately taxed. However, in 2001, when we

prepared our tax return, we learned of our mistake and our whole world turned upside down.

By 2001 the stock had dropped precipitously in value (the tech bubble burst), and, within a few months, my employer went bankrupt and I lost my job. We sold the stock for pennies a share, at a very substantial capital loss. We paid the huge AMT sum we owed in 2001 by liquidating our bank account and retirement mutual funds, funds we held sacrosanct and had never touched before. Understandably, we had spent many years saving towards achieving a retirement that could provide us with at least some dignity in our ability to meet life's future costs (medical expenses, etc.). Because of our ages (now 56 and 57), we are possibly the flip side of what is too commonly, and easily, thought of as the young college graduate who joins the Internet dot-com for fame and quick riches. We simply do not have the earning years left to recoup what the AMT has taken from us as taxes for money that we never received.

As we understand, the AMT we paid because of incentive stock options is supposed to be a pre-paid tax that can be recouped in later years. That is not the way the law is working for us. We don't earn anywhere near enough income to be able to use our AMT credit. (Ironically, President Bush's recent tax cuts exacerbated this situation.) In order to be able to use the credit, one has to have a very high income—otherwise the ordinary tax does not exceed the AMT, and one can't use the credit.

In 2001 and 2002 when we sought assistance and information from the IRS on how incentive stock options, capital losses, and AMT work, we only received incorrect and conflicting information. The IRS staff, and I spoke to several different people at the Service, did not seem to understand how the alternative minimum tax provisions work. When we sought assistance from tax accountants, we discovered the tax accountants did not understand this complex area of the law.

This seems very unfair that we have been victimized so harshly by the unintended consequences of the Alternative Minimum Tax. We ask that the law be revised so that we can fully apply the credit to our ordinary income tax. We are seeking your help in recommending that taxpayers be allowed to apply the AMT credit for the Prior Year Minimum Tax up to 100% of their ordinary income tax.

Thank you very much for the opportunity to provide you these comments and we hope that this Committee hearing will recommend changes to the law that will enable us to fully use our AMT credit so that we can one day pursue a retirement that we have worked so long and hard towards.

Ron Vasaturo

Statement of Alan C Veeck, Jr, Pittsburgh, Pennsylvania

Dear Chairman Thomas and Committee Members:

I strongly urge you to support legislation that would modify or repeal the Alternative Minimum Tax (AMT), especially as it applies to incentive stock options (ISOs). Although unintended, the AMT adjustment for ISOs has had a significantly detrimental, and in some cases, devastating, financial impact on individuals like me who exercised ISOs before the stock market downturn of 2000. Due to a severe depression in stock prices, many taxpayers who exercised ISOs in that year face AMT liabilities that are far larger than the exercised stock was worth in 2001 and beyond.

Affected taxpayers face huge tax bills, some in the hundreds of thousands and millions of dollars, on income that they will never receive. Although taxpayers can use their AMT payments as credits against future income, they will likely never recover the AMT credit because of the way the current law is written. Moreover, collecting credits into the future is hardly a consolation for those facing unbelievable cash crunches due to the magnitude of the tax. This result is vastly inconsistent with Congressional intent in enacting the AMT. Instead of assuring that "the rich pay their fair share of taxes", the AMT on ISOs is literally leaving middle-class Americans like me in, or near, financial ruin.

Here is my story: in April 2000, I exercised 6,000 options that I earned with the company that I helped to build in Pittsburgh—FreeMarkets, Inc. My exercise price was about $5/share, so I had to scrape together $30,000 to exercise these options. My plan was to hold the shares for a minimum of year, but more realistically several years because I truly believed in the long-term success of my company, and in this way I could recognize profits from stock sale as capital gains as opposed to in-

come. I always do my own taxes, so when I fired up TurboTax and input my financials, I was more than a little shocked to find that I owed the IRS $85,000, and state and local taxing authorities about $10,000. ***This amounted to 110% tax on my earnings, when I have realized no actual cash gain!*** In analyzing my available solutions, even if I exercised my next set of options and sold the entire lot (12,000 shares), I would not be able to meet my tax obligation for the 2000 tax year.

Quite obviously, this is an absurd situation. I have always, and will continue to, pay my taxes like every other red-blooded, patriotic American. I fully agree with the concept of paying my "fair share" on realized cash gains. But the AMT is forcing me and my family of five to face real financial ruin. My mother and father pulled significant money from their retirement savings to loan me money to pay the government so that my family did not have to sell its most important possessions. I haven't had to borrow money from my parents since I was sixteen!

Your support for AMT reform is crucial, as this unfair and unintended tax is beginning to affect more and more honest, hard-working taxpayers in the lower and middle income brackets.

Thank you for your consideration of this very important issue.

