INTERACTION OF TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

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INTERACTION OF TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

WEDNESDAY, FEBRUARY 8, 2012

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

The committee met, pursuant to call, at 9:05 a.m., in Room 1100, Longworth House Office Building, the Honorable Dave Camp [chairman of the committee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

Congressman Camp Announces Hearing on Interaction of Tax and Financial Accounting on Tax Reform

Wednesday, February 8, 2012

Congressman Dave Camp (R–MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold the first of two hearings on how accounting rules affect how businesses evaluate tax policy. This hearing will focus on the interaction of tax policy and financial accounting rules (such as Generally Accepted Accounting Principles, or "GAAP"), and how this interaction affects how publicly-traded companies respond to tax policy. The second hearing will focus on the special challenges faced by small and closely-held businesses that are less concerned with GAAP but must confront tremendous complexity in dealing with tax accounting and related rules such as choice of entity. **The hearing will take place on Wednesday, February 8, 2012, in Room 1100 of the Longworth House Office Building, beginning at 9:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. 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. A list of invited witnesses will follow.

BACKGROUND:

Publicly-traded companies and other businesses that rely on outside investors must prepare financial statements (e.g., balance sheets and income statements) in conformity with GAAP. The impact of federal tax liability on certain key GAAP calculations, however, can diverge significantly from a company's actual cash tax liability. For instance, full expensing of capital investments can improve a company's cash flow in the short term, but it does not improve a company's earnings per share ("EPS") as calculated under GAAP. Thus, comparing a rate cut with expensing requires consideration of the impact of financial accounting considerations on business investment decisions.

More generally, tax policymakers might create unintended consequences when they enact tax policies without considering how such policies will affect financial statements. For instance, tax provisions might not work as intended if the GAAP treatment of such provisions diverges sharply from the effect on cash flows. Conversely, when policymakers structure tax policy around financial statement effects, they run the risk of adding complexity to the Tax Code in order to try to conform tax laws with financial reporting rules that were created without tax considerations in mind.

In any case, the large and growing number of enacted and proposed temporary business tax incentives and other provisions creates planning and economic uncertainty for public and private companies alike, and diminishes the intended policy objectives of these provisions. As a result, companies across the business community have identified the need to bring stability to our tax laws as a key tax reform objective.

In announcing this hearing, Chairman Camp said, **"As the Committee evaluates tax reform options intended both to make the United States a more attractive place to locate activity and to simplify tax compliance for business taxpayers, it is important to understand how financial accounting rules influence behavior. Tax policy does not exist in isolation, and the Committee needs to understand the interaction between tax policy and accounting rules so that we make informed decisions about which policy choices will help employers grow and create jobs."**

FOCUS OF THE HEARING:

The hearing will consider how public companies evaluate tax policy options in light of financial accounting considerations. It will examine whether tax legislation works as intended when Congress fails to account for the effects of financial accounting on corporate behavior.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments 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 "Hearings." 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, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, February 22, 2012**. 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) 225–3625 or (202) 225–2610.

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 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.

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.

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

Chairman CAMP. Good morning.

Today we are continuing our series of hearings on comprehensive tax reform. This morning's hearing will focus on the interaction of tax policy and financial accounting rules such as generally accepted accounting principles, or GAAP, and we will examine how this interaction affects the way in which publicly traded companies respond to tax policy.

A later hearing will look at the special challenges faced by small and closely held businesses that might be less concerned with GAAP but must confront tremendous complexity in dealing with tax accounting and related rules such as choice of entity.

During today's hearing, though, we will consider how public companies evaluate tax policy options in light of financial accounting or book considerations and, as such, will examine whether tax legislation works as intended when Congress does not consider the effects of financial accounting.

When companies report profits in financial statements the primary purpose is to convey information about a company's financial condition to investors and creditors. Conversely, the primary purpose of tax accounting is to measure income for levying the Federal income tax. These two functions are not necessarily consistent and in some cases may even be at odds. For publicly traded companies focused on earnings per share in addition to cash flows, changes in tax policy might not produce intended results if the effective tax policy on earnings per share is not well understood.

As a recent Tax Notes article suggests, when presented with an option between targeted tax benefits and lower corporate rate, many publicly traded companies might prefer a lower corporate rate over those tax benefits because of the book treatment. Similarly, tax provisions that provide cash benefits might not have their desired effect on behavior due to a less favorable book treatment.

A variety of factors can affect publicly traded companies in their decision making processes differently. For instance, the high U.S. corporate rate is an important factor for companies that use either GAAP or international accounting standards. If the rate is too high, companies will, all other factors being equal, allocate capital to a location that provides more favorable tax treatment.

Today, the current top Federal corporate income tax rate in the United States is 35 percent and the average combined Federal-State corporate income tax rate is 39.1 percent, second only to Japan's 39.5 percent rate. However, in fewer than 60 days, effective April 1, 2012, Japan will lower its combined corporate rate to 38 percent. That will leave the United States with the highest corporate tax rate in the entire industrialized world. This dubious distinction will make it that much more challenging to attract businesses to hire and invest here at home where we need jobs.

However, not all employers have the same tax profile. The impact of Federal tax policy on certain key book calculations can diverge significantly from the impact of the same policy on a company's cash tax liability. We need to understand better how public companies respond to tax policy when such divergences occur. If the goal is, as I believe, to transform the code and create a climate ripe for hiring and investment, then we must solicit input and insight from the very job creators who will do the hiring and investing.

Properly designing tax reform requires an understanding of the financial accounting rules and how those rules might influence the investment decisions of public companies. I am pleased to have some of those businesses here today, along with members of the academic community, who have done extensive research on how financial accounting affects corporate behavior, and I look forward to hearing from them all.

Chairman CAMP. With that, I will yield to the ranking member for purposes of an opening statement.

Mr. LEVIN. Thank you very much, and welcome.

When this hearing was scheduled on the interaction of tax and financial accounting on tax reform I thought I would take out my accounting book from law school. Fortunately, I could not find it. I remember so well the course taught by a brilliant teacher, and it convinced me I never wanted to be an accountant. That was I think the main lesson I learned from his brilliance.

It is useful to have this hearing to discuss these various techniques, important as they are, and their impact on tax reform. I do think we need to continue to talk about tax reform and always to keep our eye on the ball, and that is what are the purposes of tax reform and what would be the impact on what our needs are. And this is why I think it is so essential that we not jump to conclusions or essentially embrace I think rather simplified alternatives.

As we know, we asked Joint Tax to take a look at the code and to determine if the rate were lowered to a certain level what would be the impact. And they came back with the conclusion that even if we eliminated all of the specific provisions it would not bring the rate down to 25 percent; and I think the challenge is now intensified, because at long last we are beginning to understand fully the importance of manufacturing in the American economy. I think we somewhat lost that understanding.

And now I think with the return of the auto industry, with the help of the Federal Government, not to run the companies but to get all of them back on their feet, I think it has helped to highlight how as we proceed as we must, talking about tax reform, we keep our eyes on the ball. And here I want to quote what the President said just a few weeks ago:

“If you are an American manufacturer”—and this was part of his plea that we continue to help American manufacturing get fully back on its feet. “If you are an American manufacturer, you should get a bigger tax cut. If you are a higher tech manufacturer, we should double the tax deduction you get for making your products here. And if you want to relocate in a community that was hard hit when a factory left town, you should get help financing a new plant, equipment, or training for new workers.”

The chairman and I—that is the end of the quote—for years have tried to expand, to strengthen the R&D tax credit; and here we are many, many months into this new session, a year plus a month now, and the R&D tax credit seems to be in jeopardy.

So I think we very much welcome the testimony. I think at first some of us were somewhat perplexed whether we would ever understand what you are talking about. We will try.

I yield back.

Chairman CAMP. Thank you.

We are pleased to welcome our panel of experts, all of whom bring a wealth of experience, either from academia or the private sector; and I believe that their experience and insight will be helpful as we focus on the interaction of tax policy and financial accounting rules.

First, I would like to welcome and introduce Michael Fryt, the Corporate Vice President for Tax for the FedEx Corporation. Mr. Fryt has spent the last 30 years as a tax attorney for different corporations and comes to us today from FedEx's headquarters in Memphis, Tennessee.

Second, we will hear from Mark Schichtel, the Senior Vice President and Chief Tax Officer for Time Warner Cable. He is responsible for all areas of tax at Time Warner Cable, including policy planning, financial reporting, and compliance.

Third, we welcome Michelle Hanlon, an Associate Professor of Accounting at the Massachusetts Institute of Technology Sloan School of Management. Ms. Hanlon's research focuses on the intersection of taxation and financial accounting.

Fourth, we will hear from Tom Neubig, the National Director of Quantitative Economics and Statistics for Ernst & Young, LLP, and the former Director and Chief Economist for the Treasury's Office of Tax Analysis. Mr. Neubig leads a group of 24 quantitative analysts who assist clients with tax and economic policy issues.

And, finally, we welcome Mr. Timothy Heenan, the Vice President for Treasury and Tax at Praxair, Inc. Praxair is the largest provider of industrial gases in North and South America. Mr. Heenan joined Praxair in 2004 from Ernst & Young where he last served as a senior manager specializing in the development and implementation of international tax strategies.

Thank you all very much for your time today. The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks followed by questions.

So, Mr. Fryt, we will begin with you. You are recognized for 5 minutes.

STATEMENT OF MICHAEL D. FRYT, CORPORATE VICE PRESIDENT, TAX, FEDEX CORPORATION

Mr. FRYT. Thank you.

Good morning, Chairman Camp, Ranking Member Levin, Members of the Committee. I very much appreciate this opportunity to appear before you today to discuss the importance of tax reform to FedEx. We believe that reducing the U.S. corporate tax rate significantly to be more in line with the rest of the developed world is essential to overall economic and job growth and will help our company continue to invest in critical infrastructure to compete and grow.

Before I delve into the details of how we analyze tax reform, I would like to make a couple of points about FedEx and our business and our tax profile.

With respect to our business, through our global expedited transportation network we connect more than 90 percent of the world's GDP in 48 hours or less. So if a business of any size wants to send its product from Beijing to Billings or Cleveland to Cologne, we can do that for them without them having to invest billions of dollars to build their own distribution networks. Our business is based on this global network. If our global network is competitive, it will grow, so will we, both around the world and in the United States.

With respect to our tax profile, we are a full-rate taxpayer. Our effective tax rate has not been below 35 percent in more than 20 years. This is a real competitive disadvantage for us.

We are also troubled by other aspects of the current corporate Tax Code. It creates distortions in economic decision making, it diverts capital from its most efficient and effective use, and it leads to lower wages in employment.

Like many of you in Congress, our company has also been evaluating, and even modeling, some of the tax reform proposals. We look at these from the perspective of both what is good for our country and what is good for our company.

Overall, we believe the ideal corporate tax system would include a materially lower tax rate, something at least close to the average OECD rate, along with capital investment incentives, such as 100 percent expensing.

We have also said, however, that if tax reform must be revenue neutral so be it. We are willing to put all base-broadeners, including expensing or accelerated depreciation, on the table in exchange for a materially lower tax rate. Doing so, however, would come with a cost, both macroeconomically and to our company.

Strong capital cost incentives, like expensing, generate new investment and new productive assets in the United States; and, as reflected in the chart—this chart that I attached to my written testimony—there is an almost perfect correlation between new investment and jobs in this country.

From our company's perspective, we would generally expect a lower tax rate to increase our cash flow, bottom line earnings, and earnings per share. To the contrary, reducing capital incentives would have a generally greater adverse effect on our cash flow. This is important because, as is often said, cash is the lifeblood of any business.

Our investors pay close attention to our cash flow, as well as to our bottom line earnings and earnings per share, and they routinely quiz our CEO and CFO about all three. One of our biggest cash outflows that gets a lot of attention is capital expenditures, $4.2 billion in our current year, for example, up from $3.4 billion last year.

So while there are other factors, assuming business tax reform must be revenue neutral, the most critical analysis from my company's perspective is a comparison of the cash flow detriment from slowing capital cost recovery versus the earnings and cash flow benefits of a lower tax rate. If a tax reform package cannot get us to a materially lower tax rate, it will not address our competitiveness issues, particularly if capital cost incentives are reduced as part of the deal.

One other thing that needs to be considered in the mix of tax reform is simplification. This is difficult, if not impossible, to measure, but its value should not be underestimated.

In closing, we commend the recent tax reform discussion draft released by you Chairman Camp. We think it is an excellent starting point, and we urge that you continue your efforts to lower the corporate tax rate to be consistent with the OECD average and to simplify. We need to get back to the basics, where businesses compete on the basis of the merits of their products and services, not on the basis of what the Tax Code says.

Thank you.

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

[The prepared statement of Mr. Fryt follows:]

Testimony of Michael D. Fryt

Corporate Vice President, Tax

FedEx Corporation

Chairman Camp, Ranking Member Levin and members of the Committee, I very much appreciate the opportunity to appear before you today to discuss FedEx and the importance of fundamental tax reform to FedEx. We believe that reducing the U.S. corporate tax rate significantly to be more in line with the rest of the developed world is essential to overall economic and job growth and will help our company continue to invest in critical infrastructure to compete and grow.

FedEx Corporation is a Fortune 100 company headquartered in Memphis, TN. We provide a broad portfolio of transportation, e-commerce and business services under the respected FedEx brand. Consistently ranked among the world's most admired and trusted employers, FedEx inspires its more than 290,000 team members to remain "absolutely, positively" focused on safety, the highest ethical and professional standards, and the needs of our customers and communities.