Statement of Robert E. Wellston, Jr., Acworth, Georgia

Executive Summary—The Fair Tax Plan

- Tax Reform Requirement—Simple without complexity of the current plan.
- Previous attempts at reform of Current System have led to a more complexity.
- Flat Tax is not the answer, the current system started as a flat tax of 1%.
- Value added Tax not the answer already have a 20–25% tax built into Cost of Goods. Economic disadvantage in the world markets.
- Fair Tax taxes consumption, not income:
  - Simplicity of the Fair Tax Plan—no forms to file, no records to keep. Productive time lost due to current tax requirements will be recaptured.
  - Truly a progressive tax—more consumption—higher tax burden.
- Current System Problems:
  - Penalizes Savings and Investments.
  - Tax Avoidance and Reduction drive much of system.
  - Easy to cheat by under-reporting or under table payments.
- Fair Tax drives out compliance costs and market place squeezes out built-in tax burden out as corporate income tax are gone.
- Collects taxes from illegal immigrants as consumption is taxed.
- Under Fair Tax Plan, tax payer receives:
  - 100% of Income in every pay check.
  - Pre-bate of taxes based on poverty level to all tax payers.
- Fair Tax Plan is an idea whose time has come.
- Critics of the Plan usually show ignorance of the plan through wild comments.
- Must repeal the 16th Amendment to make plan work.
- Current System encourages Class warfare—Fair Tax Plan eliminates it.

The Fair Tax Plan

President Bush charged the Tax Reform panel with looking at the current tax code and determine if the system can be reformed or whether a new system is needed. The President's requirement was that any new system be easy to understand, administer and most of all fair. With this and other charges in mind, the Tax Reform Panel heard various proposals. I would like to comment on the Fair Tax Plan also referred to as the National Retail Sales Tax Plan.

I consider myself to be fairly intelligent, but I shudder every time I have to prepare my income tax. With all of the changes that occur every year, it is almost impossible to feel confident about your tax preparation after you complete all of the forms. The hours spent gathering the information and then filling out the forms is the least productive time of the year. Any system that eliminates the need for the taxpayer to file tax forms is less complicated.

The Fair Tax Plan is simpler because an individual does not have to keep useless records or spend endless hours pouring over the Income Tax forms because there are no forms. The tax is collected at the point of sale. An individual's need to file is gone.

Various proposals for reforming the current system were presented. Reform of the current system is doomed to failure because it will only add to its complexity as previous attempts at reforms have clearly demonstrated. Special interest groups will

quickly undo any attempt at reform. The current system is clearly beyond reform a new system is needed.

The Flat Tax is another proposal made to the panel. It is important to remember that our current system started out as a flat tax, a one percent tax on income. The one percent flat tax did not last long. It took less than one hundred years for a simple one percent flat tax to turn into the monster we currently have. Another flat tax would take less time to be screwed up, the special interest groups and the Congress have learned a lot about putting their hands in the Tax Payers' pockets. Somehow the idea that the money belongs to the people that earn it gets lost when people are sent to Washington to take care of the people's business.

Some have called for a Value Added Tax. Reputable economists have stated that the built in tax burden on all goods and services is approximately 20–25%. How much greater tax burden can the American Cost of Good Sold support without putting the United States at a greater economic disadvantage than it already faces in world markets.

There was one tax reform proposal presented to the panel that meets the President's requirement that reform must simplify the current structure. This plan is the Fair Tax Plan (HR 25/S 25). The Fair Tax Plan eliminates a number of problems that the current system produces. It is eminently fair because it taxes consumption and not income. It is truly a progressive tax in that the more an individual or family consumes, the more taxes that individual or family pays. "It is a singular advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit, which cannot be exceeded without defeating the end purposed—that is, an extension of the revenue."—Alexander Hamilton, Federalist No. 21

One of the major problems with the current system is that it penalizes savings and investment. The truth of this statement is demonstrated in the existence of the 401K Plan and its ilk, the IRA Plan, the RRA Plan, Corporate Deferred Income Plans, etc. The one thing that all of these plans have in common is the near term avoidance of tax on savings and investments. Most of the plans seek to defer taxes until such time as the earners taxable income is less and therefore taxed at a lower rate. Even the sacred deductions for mortgage interest, charities, and others are viewed as a way to avoid income tax. Those that cry out that the Fair Tax Plan would eliminate these deductions ignore the fact that if the taxpayers were not paying taxes on income but on expenditures, these deductions and special saving plans would not be needed. They also ignore the fact that as tax rates have fallen, donations to charity have risen. If an individual or family chooses to invest extra income to create personal wealth and boost the economy, there is no tax or disincentive to invest.

If the Fair Tax Plan was enacted the cost of new goods would be reduced significantly as the market place squeezes the cost of the tax burden out of these goods and services. The overall impact on the tax payer would be neutral or slightly positive, assuming that the Fair Tax Plan as implemented would have an approximately 23% tax rate. The economists have also stated that the impact on the American economy would be unbelievable, doubling the size of the economy in approximately five years. Concerns about jobs going overseas would not disappear, as lower skill jobs continued to move to lower skilled labor pools, but the higher skilled job market would boom, as the United States became the Land of Business.

It is easier under the current system to cheat by under-reporting income or by being paid under the table for services. The decision not to report income is an individual choice. Under the Fair Tax Plan, it requires a conspiracy of the buyer and seller to cheat. An audit of the seller's inventory will demonstrate if sales are under reported, the same type of audit that states with sales tax currently perform.

In addition to attracting new business to the United States because of the business friendly climate, the compliance costs associated with the current tax code would be driven out of the Cost of Goods Sold. Many tax payers erroneously think that corporation are paying taxes to the government, and that more revenue can be generated by raising corporate taxes. This is totally untrue. The cost of those taxes are embedded in the Cost of Goods Sold and the taxpayer ultimately pays those taxes. Eliminating Corporate Income Tax is a good thing.

There are several added side benefits of the Fair Tax Plan that are easily overlooked. Illegal immigrants and legal visitors to our shores would have to pay the 23% on retail goods. Currently, the illegal aliens do not pay Income Tax, but they receive benefits from our government. This free ride would be eliminated. The additional tax burden placed on illegal immigrants may discourage many from crossing our borders illegally. Our neighbors to the South would have to find ways to fix their economic problems besides the billions of dollars sent home every year by ille-

gal immigrants to our country. An additional side effect of the Fair Tax Plan is helping to secure our borders.

The Fair Tax Plan would also allow for adequate funding of Social Security. The so-called payroll tax would be eliminated under the Fair tax Plan and Social Security and Medicare would be paid out of the general revenue received from the tax. There would be no more hidden taxes and Members of Congress and Senators would have to vote openly to increase the Fair Tax Rate.

The pre-bate provision of the Fair Tax Plan specifically addresses problems that lower income earners might have with cash flow. It is important to remember that the wage earner now has a chunk of his/her wages withheld, but under the Fair Tax Plan every income earner would receive 100% of his/her wages. The pre-bate provision reimburses all taxpayers the amount of taxes they would pay based on the Federal poverty guidelines. So basically a low-income wage earner would receive 100% of their wages plus the pre-bated taxes the government estimates they would pay for basic necessities of life prior to expenditure. The low wage earners might actually have an opportunity to save some money for a home, or an education, or retirement.

The Fair Tax Plan is an idea whose time has come. Texas and Florida function very well without income tax as does Tennessee and Nevada. It is time to make the government live within the means of the American people. The Fair Tax Plan is about taxation only. It is not political in that neither party wins nor loses with its implementation. If it has some beneficial side effects like solving the funding problems for Social Security, or lowering transfer payments to the poor, or making America a less attractive place for illegal immigrants, who are we to complain.

I believe that if the Tax Reform Commission put its collective ears to the ground they would hear the ground swell of support for the Fair Tax Plan. The people who speak against the Plan usually display their ignorance of the plan through the statements that they make. They usual wild claims include that the plan is another "tax the poor, for the benefit of the rich" plan. Remember the Tax is only levied when an item is purchased new. So if a low-income earner buys a used car without paying the Fair Tax and buys a previously owned home without paying the Fair Tax, how does this plan adversely impacts the low-income earner? It the low-income earner receives his/her whole pay check instead of 75% of it, how does this adversely impact the low-income earner? If the low-income earner receives a transfer payment from the government for the taxes they would pay for the basic necessities of life, how does this adversely impact the low-income earner? The current system with its built-in breaks encourages class warfare; the Fair Tax on consumption eliminates class warfare. The so-called rich, who are in actuality hard working small business owners and others who have made positive choices in their lifetime to work up to a higher standard of living, consume more—more gasoline, more food, more housing, etc., they would pay more taxes. The more you consume, the more you pay. If these "rich" don't consume all of their income, then they are saving and investing, thereby creating job opportunities for others.

One critical element that must be included in any legislation to implement the Fair Tax Plan is an amendment to repeal the Sixteenth Amendment. Without the repeal of the Sixteenth Amendment, the American Tax Payer is open to confiscatory tax rates that will undoubtedly lead to a New American Revolution. A lack of meaningful reform could easily lead to that same revolution. We are getting close to "No Taxation without Representation!" echoing throughout our land once again.

Statement of Michael Wertheim, Oakland, California

I am an average middle class employee. In 2000, I worked for an internet company called Critical Path. I received incentive stock options as part of my compensation. I exercised the stock and have not sold it. No one ever advised me to sell the stock before the end of the calendar year to avoid certain Alternative Minimum Tax problems. By the time my accountant prepared my income tax bill for 2000, the Alternative Minimum Tax on my stock was $64,000. This is despite the fact that the current value of the stock at the time was only $8,000 (and is now worth only $2000). The $64,000 tax bill far exceeded my net worth.

I paid the entire $64,000 tax bill on April 15, 2001 and generated a $64,000 tax credit, by liquidating savings and borrowing money from my family. At this rate, it will take me over 20 years to use up my AMT credit because the tax code allows me to apply only $3000 of my AMT credit towards my income tax each year. Essen-

tially, I have been forced to make a $64,000 20-year loan to the government interest-free.

Some day my wife and I would like to buy a house and send our daughter to college, but both of those plans are on hold until we can regain our financial standing. After my parents loaned me money to pay my tax bill, the rest of the family is feeling the financial pain, too. My parents, who are both in their 60s, no longer feel that they have enough money for their retirement. All these changes—to pay tax on income I never actually received.

Please fix the tax code to better reflect reality. Taxes should not exceed the value of the actual gain or stock being taxed.

Please also make it possible for people in my situation to make quicker use of AMT credit by changing the $3000 per year limit.