Before delving into the details of how we analyze tax reform, it is important I describe a couple of fundamental aspects of our business and our tax profile. First, with respect to our business, we own and operate a global expedited transportation network, which is a huge part of the value proposition we provide to our customers. We connect more than 90% of the world's GDP in 48 hours or less. So, if a business of any size – small, medium, or large -- wants to move its product from Beijing to Billings, or Cleveland to Cologne, or Manila to Mexico City, we can do that for them, without them having to invest the many billions of dollars in capital that would otherwise be required to build their own distribution networks. And given that 95% of the world's population, and 75% of its purchasing power, is today outside the U.S., it goes without saying that global markets are a critical component of the future growth and success of U.S. businesses and, I daresay, the United States itself.

More to the point, our business, and value proposition to our customers, is based on our *global* network. If our global network is competitive and grows, we grow, both around the world, and in the United States. If it does not grow, or has too many holes, we will not be competitive and will not grow – or worse.

This is demonstrated by a few facts about our company. In 1989, before we began operating a global network in earnest, we had 56,000 U.S.-based team-members and $4 billion in revenues. By 2010, we had grown to 290,000 team-members, 245,000 of them in the United States, and our revenues had grown to $35 billion. And our taxes *in the U.S.* (federal, state, local, income, property, sales & use, FICA, FUTA, etc.) had increased from $370 million per year to over $1.4 billion per year.

With respect to our income tax profile, we are a full-rate taxpayer. Our effective tax rate has not been below 35% in more than 20 years. As you know, this is definitely on the high end, both in the U.S. and around the world. This is a real competitive disadvantage for us.

But it is not just this competitiveness aspect of the current U.S. corporate tax code that is troublesome. In addition, today's corporate tax code creates distortions in economic decision-making; it diverts capital from its most efficient and effective use; and it leads to lower wages and employment. It is for all of these reasons that we are intensely interested in corporate tax reform and we are encouraged by the strong bipartisan momentum we see developing for this.

Like many of you in Congress, our company has also already been evaluating, and even modeling, some proposals. We are evaluating these from two perspectives – our country's macro-economic perspective, and our narrower company's perspective. We are, of course, interested in the macro-economic effects, because we, like you, and our team members, shareholders, customers, and communities, desire a strong, vibrant, competitive economy, which can improve our lives and those of our children and grandchildren. We strongly believe – as do many reputable experts across the world – that a significantly reformed corporate tax code can help provide that.

From our company's perspective, our evaluations are done bearing in mind that we have an obligation to our shareholders, team members, and other important constituencies, to maximize value, in the form of bottom line earnings, earnings per share, and cash flow. Our models are not precise, of course, particularly when there is still a good deal of information not yet available, but they do give us a directional idea of how tax reform could affect us.

Overall, we believe the ideal corporate tax reform would include a materially lower rate, something at least close to the average OECD rate of 25%, with capital investment incentives, such as the 100% expensing that just expired at the end of last December and is included in the House-passed version of H.R. 3630 currently pending before the House-Senate conference committee.

We have also said, however, that if tax reform, including corporate tax reform, must be revenue-neutral, so be it. In other words, we are willing to put all base-broadeners on the table for a significantly simpler and reformed corporate tax code with a materially lower tax rate. In that regard, if capital cost incentives, such as expensing or accelerated depreciation, are one of the things that must be put on the table, we will live with that, assuming of course, it enables a much lower tax rate. We must recognize, however that would come with a cost, both macro-economically and to our company.

From a macro-economic standpoint, strong capital cost incentives, like expensing, generate new investment in new productive property, plant and equipment in the U.S. This, in turn, generates jobs. Attached as Exhibit 1 is a chart demonstrating the very strong – almost perfect – correlation of private employment and investment over the last 50 years. And, of course, with jobs comes additional tax revenues, etc. For example, it has been estimated that a FedEx purchase of one new large aircraft from Boeing injects nearly $520 million into the economy, creates 1,940 jobs, and generates about $45 million in federal, state, and local taxes. This cause-and-effect relationship, replicated across many capital investments by many companies across the entire U.S. economy, is one of the reasons expensing/bonus depreciation has had strong bipartisan support over the years.

From our company's perspective, we would generally expect a lower tax rate to increase our cash flow, bottom line earnings, and earnings per share. To the contrary, changing the current capital cost rules to slower recovery periods and/or methods would generally adversely affect our cash flow, with less of an impact on our bottom line earnings and earnings per share. This is important, because, as is often said, cash is the lifeblood of any business.

Our investors pay close attention to our bottom line earnings and earnings per share, but they also pay close attention to our cash flow and balance sheet. Our CEO and CFO are routinely quizzed about our cash flow and major inflows and outflows therefrom. One of the biggest outflows, for a capital-intensive company like ours, is capital expenditures. In our current fiscal year, for example, we are projecting $4.2 billion in capital expenditures, up from $3.4 billion last year.

Our investors applaud capital incentives like expensing, because our after-tax cash outflow on a new capital investment can be up to 35% less than what it would otherwise be in the first year (evening out over time, of course, because it is only a temporary tax benefit). Which, we believe, is how it should be, considering that expenditures on business property, plant, & equipment are similar to almost every other business expenditure -- including salaries and wages, utilities, and many intangible development costs -- all of which are generally expensed for tax purposes as incurred.

In the current debate on business tax reform, many references have been made to the need for revenue-neutral reform. From my company's perspective, this is where the rubber meets the road, so to speak. There are other factors, but the cash flow detriment from slowing capital cost recovery versus the earnings, earnings per share, and cash flow benefits of a lower tax rate is the most critical economic analysis for us.

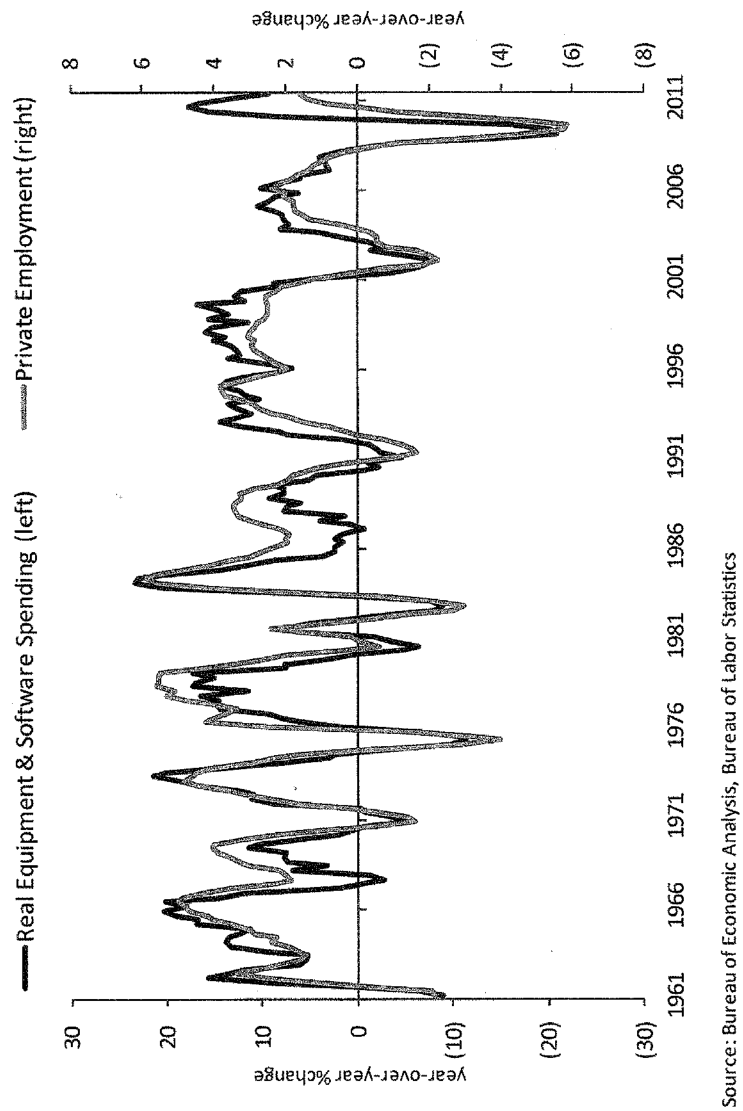
If a tax reform package cannot get us to a significantly lower tax rate – something at least close to the average OECD rate – it will not be competitive, particularly if capital cost incentives are reduced or eliminated as part of the deal. Continuation of the kinds of tax rate differentials that we now see will only perpetuate the ability of our international competitors to devote more after-tax funds for reinvestment in their global networks than we can. Over time, a 10-percentage point higher effective tax rate on our business would reduce the amount of capital we could invest in our global network by billions of dollars, leading to significantly lower network improvements and expansions. As I explained earlier, since a big part of our value proposition to our customers is our global network, if we cannot keep up with, or exceed, improvements and expansions of our competitors in their networks, we will lose those customers, with ominous potential long-term consequences.

One final factor we consider in the context of tax reform is simplification and the inherent value thereof. Value in terms of lower compliance costs, in terms of more certainty and predictability, and in terms of freeing our business people to make business decisions based on the merits of our services versus those of our competitors, not on what the tax code says. Our business decision-makers have, many times, lamented the idiosyncrasies of our "arcane" tax system. I strongly believe our decision-makers, and others in thousands of companies like ours across the country, would be more productive if they needed not to worry about the proverbial "traps for the unwary" contained in our current system. This is difficult, if not impossible, to measure, but its importance should not be underestimated.

To summarize, FedEx, like many other businesses across this country, is intensely interested in comprehensive corporate income tax reform. We believe it is critical that this occur. Indeed, we do not think continuation of the status quo is an acceptable option, either for us as a company or for our country.

We commend the recent Tax Reform Discussion Draft released by Chairman Camp. We think it is an excellent starting point and urge that you continue your efforts to lower the corporate tax rate to be consistent with the OECD average, and to simplify. As I and many others in my company and other businesses have said many times -- we need to get back to the basics, where businesses of all sizes, all types, and all forms, make business decisions – and compete – on the basis of the merits of their products and services, not on the basis of what the tax code says.

Exhibit 1



Chairman CAMP. Mr. Schichtel, you have 5 minutes.

STATEMENT OF MARK A. SCHICHTEL, SENIOR VICE PRESIDENT AND CHIEF TAX OFFICER, TIME WARNER CABLE

Mr. SCHICHTEL. Thank you.

Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you very much for inviting me to share our views on corporate tax reform. I am the Senior Vice President and Chief Tax Officer for Time Warner Cable.

I would like to first tell you about our business and the impact of taxes and tax policy on Time Warner Cable. Then I will explain why we believe that less complexity and a lower rate will benefit our investors, employees, and customers, as well as the overall economy and Americans at large.

Spun off from Time Warner Cable nearly 3 years ago, Time Warner Cable is a Fortune 150 capital-intensive domestic company that provides high-speed data, video, and voice services to over 14½ million customers. We have over 48,000 employees in 29 States. We offer our workers secure jobs and wages and benefit packages that are competitive and that support families, dreams, and retirements. Last year, we hired over 7,300 people, including hundreds of veterans.

We are part of our Nation's communications backbone that enables domestic companies to compete regionally, nationally, and globally. We help small- and medium-sized businesses grow and thrive.

Time Warner Cable spends about $3 billion a year on capital improvements, a third of which goes to wages. In 2012, we are continuing to extend our network to even more businesses and families.

Our investments also support a national network of suppliers, including nearly a quarter of a billion dollars spent annually with minority and female-owned businesses.

Our effective tax rate is historically around 39 percent, while our cash taxes paid are lower, driven by temporary incentives such as bonus depreciation, the benefits of which are now reversing. Taxes are a significant business cost, ranking among our largest in terms of magnitude, along with our programming, employee, financing, and capital outlays.

Although difficult to quantify and allocate, these taxes are ultimately borne by our investors, workers, and customers through lower returns in wages, less investment in training, and higher costs and prices. We are strongly influenced by tax policies that impact our net income, effective tax rate, and earnings per share.

We do benefit from targeted incentives, like the research credit and Section 199. Given our capital intensity, however, we currently rely even more heavily on timing incentives that don't impact GAAP financial accounting, such as expensing and accelerated depreciation, which significantly enhance our cash flows and ability to invest in our people, technology, and network infrastructure. These policies have and continue to support our business.

Over the decades, well-intentioned policy choices have helped produce a Tax Code and related regulations that are read in small print and measured in volumes. Each enacted policy objective is accompanied by nuanced rules needed to implement, clarify, and limit potential abuse.

It is not just the complexity that burdens our economy, it is the year after year starts, fits, stops, changes, and uncertainty that frustrate business leaders, analysts, and investors alike. Often, the benefits are very large, swaying or thwarting decisions of what, when, and where to invest. Subtle changes from one year to the next, intentionally or unintentionally, deny one company a benefit while often heaping on an extra helping for another.

It is time for American businesses to put aside our industry specific wish list and to work collectively to support a more coherent and equitable tax policy and corporate taxation structure. We recognize that competing priorities and deficit reduction efforts likely mean that corporate tax reform will need to be revenue neutral.

As a member of the RATE coalition, we are willing to put all of our tax incentives on the table and broaden the base in order to bring America's corporate tax rate in line with the rest of the developed world. We advocate for a significantly lower rate, a simpler code, and a predictable, consistent set of tax rules upon which business can make long-term decisions.