Gilbert, Arizona 85234
June 20, 2005

To Honorable Chairman William M. Thomas and House Ways and Means Committee—Tax Reform Hearing

Dear Chairman Thomas and Committee Members

I am writing to ask for your support and would appreciate your taking a moment to read this letter. As many others, I feel compelled to tell you about an issue which has and is devastating many American people. I am speaking, of course, about inequitably taxing individuals via the Alternative Minimum Tax (AMT). The AMT has become a particularly critical issue for many Americans for the past several tax seasons and looks to remain critical for many years to come.

As a working professional for the past 20 years I was fortunate to work for a company that offered ISOs as additional compensation for my hard work. After acquiring much of my stock in contemplation of retirement, I held it so as not to be penalized for selling it in the short term. I then watched helplessly as my dream of retirement vanished. My loss was not the result of the drop in stock price but the inequitable taxes I faced under the AMT.

I lost about 75% of my retirement nest egg because of the unexpected $460,000 AMT bill and a $200,000 margin loan left over from meeting the tax obligation, which accumulated thousands of dollars of interest monthly. After several years of anguish and finally selling additional stocks to pay the margin loan created by the AMT, the end result was a loss of 32,000 of my 36,000 shares of stock, which I had accumulated over the past 20 years. Not only did I lose the 18,000 shares I exercised that particular year, which created the AMT, but I also lost 14,000 shares I had accumulated, owned, and had paid taxes on already for the previous 20 years. When the dust settled I was left with 4,000 shares of stock out of 36,000; I had to use the rest to pay taxes on a gain I never realized.

Some type of reform and return of taxes paid on my imaginary gain are all I can hope for along with a hope that some of my remaining investments will recover, but I now realize I will never be as financially independent as I once was. The damage has been done and I will never be able to recover the investments that I liquidated to pay this tax.

Please do not misunderstand me; I have no problem paying my tax obligation, but I should have paid it on my actual gain when I realized it—not on an imaginary paper gain that never materialized, thereby devastating my financial future.

Because of this outdated law, I, along with many of my co-workers, friends, family, and many Americans, now find myself in this dreadful situation. Many American families are now on the verge of declaring bankruptcy and others are forced to sell assets (including their children's college, savings, cars, refinancing or selling of homes, 401k/IRA pension plans liquidation etc.) to help pay the taxes on monetary gains that they never realized.

Some may argue that this tax payment actually becomes a credit, yet in most instances it is a credit that the taxpayer can never recover. It is doubtful my investments will ever see the growth seen in the 1990's and, therefore, I will never be able to realize any significant returns from my huge credit. In essence, the taxpayer can lose all their investment money, and also other assets, simply to create a tax credit in their IRS account.

This practice of requiring the payment of taxes when stock is purchased is misguided and can lead to dangerous economic consequences. Forcing people into bankruptcy and draining life long retirement savings does not serve the interests of hard working Americans.

Your support is needed, now, to circumvent the damage being caused by the existing law and to help those whose financial future was ruined. We respectfully ask that you further investigate the disastrous consequences of the Alternative Minimum Tax and please support all efforts towards reform and recovery for those who have lost their hope of comfortable futures in their senior years.

Respectfully,

Jeff Wienrich

Statement of Raymond Woodward, Lombard, Illinois

Fair Tax Explanation

The Fair Tax plan (Senate Bill S25/House Bill HR 25) is a plan to eliminate all income and payroll taxes and replace them with a National Retail Sales Tax (NRST) of up to 23% (tax-inclusive).[1] Many people will hear this and think, my God, we are going to have to pay a 23% sales tax on top of what we already pay? NO WAY I'M SUPPORTING THAT! Well this is not exactly true. Here is how it will work:

1. ***The 16th amendment will be repealed,*** and all income and payroll taxes will be eliminated. Employees will take home 100% of their pay. Income from investments, savings accounts, etc will no longer be taxed. Whatever money you earn, you keep. This is equivalent to at least a 8% raise for low income workers to a 25% raise to middle income workers.
2. **All taxes on businesses will be eliminated.** These taxes are not really paid by the businesses but are passed along to the consumer. According to a Harvard University study, approximately 22% of the price of consumer goods is due to taxes. Since the sales tax will be approximately 23%, it's effectively a wash.
3. **The REFUND.** The government would send out a check (or a bank transfer) for the sales tax paid on the basic necessities based on the size of your household. For an example, take a family of four. The basic cost of living, which is already calculated by the government, is approximately $24,100 for a family of four. Assuming a maximum sales tax of 23%, that family would pay $5543 in sales tax for the basic cost of living. To compensate for this, the government will send out a refund of $461.92 every month to every family of four in the country.

Why will this work?