America has so many business advantages. Yet, we are saddled with an inefficient tax structure and an uncompetitive tax rate. We are pleased that there is growing consensus for reform that significantly reduces the corporate tax rate. We want to commend Chairman Camp and this committee for its leadership in this regard. We would welcome the opportunity to work with the committee and its members and staff in dealing with these issues as tax reform progresses.

Once again, I want to thank Chairman Camp, Ranking Member Levin, and the members of this committee for inviting me today. I very much appreciate this opportunity to testify and would be happy to answer any questions you might have.

Thank you.

Chairman CAMP. Thank you, Mr. Schichtel.

[The prepared statement of Mr. Schichtel follows:]

Testimony of Mark Schichtel

Senior Vice President and Chief Tax Officer
Time Warner Cable Inc.

Before the House Committee on Ways and Means
Washington, DC

February 8, 2012

Chairman Camp, Ranking Member Levin and members of the Committee, thank you very much for inviting me to appear before you today to share our views on corporate tax reform. I am the Senior Vice President and Chief Tax Officer of Time Warner Cable and have held that position since we spun off from Time Warner nearly three years ago. As a Fortune 150 capital-intensive domestic company, we believe that tax reform that significantly reduces the corporate tax rate is critical not only to our growth, but to the growth of the overall economy.

Time Warner Cable provides high-speed data, video and voice services to over 14.5 million customers in the United States. We employ over 48,000 employees in 29 states across the country. We offer our workers secure white-collar and blue-collar jobs with competitive wages and generous benefit packages that support families, dreams and retirements. Last year, we hired over 7,300 people, including hundreds of veterans.

We are part of our nation's backbone that enables domestic businesses to compete regionally, nationally and globally. We connect individuals and businesses through high-speed broadband, video and voice services in ever evolving, consumer-driven ways. One of our highest growth areas relates to commercial services, helping businesses, especially small and medium-sized businesses, grow and thrive even in a challenging environment.

To better serve our customers and the communities in which we do business, we continue to invest to expand our broadband network, to improve our technology and to hire new people. Time Warner Cable spends about $3 billion a year on capital improvements, one-third of which goes to wages. In 2012, we are continuing to extend our network to new areas, connecting the internet and our services to even more businesses and families. Similarly, our capital investment supports the growth of our broad supplier network, including small and medium size suppliers across our national footprint and nearly a quarter of a billion dollars spent annually with minority and female-owned suppliers.

And the cable industry as a whole is a key economic driver. As of 2010, the cable industry (directly and indirectly) accounted for nearly 1.8 million U.S. jobs representing almost $77 billion in personal income. Gross economic output attributable to the industry amounts to more than $251 billion. Additionally, historical data suggests that for every $1 billion in revenue, "core" network companies provided 2,329 jobs.

As a business and an industry, we understand that our growth is largely tied to the overall economy. That is why we are strong advocates for tax reform generally and for a significant reduction in the corporate tax rate.

The 35 percent statutory tax rate will soon be the highest in the OECD (if Japan advances its plans to lower its rate in 2012). Our high corporate tax rate discourages domestic investment by U.S. companies, and makes the U.S. a less attractive place for in-bound foreign investment. Our higher cost structure, also places upward pressure on the price of products and services sold in the U.S. and the price competitiveness of our exports abroad. Thus, the current tax system is a barrier to economic growth. We believe that tax reform that significantly lowers the corporate tax rate will enhance economic growth, increase investment and employment, make domestic businesses more competitive and reduce the role of taxes in business decisions.

Our business and the cable industry generally have a high tax burden as compared to other businesses and industries. Our effective tax rate is historically around 39 percent, while our cash taxes are lower driven by temporary capital cost timing incentives such as bonus depreciation, the benefits of which are now reversing. Taxes are a significant business cost, ranking among our largest in terms of magnitude along with our programming, employee, financing and capital outlays. Although difficult to quantify and allocate, these taxes are ultimately borne by our investors, workers and customers through lower returns and wages, less investment and training, and higher costs and prices. And, because taxes affect rates of returns on investments and the prices of products and services, they are a major factor in our business planning.

Like most companies, we are strongly influenced by tax incentives that improve our GAAP financial reporting metrics, such as our reported income, effective tax rate and earnings per share. Items like the research credit and the section 199 domestic production incentive are differences that permanently reduce our taxes paid and concomitantly our effective tax rate, thereby encouraging new investments.

Given the capital intensity of our business, however, we rely even more on timing incentives that do not impact GAAP financial reporting, such as expensing or accelerated depreciation, which significantly enhance our actual cash flows and ability to invest in our people, technology and network infrastructure. These policies have and continue to support our business, consumers and the communities that we serve.

Over the decades, well-intentioned policy choices have helped produce a tax code and related regulations that are read in small print and measured in volumes. Each enacted policy objective is accompanied by a hefty helping of nuanced rules needed to implement, clarify and limit potential abuse. It's not just complexity that burdens our economy; it's the year-after-year starts, fits, stops, changes and uncertainty that frustrate business leaders, analysts and investors alike. Often the benefits are very large, swaying or thwarting decisions about what, when and where to invest. Subtle changes from one year to the next, intentionally or unintentionally, deny one company a benefit, while often heaping on an extra helping for another.

It's time for American businesses to put our industry-specific wishlists to the side and work collectively to support a more coherent and equitable approach to corporate taxation. We recognize that given competing priorities and deficit reduction efforts, corporate tax reform will most likely need to be revenue neutral.

We are part of the RATE coalition, a group of major companies and associations willing to put all of our respective tax expenditures on the table and broaden the tax base in order to bring America's corporate tax rate in line with the rest of the developed world. We advocate for a significantly lower rate, a simpler tax code, and predictable, consistent tax rules upon which business can make long-term decisions. We strongly believe that such changes will spur economic growth and create jobs in the U.S., increase American competitiveness and benefit American workers.

According to the Heritage Foundation, lowering the corporate tax rate to 25 percent would create an average of 581,000 jobs in the U.S. annually from 2011 to 2020. At their current high corporate tax rates, the U.S. and Japan suffered a net loss of 46 and 39 Fortune Global 500 company headquarters respectively between 2000 and 2011. Finally, studies suggest that workers bear up to 75 percent of the burden of the corporate income tax. According to Ernst & Young, this equates to lower wages and benefits of $100 - $200 billion at the average level of corporate taxes in the U.S. between 2000 and 2010.

We have so many advantages that make America a great place to invest and grow a business – our people, legal system and capital markets. Yet, we have an administratively cumbersome tax structure with an uncompetitive high statutory tax rate. We are pleased that there is a growing consensus for corporate tax reform that significantly reduces the corporate tax rate. We commend the Members of the Committee for their leadership in this regard.

We support such efforts, not just because it is advantageous for our company or industry, but also because it is good for our economy and our country. It's what we need to create a business climate that attracts investment, grows jobs and invigorates our economy. We would welcome the opportunity to work with the Committee Members and their staff on these important matters as tax reform progresses.

Once again, I want to thank Chairman Camp, Ranking Member Levin and the Committee for inviting me today. I very much appreciate this opportunity to testify and would be happy to answer any questions you might have.

Chairman CAMP. Ms. Hanlon, you are recognized for 5 minutes.

STATEMENT OF MICHELLE HANLON, ASSOCIATE PROFESSOR OF ACCOUNTING, MIT SLOAN SCHOOL OF MANAGEMENT

Ms. HANLON. Thank you. Chairman Camp, Ranking Member Levin and distinguished members of this committee, thank you for the opportunity to testify before you today.

The main point of my testimony is that the responsiveness to tax policies can be affected by the financial implications of those policies. I would like to first offer some general examples of the importance of financial accounting to managers of publicly traded companies.

One example is found in a study of companies accused by the SEC of fraudulently overstating accounting earnings. It turns out that these companies also overstated their income to the IRS and paid taxes on their inflated accounting income. This suggests that these companies were willing to pay substantial sums of cash in order to report higher financial accounting earnings. In the literature we call this the book-tax tradeoff.

A second example is found in a recent survey of tax executives of publicly traded companies. Eighty-five percent of the tax executives said that top management at their companies view the accounting effective tax rate as being as least as or more important than the actual cash taxes paid.

To illustrate the financial accounting effect of tax policies, my written testimony discusses three current tax policies related to investments.

As you know, the U.S. has one of the highest statutory corporate tax rates in the world, with a top rate of 35 percent. Rather than reducing our corporate rates, our policies have instead included targeted tax provisions such as bonus depreciation and Section 199 in attempts to reduce economic effective tax rates and promote investment.

In addition to high corporate statutory tax rates in the U.S., we have a worldwide tax system with deferral, which has in part led to multinational U.S. companies holding a great deal of cash overseas. Financial accounting has affected corporation tax policy responses in each of these cases. Because the details can become technical quickly, I will discuss only one of these in detail today, accelerated depreciation, including bonus depreciation.

Accounting earnings are computed using the accrual method of accounting. This means, for example, that expenses are recorded in financial statements when incurred, regardless of when the actual cash is paid. The same method of accounting applies to the accounting for income tax expense.

In the case of depreciation, most companies use straight-line depreciation for both purposes and accelerated depreciation for tax purposes. Thus, the tax deduction for depreciation is larger than the depreciation expense for financial accounting in the early years of an asset's life. However, this is only temporary in nature, because the same amount will be depreciated for financial accounting and tax purposes over the life of the asset. The deduction for tax is just faster than the expense for book.

To compute the income tax expense for financial accounting purposes in this case, the accounting rules require expensing not only the cash taxes actually paid but also accruing and expensing the future taxes that will be paid because a company used that tax shield early. Thus, accelerated or bonus depreciation does not reduce a firm's accounting income tax expense, it will not reduce their reported effective tax rate, and it does not increase reported accounting earnings relative to a world without accelerated depreciation for tax purposes.

When asked, corporate management will often reveal a preference for a rate cut over bonus depreciation for several reasons, one of which is that there is no reduction in income tax expense on the income statement but there would be with a rate cut. In addition, empirical evidence on the responsiveness to accelerated depreciation relative to the investment tax credit which did reduce financial accounting income tax expense reveals that the responsiveness to the credit was greater holding the present value of the cash tax savings constant. This evidence suggests that the accounting effect is important and serves to mitigate the responsiveness to accelerated depreciation because there is no financial accounting benefit.

In conclusion, the main point of my testimony is that what many consider to be cosmetic accounting effects actually play a role in responsiveness to tax policy. These financial accounting implications can often mitigate the effectiveness of policies, such as bonus depreciation for public firms.

In addition, as I discuss more fully in my written testimony, sometimes the accounting implications lead to other unintended consequences, such as exasperating the tax incentives to leave cash overseas for U.S. multi-nationals.

In addition, at times concern over the accounting implications has caused tax policy to be enacted in a particular manner, as was the case with Section 199.

In sum, it is important to recognize that both tax and financial accounting effects are included in the set of factors that public corporations will consider in their decision making process.

Thank you for inviting me to testify today. I look forward to your questions.

Chairman CAMP. Thank you, Ms. Hanlon.

[The prepared statement of Ms. Hanlon follows:]

Testimony of Michelle Hanlon

before the
United States House Committee on Ways and Means
February 8, 2012

Chairman Camp, Ranking Member Levin, and distinguished members of the Committee, I appreciate the opportunity to participate in this hearing. I am an associate professor of accounting and taxation at the Sloan School of Management at the Massachusetts Institute of Technology. I am an editor of the *Journal of Accounting and Economics* and the chair of the accounting group at MIT Sloan.

The main point of my testimony is that financial accounting implications for publicly traded companies can influence the effectiveness of tax policies, including policies related to investment. The financial accounting effects represent a non-tax cost (or benefit) that public companies consider in their decision-making process. Thus, companies' responses to tax policies are not only governed by the tax effects, but also the cosmetic financial accounting effects, often producing unintended consequences.

I illustrate the financial accounting effects using current U.S. tax policies. The United States has one of the highest statutory corporate tax rates in the world. In recent years, rather than reducing the corporate statutory tax rate, our policies have instead included targeted tax provisions such as bonus depreciation and the IRC Section 199 Domestic Production Activities Deduction in attempts to reduce economic effective tax rates and provide incentives for investment. There is little evidence that these policies have spurred aggregate investment. Furthermore, because the U.S. has retained such a high corporate tax rate, U.S. multinational corporations hold a great deal of cash overseas, an amount in excess of $1 trillion. Financial accounting has affected corporations' tax policy responses in each of these cases.

I offer a detailed discussion and support in the remainder of the document, but a summary is as follows. First, companies respond less than predicted to bonus depreciation partly because the tax savings are not reflected on a firm's accounting income statement. Second, the Section 199 deduction was structured as a deduction at least partially because of financial accounting. Specifically, firms with substantial deferred tax assets on their accounting balance sheets would have had to write-down these assets if the provision were structured as a rate cut. Structuring the provision as a deduction, however, has led to a complex tax rule that is expensive to comply with and expensive to police and enforce. Finally, financial accounting provides an unintended, additional incentive for multinational companies to leave cash in offshore locations. If the foreign earnings are designated as permanently reinvested for financial accounting purposes, repatriating the cash and subjecting it to U.S. taxation requires not only an additional cash outlay but an additional financial accounting expense as well. Firms' reluctance to repatriate foreign earnings leads to more corporate debt in the U.S., lower payouts to shareholders, and quite possibly less investment in the U.S. and less efficient investment in foreign jurisdictions. I would like to emphasize, however, that given the current tax rules, the financial accounting treatment is correct. A reduction in the corporate tax rate (and/or move to a territorial tax system) would simultaneously lower both the tax and accounting disincentives related to the repatriation of foreign earnings.