1. The Fair Tax will tax people on consumption. The current system taxes based on productivity. People who are productive are penalized while those who are not productive benefit. This can lead to a decline in production. An addition, the current tax code encourages people to avoid the system (illegal or under-the-table work) or to get special dispensations (exemptions or loopholes). Tax lobbying is a multi-billion dollar a year business.
2. The tax is on the retail level. It doesn't include private party sales and other sales of used items. There will be no taxes on you neighborhood garage sales, used cars, or even used homes.
3. ELIMINATE THE IRS. This benefit is multi-fold. The cost of operating the IRS is huge. In addition to the salaries for the auditors, return examiners, etc, there are also legal fees associated with collecting back taxes, etc. Another benefit is that you won't have to report your life history to the IRS just to get your deductions. It also eliminates loopholes as a lobbying strategy as well as playing politics with taxes and class warfare (e.g. giving tax cuts to rich people or saying that your opponent wants to give tax cuts for rich people). As for collecting taxes, 46 states already collect sales tax at the retail level. The additional taxes could be collected by these state systems with little or no increased costs. The remaining duties of counting the taxes, etc. could be folded into the GAO or kept in a much reduced form.
4. There is currently a $1-$1.5 trillion per year underground economy. This economy currently pays no taxes. However the people who make this money still go out and spend it. The Fair Tax would bring in more than $300 billion per year (30% of 1 trillion since this money is tax-exclusive) in additional revenue from the underground economy alone.

[1] Tax-inclusive—The National Retail Sales Tax rate would actually be 30%, tax-exclusive. However, for comparison purposes, a tax-inclusive rate of 23% is used. Here is why:

5. Up to 18% of our economy is spent on complying with the current tax code. By eliminating the tax code, the economy would save $4 trillion over the next 10 years.

Progressivity

Many people say that a 23% tax rate is not progressive because 1) poor people currently pay no taxes and 2) poor people have to spend a much larger percentage of their income on cost of living expenses. Those who think that poor people pay no taxes are kidding themselves. Businesses pass along taxes in the form of higher prices, and any time someone buys an item they are paying taxes. This includes those who can afford it the least, the poor. By eliminating these embedded taxes and giving a rebate on taxes paid up to the cost, poor people will truly pay no taxes under the FairTax plan. This applies to those who qualify for the earned income tax credit as well as those on social security who pay no taxes. Any family of 4 that makes less than $24,000 not only will pay no taxes, the prices they are paying for items will be 22% less. A family making $50,000 will only pay taxes on 50% of their income. A family making $100,000 will pay taxes on 75% of their income. That is progressivity.

So what does this mean for poor and middle class people?

Take that family of four that makes $24,000 a year. Under the current system, they are bringing home approximately $1800 per month ($2000 per month minus social security, medicare, and FICA which adds up to about 10%). Although money may be taken out for income tax, they will receive a refund, so that money is not included in the calculations. Under the Fair Tax system, they would take home $2000 per month. In addition, they will receive a monthly check for $462 a month. So their monthly income is now $2462. The price of goods will be about the same, so they have more spendable income.

What about someone making less like that elderly couple on social security? People on social security pay no taxes, you say, so how will they benefit? While it's true they don't pay any income tax, they do pay the embedded 22% taxes in goods and services they purchase. Eliminating these will offset the sales tax. In addition, they also get the refund, which should basically refund all of the money they spend on sales tax. So under the Fair Tax system, they are actually BETTER OFF than under the current system.

Summary—How it would affect families of three at different economic levels?

A. $25,000/year income—Under the current system a family of 4 making $25,000 per year not only pays no income taxes, but receives a small rebate due to the earned income tax credit (EIC). However, they spend all of their income on the basic necessities and have about 8% of their income taken out in payroll taxes. The FairTax leads to a 22% increase in spendable income.

	Current System	FairTax
Income	$25,000	$25,000
Income Taxes	—$0	—$0
Payroll Taxes	—$1,912	—$0
Embedded Taxes	—$5,471	—$0
Sales Tax	—$0	—$5,750
Rebate	$1,780 (EIC)	$5,727
Spendable Income	$19,397	$24,977

B. 50,000/year income—Under the current system a married family of four making $50,000 per year pays a small amount in income taxes in addition to payroll taxes. The FairTax calculation assumes that they spend all of their income rather than saving any, which would reduce their sales tax reduction. The FairTax leads to a 21% increase in taxable income.

	Current System	FairTax
Income	$50,000	$50,000
Income Taxes	—$1,350	—$0
Payroll Taxes	—$3,825	—$0

	Current System	FairTax
Embedded Taxes	—$9,861	—$0
Sales Tax	—$0	—$11,500
Rebate	$0	$5,727
Spendable Income	$34,964	$44,227

C. 100,000/year income—Under the current system a married family of four making $100,000 per year pays a significant amount in income taxes in addition to payroll taxes, even factoring in deductions. The FairTax calculation assumes that they spend all of their income rather than saving any, which would reduce their sales tax reduction. The FairTax leads to a 24% increase in spendable income.

	Current System	FairTax
Income	$100,000	$100,000
Income Taxes	—$10,630	—$0
Payroll Taxes	—$7,030	—$0
Embedded Taxes	—$19,507	—$0
Sales Tax	—$0	—$23,000
Rebate	$0	$5,727
Spendable Income	$62,833	$82,727

What does that mean for the economy?