The remainder of the document proceeds as follows. I first provide a brief discussion of the reporting rules for public corporations in the U.S. to provide a basis for describing the accounting effects of tax policy. I then provide evidence on the importance of accounting to firm management and describe the accounting effects related to bonus depreciation, Section 199, and the international tax system of the U.S. I close with conclusions and caveats.

Book-Tax Differences and Accounting for Income Taxes

Publicly traded companies compute two different measures of income every year – taxable income and financial accounting (book) income. The two measures of income are computed for different purposes. Financial accounting is intended to measure economic performance for external stakeholders. The rules for computing accounting income are conservative in nature, requiring the recognition of expenses and losses earlier than the recognition of income and gains. Taxable income is not publicly available and is not intended to inform external parties. The rules for taxable income are, of course, not guided by conservatism. Rather, the income tax rules are written to ensure taxpayers do not understate their income and to raise revenue to finance the government.

The line item differences between book and taxable incomes are referred to as book-tax differences and include two types – temporary and permanent. Temporary differences are items of income or expense that are included in both income computations but in different time periods. Thus, a temporary difference in the current period will reverse in some future period. The classic example of a temporary book-tax difference is depreciation. In the early years in the life of a depreciable asset, tax depreciation (accelerated) will often be greater than book-depreciation (generally, straight-line). As the asset nears the end of its life, however, this difference will reverse such that the same total amount of depreciation is taken for both book and tax purposes over the life of the asset.

The financial accounting rules require firms to account for these temporary differences. The income tax expense on the financial accounting income statement is an accrual based expense; it is not the cash taxes paid by the company. In essence, what this means is that the income tax expense related to this period's accounting earnings is accrued and expensed regardless of when the cash is paid. In the depreciation example, for instance, the company receives an additional tax deduction in the current year but in some future period will have a tax deduction for depreciation that is less than book depreciation expense. Thus, for financial accounting, the future tax related to the reversal is accrued (expensed) in the current period. Again, the total income tax expense for accounting purposes will represent the current and future tax on reported accounting earnings which in this case means allowing only straight-line depreciation. As a result of the accrual basis accounting for income taxes, accelerated depreciation does not reduce income tax expense for accounting purposes in the current period even though it saves cash taxes in the current period.

Such an accrued expense (or benefit) without a corresponding cash payment (or receipt) creates a liability or asset on the firm's accounting balance sheet. The liabilities, termed deferred tax liabilities, represent the tax effects of future reversals that result in an increase to future taxable income relative to book income (or a decrease in future book income relative to taxable income). The depreciation example above creates (or increases) a deferred tax liability in the years that tax depreciation is greater than book depreciation. The assets, termed deferred tax assets, represent the tax effects of future reversals that reduce future taxable income relative to future book income (or increase future book income relative to future taxable income).

Deferred tax assets and liabilities are computed by taking the tax rate expected to be in effect in the period that the temporary book-tax differences reverse times the cumulative temporary book-tax differences (i.e., differences between book and tax bases). Thus, a corporate tax rate increase causes an increase in the amount recorded for deferred tax liabilities and a corresponding increase in income tax expense in the period in which the rate change becomes known. A rate increase applied to net deferred tax assets increases the amount recorded for deferred tax assets (i.e., computed at the higher rate) and decreases income tax expense. Conversely, a corporate tax rate decrease requires a decrease in the amount recorded for deferred tax assets and liabilities. Thus, for firms with deferred tax assets in excess of deferred tax liabilities, a tax rate decrease reduces recorded net deferred tax assets on the balance sheet and results in a one-time decrease to reported accounting earnings.

The total amount of deferred tax assets and liabilities are substantial. Ernst & Young recently tabulated the deferred tax assets and liabilities in the financial statements of the 50 largest U.S. companies (ranked by 2009 revenues). The gross deferred tax assets totaled $521 billion in 2010 for these companies and the deferred tax liabilities totaled $465 billion.[1]

Permanent differences are straight-forward. The classic example is municipal bond interest. This type of interest income is not taxable so is not included in taxable income in any period, current or future. Municipal bond interest is, however, included in accounting income. Thus, there is a difference between book and taxable incomes that is permanent in nature – it will

[1] Neubig, T., C. Abell, and M. Cox (2011) "Some Financial Reporting Considerations for the Tax Reform Debate: Changing the Corporate Tax Rate" Ernst & Young Tax Insights Report. Deferred Tax Assets net of the valuation allowance totaled $396 billion.

never reverse. Because there is no future reversal there is no deferred tax asset or liability. Thus, permanent differences affect the income tax expense on the firm's income statement and correspondingly affect reported accounting income.

The Importance of Accounting and How Tax Policies Affect Accounting Numbers

Accounting income is an important performance measure used in the capital markets, many lending contracts, and often for internal performance evaluation. Indeed, there is a long-line of research in accounting that shows that companies will often tradeoff tax savings in exchange for more favorable accounting treatment. One example, documented in a study I co-authored with Merle Erickson and Ed Maydew, is that some companies that were accused of fraudulently overstating financial accounting earnings by the Securities and Exchange Commission (SEC) also overstated their income to the Internal Revenue Service. Management at these companies paid cash (to the IRS) in order to overstate their accounting earnings.[2] There is also evidence that companies not only care about pre-tax accounting earnings but also the reported income tax expense for financial accounting purposes. In a recent survey of tax executives, 85% of the tax executives from publicly traded companies responded that top management at their company viewed the effective tax rate for financial accounting purposes (defined as total income tax expense for accounting purposes divided by pre-tax accounting earnings) as being at least as important or more important than cash taxes paid.[3]

Bonus Depreciation

As stated above, accelerated depreciation, including bonus depreciation, is a temporary book-tax difference and therefore, does not affect accounting earnings. Tom Neubig wrote an article in 2006 that he entitled "Where's the Applause?"[4] He presented portions of that article in his testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. In the article, he discusses the Growth and Investment Tax Plan outlined in the President's Advisory Panel on Federal Tax Reform. This plan essentially included an expensing option allowing for a first-year 100% write-off of capital investment. Contrary to his expectations, the response from corporate America was the "proverbial sound of one hand clapping." Companies much preferred the alternative reform option of a lower corporate tax rate. One reason Neubig offers about why companies were not excited about the targeted expensing provision is that it is only a timing benefit and does not reduce the accounting effective tax rate.