Because businesses will no longer have to pay an overwhelming tax burden, the implications of this plan on the economy are overwhelming. The prices of American made goods are going to drop by approximately 22%, making them more competitive in the overseas markets. Studies estimate that exports will increase approximately 26% in the first year alone. An increase in the sales of American-made goods will mean an increase in jobs. That doesn't count the increase in sales of U.S.-made goods here in the U.S. In addition, foreign countries will want to take advantage to the tax shelter provided by the U.S. and will bring their businesses here. This will further increase the jobs available. The U.S. would be the fastest growing economy in the world.

In addition, the FairTax would encourage saving and investing. Saving and investing would further drive economic growth. Our current tax code actually discourages investing, at least from domestic investors. Foreign investors, who are not subject to our tax code system, are able to accept lower rates of return because none of their returns are being eaten up by taxes. This gives foreign investors a much greater advantage in the U.S. economy, one that might be dangerous in these politically unstable times.

Why is the Fair Tax better than alternative plans such as the Flat Tax?

1. The Fair Tax plan places the tax burden on those who spend money. Since those who have more money tend to spend more money, it will tax people who have money more than it will those who don't.
2. In addition, both the economy and individual situations tend to be cyclical. People tend to spend more when they are in a good financial situation than when they are in a bad financial situation. The Fair Tax plan would distribute the tax burden more heavily onto those in a good financial situation while reducing the burden on those in a bad financial situation. The Flat Tax taxes you equally under both situations.
3. The Fair Tax plan doesn't penalize you for saving money and investing. Only for spending.
4. It is simpler to tax everything and then give a refund than to exempt certain necessities (food, clothing, etc). For example, if you exempt food, what about candy bars? Should they be considered food? If a wealthy individual goes out and spends $3000 for food for a party, should they not pay taxes on that food? The same thing goes for clothing. Does that $3,000 Armani suit get an exemption? Where do you draw the line? The refund eliminates these loopholes.

5. The Fair Tax is better than a Flat Tax for several reasons. First of all, the current tax system started out as a Flat Tax. Second, the Flat Tax still requires an IRS. Third, the Flat Tax still penalizes productivity and is easier to avoid by paying under the table. You still have to file an income tax return, so there is still the cost of compliance. The Flat Tax still penalizes businesses in this country, making it more difficult for them to compete against overseas companies and encouraging outsourcing.
6. The Fair Tax frees up money for companies to expand, hire more people, give better benefits, etc. In fact, with the economic growth predicted if the Fair Tax is passed, so many jobs would be created that the unemployment rate would shrink to next to nothing.
7. The tax revenues from the Fair Tax increase as the economy grows.
8. Tax increases are less likely to occur. The current tax code has many hidden taxes (such as taxes on businesses) which are passed on to the consumer but which you don't see. With the Fair Tax, the tax is in the open, and politicians are less likely to raise it due to fear of public outcry.

Why the Fair Tax is going to be difficult to pass

1. The current tax code has major advantages to those in Washington.
    a. There is a multi-billion dollar industry that is designed around lobbying for exemptions and loopholes for different products and industries. This industry is located in Washington DC and has the ears of the politicians.
    b. Politicians use the current tax system to get elected and maintain their careers (e.g. tax cuts for the rich; two Americas). They tend to put what's best for them ahead of what is best for their constituents.
2. Politicians are resistant to change. They don't like to rock the boat. Just look at Social Security reform.

THE FAIR TAX PLAN IS PICKING UP SUPPORT IN WASHINGTON, BUT IT WILL TAKE MUCH MORE TO GET IT PASSED. IT WILL REQUIRE A LOT OF PRESSURE FROM THE AMERICAN PEOPLE ON THEIR SENATORS AND REPRESENTATIVES IN ORDER TO MAKE THEM UNDERSTAND THAT THIS LEGISLATION IS IMPORTANT TO YOU. LOBBYISTS ARE ALREADY AT WORK TRYING TO SHUT THE FAIR TAX MOVEMENT DOWN, AND THEY HAVE THE EARS OF THE POLITICIANS. IF THE FAIR TAX IS TO BECOME REALITY, THE MEMBERS OF CONGRESS MUST BE MADE TO UNDERSTAND THAT THEY NEED TO PASS THIS LEGISLATION. WRITE YOUR CONGRESSMEN TODAY!

If you purchase an item for $100 and of that total $23 goes to the government while $77 is retained by the retailer, the tax rate is 23% tax inclusive. If you purchase an item which costs $77, a 30% sales tax would increase the item by $23, bringing the total to $100. The first example is the tax-inclusive rate while the second rate is tax-exclusive. Because embedded taxes and income taxes are calculated tax-inclusive, we use the tax inclusive rate for the income tax rate for proper comparison.

Sources:

Americans for Fair Tax—http://www.fairtax.org/
Citizens for an Alternative Tax System (CATS)—http://www.cats.org/index1.php4
Presentations to the President's Advisory Panel on Federal Tax Reform March 16, 2005 (particularly presentations by Brian Westbury and Katherine Kennedy) http://www.taxreformpanel.gov/meetings/meeting-03162005.shtml

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Elmsford, New York 10523
June 4, 2005

An extremely important and delicate relationship exists between the citizens of this great country and its Federal Government. Putting it lightly, this relationship is very much aggravated by our current income tax system. Why must we have a tax system that causes so much friction? It need not be like this. As Mr. Goldberg so clearly stated, *"What I find so discouraging is the gulf between what can be done and what's being done. It's not as though we are lacking for ways to simplify the system . . . there is no end to the good ideas; what's lacking is their enactment into law"*[1].

[1] TAX CODE SIMPLIFICATION—FRED T. GOLDBERG, JR. 15 June 2004, Congressional Testimony by Federal Document (c) 2004 FDCH / eMedia, Inc. All Rights Reserved.

We have created an environment that punishes hard work, savings, capital investment, and the entrepreneurial spirit. A tax system that has sliced and diced our country into a myriad of categories, groups, industries, races, classes, non-profit/profit, all clamoring and pleading with Washington for "breaks", causing the very foundation of America to twist and bend with those who best promote their cause. The end result causing friction, lack of confidence, confusion, frustration, anger, in a nutshell, class warfare between all Americans.

We spend over $200 billion dollars and 6 billion hours in complying with over 42,000 pages of code. At the end of it all it is estimated that some $300—$500 billion dollars escapes taxation and no tax preparer arrives at the same conclusion given a set of circumstances. Knowbody knows what the heck is going on!

The Whole System is Unfair because it doesn't treat everybody equally. It has strayed from what should be the original intent of any taxing system, the Collection of Taxes. It has been warped into a tool for social change, (this is like trying to clean a window with a bulldozer), causing the environment which I have described above.

The following must be recognized:

- The sole guiding principal is Collection with Simplicity and Fairness as the characteristics.
- Administered equally to all with one rate and with no exclusions. Note that I am a home owner and I donate to many causes
- Any re-distribution of wealth should be in the form of specific targeted accountable programs. Of course we need to help those who are less fortunate, however, do not do it in the tax system.
- Only consumers pays taxes.
- Don't be too overly concerned with transitioning. Though we don't like having to do it, we have become quite resourceful and adept at doing it. How? With every modification that occurs with the current income tax code and there have been over 14,000 changes since 1986.

I am of the belief that we pull the income tax out by its roots so it will never grow back. *I implore you to support the FairTax, H.R. 25 & S.25.*

Realize, that we find ourselves in a wonderful moment in time where we have a leader in President Bush who recognizes that America has problems and is willing to confront those problems. I believe our income tax system is one of the largest and most pervasive problems that we face today and it isn't worthy of our United States of America.

Thank you.

Most Respectfully,

Adam S. Yomtov

PS. Pregnancy is complicated. Paying our Federal taxes need not be!

Statement of The Honorable Fred T. Goldberg, Jr. Commissioner, Internal Revenue Service, 1989–1992

Subcommittee on Oversight/Committee on House Ways and Means June 15, 2004

Statement of Heather and John Youskauskas, Eldersburg, Maryland

Dear Chairman Thomas and Committee Members: My name is Heather Youskauskas and I am writing on behalf of my family, John, William and Robin. We appreciate the opportunity to discuss the hardships we have suffered due to the challenges that have been set forth by the Alternative Minimum Tax Laws. We hope that our situation can assist with putting into place changes that will allow for more reasonable tax guidelines as opposed to such restrictions that have been causing financial turmoil for so many Americans.

I am attaching the original letter that we wrote when we first experienced our AMT issue and although the language is fairly bitter, I felt it needed to be included as we truly feel that this has come to harm so many taxpayers. It was a plea for help because our situation, while unique, is so similar to many other Americans and we felt helpless. My only hope is that you will read it with compassion and be open-minded as there are thousands of stories that are more heart wrenching than ours.

We have since reconciled our tax debt, but still are waiting on tax credits that will come to us in small portions over the next several years. Please help us implement a new tax law that does not create a phantom tax on unrealized gain. No one should have to pay tax for something that is not tangible, but rather looks good on paper. We beg of you and your committee members to take a look at how this would

affect you if you were faced with the same situation. Only then will change be possible.

Respectfully,

Heather L. Youskauskas

To Whom It May Concern:

The spirit of Naziism, Socialism, and Communism has found a protective incubator in the IRS. In other words, the IRS has become a police state, an entity so independent that it rules, as does no other area of our government, with utter disregard, indifference and hostility toward the populace. It is astounding that those words, thoughts, and feelings of contempt would be vocalized by me. The issue of injustice concerns a young couple in their early 30's, Heather and John, parents of a 10 year old boy and a one-month-old baby girl. They are Middle Americans, both hard working. Heather's company went public one year ago in July and was the largest IPO to hit Wall Street raising capital in excess of $400 million. On the day she was hired with the company, she was given Incentive Stock Options (ISO's), which was the norm at that time warranting lower salaries and possibly attracting more experienced employees. At the time of the gift, the value of the stock was $1.15 a share. They were told that the stock could not be sold, traded, disposed of in any lucrative way for six months (with additional lockup periods each quarter due to her being considered an "insider.") she was forced to sign a Lockup Agreement. Then, during this period of no-sale, two things happened. The value of the stock went from $114 to $25, and another tax year was entered. Also, even though they were prohibited from selling, the IRS valued the stock as though it was income, which it was not and subsequently levied the tax along with penalties and interest, as they could not afford to pay.

She was not allowed to cash in this "gift", and so received nothing from it. However, on paper, the stock was highly valued, as were so many of those high-tech companies. Consequently, the IRS, seeing dollars on paper, declared that Heather and John owed approximately $83,000 in taxes (due to the Alternative Minimum Tax Laws or AMT); however, after interest and penalties over a six month period, they now owe $96,000 and have been forced to hire a tax attorney to assist them in dealing with the IRS. Shocking, as their net worth or income nowhere approach this number and have greatly decreased due to the downward market trends.

I do understand tax levied on real income. I do not understand how tax can be levied on phantom income from anyone whether white collar, blue collar or destitute. Not only have they not received a penny from the stock, but real money will be paid to satisfy this levied burden—monies which have already been taxed once because that is how the IRS tax laws are written. In addition, they will literally be loaning the IRS money interest free, but will have to take approximately 28 years to get it back through tax credits as you may only claim a certain amount each year. Thus, shattering any hopes of putting money away for their children's education, not to mention possibly being forced to file for bankruptcy to alleviate paying other debts in order to pay the tax bill. Is this really what the "Land of the Free" is all about? Please tell me that I have misunderstood and there is some way to rescue them??

The young folks tried explaining their situation to the IRS officials. The "kinder" IRS folks retaliated by telling them to sell their home of two years, their cars, turn over their savings account and all their monies in their IRA's. The "kinder" IRS was indifferent to the fact that the couple never received any distribution from the stock. The "kinder" IRS was indifferent that the young mother was placed on disability because of pregnancy complications and then subsequently laid off from the company, whose stock has now plummeted to $.70 a share. The "kinder" IRS was indifferent to the mother's concern over the baby's heart murmur and breathing problems. The "kinder" IRS told her to find a job soon so that she could begin to pay these taxes. Obviously the "kinder"IRS honors money ahead of motherhood and family values. The "kinder" IRS would not take into consideration that it would cost more than $700 per month for child care for the baby, and that this amount would not cover any before and after school care for the 10 year old son if she went back to work. The "kinder" IRS would not listen to the mother's physical needs, which are recovering from the Caesarian section, leaving her a bladder with no sensation. The "kinder" IRS does not understand kindness. The "kinder" IRS is unable to quantify a situation. The "kinder" IRS can only see numbers on a paper and is indifferent to the honest situation surrounding those numbers. As I said in the beginning, the "kinder" IRS is its own Gestapo State.

This problem is perceived by U.S. Congress as being inappropriate, but measures to correct it in the House were defeated by reasons unknown. However, my understanding is that while these measures were defeated, Government respectfully asked that the IRS not go after victims of this nature. Maybe this is the government's way of taxing the rich and protecting the lower and middle-income citizens; however, this type of situation has hurt many middle Americans and will continue to do so unless something is changed and fast. Taxpayers should not be forced to pay tax on income that never materializes in order for the IRS to protect their interests up front from any massive overall gain. How the Government can standby and watch this happen to so many, I will never understand. Especially in a time when things are so tough financially.

In closing, I would like to say that I have always loved the simple fact that I am an American. Nothing filled me with more pride that being from a country that fought so hard for its freedom and protecting its own other than watching my children smile and reach for their dreams. Living the "American Dream" is all I ever wanted. However, it has been a long cold year and I fear that my pride is turning to hate and utter contempt for my country for the simple fact that we can run to protect so many other countries, forgive foreign debts beyond comprehension, and pardon those who honestly do not deserve it, but when given the chance to truly help our own, we refuse or reply, "I'm sorry, but that is just the way it is." Please tell me that this is not the way it is and that we can rest knowing that this will be taken care of because it is truly not right? Please tell me that I do not have to explain to my children why we could not put away money for their education and other things and pray they do not develop mere hate and contempt as well, but rejoice and give thanks that we live in a land where people are truly merciful??

Bitterly,

John & Heather Youskauskas

March 17, 2005

In continuation of this letter written in 2002, we have been through many trials and tribulations in order to free ourselves of this battle with the "phantom" AMT and finally have been successful. While it took the assistance of a seasoned tax attorney, and of course money, nothing can compare to being relieved of this issue. We originally owed the IRS in excess of $120,000 after all of the penalties and interest had accrued and with the help of our attorney we realized that we should not have owed the tax to begin with as our situation was unique based on the IRS laws and regulations. We wonder how many others have suffered as we have for over 2–3 years trying to bring resolution to their cases and been unsuccessful. We still await our tax credits and only in increments of $3,000 each year, but we guess that is a small price to pay compared to what we were originally told that we owed.

Please don't misunderstand, we may have solved our issue; however, we strongly feel that the way tax laws are currently written that many people have suffered and will continue to suffer unjustly until the AMT is reformed to bring balance to American taxpayers. No one should be forced to pay taxes on phantom money or money that may never be realized. This is nothing but a benefit to the IRS in collecting money up front when possible losses are at stake. Not to mention, the corporations have no liability in these matters when they reward employees with stock options and refuse to educate them as well.

Thank you for the opportunity to share our story. We look forward to the "new" reformed AMT.