[2] Erickson, M., M. Hanlon, and E. Maydew (2004) "How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings" *The Accounting Review* (April).
[3] Graham, J., M. Hanlon, and T. Shevlin (2011) "Inside the Corporate Tax Department: Insights on Corporate Decision Making and Tax Planning" working paper.
[4] Neubig, T. 2006. "Where's the Applause? Why Most Corporations Prefer a Lower Rate" 111 *Tax Notes* 483 (April 24).

A recent study by economist Jesse Edgerton also provides evidence on this issue.[5] He compares the effectiveness of accelerated depreciation to the effectiveness of the investment tax credit, which in contrast to accelerated depreciation reduces income tax expense and increases accounting earnings. He concludes that the investment tax credit had more of an effect on investment than accelerated depreciation because of the accounting benefits of the credit.

Section 199 Domestic Production Activities Deduction

Under the rules for Section 199, qualified activities are eligible for a deduction equal to 9% of the lesser of taxable income derived from qualified production activities, or taxable income. For a C-corporation subject to the highest corporate tax rate, the provision results in qualified activity income being subject to a 31.85% rate rather than a 35% rate. By structuring the provision as a deduction rather than a corporate tax rate reduction, the benefits were made available to non-corporate taxpayers. In addition, it avoided a negative financial accounting effect for the firms with deferred tax assets. Hanna (2011) describes the efforts by these companies to obtain deduction treatment – they wanted a deduction rather than a rate cut in order to avoid the earnings charge that would result from a tax rate reduction (i.e., from a write-down of the tax assets).[6]

While the tax rules allow an additional deduction under Section 199, there is no analogous expense for financial accounting purposes and never will be. Thus, a permanent difference is created and the Section 199 deduction reduces accounting tax expense. In other words, the Section 199 deduction has no mitigating financial accounting effect. However, structuring the policy as a targeted provision rather than a rate reduction (which also would not create a mitigating accounting effect) has resulted in a complicated tax rule that is more expensive to comply with, more difficult to audit (e.g., Section 199 is a Tier 1 audit issue), less effective at promoting real investment, and easier to game.[7] In my opinion, the fact that some firms with deferred tax assets would have to write-down the value of those assets if corporate tax

[5] Edgerton, J. (2011) "Investment, Accounting, and the Salience of the Corporate Income Tax" working paper, Federal Reserve Board.

[6] Hanna, C. (2009) "Corporate Tax Reform: Listening to Corporate America" *J Corp Law* 283 (Winter). See also White, G. (2011) "Dead Space 2: Tax Rip-Off? *Tax Notes*, October 3; and Poterba, J., N. S. Rao, and J. K. Seidman (2011) "Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Rate Changes" *National Tax Journal*, March. I note that other jurisdictions have also adjusted the form or method of implementation of tax policy because of the deferred tax issue, for example the state of Ohio and the U.K. See Neubig et al. (2011) and Poterba et al. (2011) referenced above for further discussion.

[7] For example, Scott Naatjes, V.P. and General Tax Counsel at Cargill, Incorporated, in his oral testimony before the Senate Committee on Finance in September 2011 stated that most tax directors of large companies would agree that such targeted provisions are "...calculated after year-end in back offices by CPAs for months on end...they hardly ever motivate anything in the boardroom...they spawn an industry to capture them and an industry to lobby for them but at the end of the day are not as effective as low rates." In addition, an internet search of "Section 199 Deduction" produces a myriad of advertisements and fliers such as the advertisement from Freed Maxick & Battaglia, PC. CPAs that states "Domestic Manufacturers' Deduction: A guide to finding new opportunities others might miss."

rates are reduced should not stop the U.S. from lowering the corporate tax rate. Even this sub-set of companies will benefit from lower rates if they become profitable in the future.

Worldwide Taxation and High Statutory Tax Rate

Operating income earned by a U.S. multinational in a foreign subsidiary is not included in U.S. taxable income until the earnings are repatriated.[8] For financial accounting purposes, the income is included in reported earnings in the period earned. Thus, the foreign income included in accounting earnings but not included in U.S. taxable income (until repatriated) is a temporary book-tax difference which requires a deferred tax liability and a related deferred tax expense to be recorded. There is an exception, however, to the deferred tax accounting for these earnings (in ASC 740, previously in APB 23). This exception requires firms to designate the amount of foreign earnings that are "permanently reinvested." For earnings that are permanently reinvested, the book-tax difference is accounted for as a permanent difference – and thus no deferred tax liability or expense is recorded. Permanent difference treatment reduces income tax expense and increases earnings compared to a case where the U.S. income tax is fully accrued. The result of this exception to deferred tax accounting is that the accounting statements are more comparable to the statements of companies in jurisdictions with territorial taxation because there is generally no home country tax to record in territorial regimes. This also puts U.S. companies in a more competitive position relative to companies from territorial jurisdictions in terms of accounting returns.

If a U.S. multinational repatriates earnings that were previously designated as permanently reinvested the company not only has to pay cash taxes but also has to record an accounting expense. This accounting effect is an additional reason why firms do not repatriate earnings.[9] One anecdote is found in a letter to the editor of the *Wall Street Journal* written by James Tisch, CEO of Loews, that states "Unbeknownst to many… GAAP allows corporations to avoid the accrual of taxes on foreign earnings…The results of the interaction of our repatriation tax laws and the GAAP accounting rules is that very little in the way of foreign earnings are repatriated…The accounting penalty for repatriating even a penny of foreign profits is so great that those foreign funds will not come back to the U.S…" (July 5, 2008).

Further evidence is found in a recent survey of tax executives. Depending on the sample, between 44% and 65% of the respondents indicate that the financial accounting effect is important in their decision of whether to repatriate earnings. Indeed, overall, the financial

[8] The repatriated amount is taxable at the U.S. rate and a foreign tax credit is allowed. Expense allocation rules are used in determination of the allowable credit.
[9] To be sure, neither taxes nor accounting are likely primary drivers of foreign investment or retention of cash overseas (especially for non-intangibles based companies). Companies consider many factors – growth in the foreign markets, location of customers, and other determinants – which often dominate tax and accounting considerations.

accounting effect has an importance rating that is statistically equal to the importance rating of the cash tax effect.[10]

Conclusions and Caveats

The main point of the above testimony is that financial accounting effects can act to mitigate or strengthen incentives provided by the tax code. That is, financial accounting effects have the potential to blunt the intended incentive effects of policies designed to lower the effective U.S. corporate tax rate and they have the potential to lead to unintended consequences.

There is little evidence that the current bonus depreciation provisions are effective at increasing investment. Studies have shown that "taxes matter" in the sense that the timing of investment is altered, but the evidence that aggregate investment has responded is scarce. The Section 199 deduction is complex and as a result is costly to comply with for taxpayers and is costly to audit and enforce for the tax authority. In addition, the complexity likely enables gaming and ex post maximization. Financial accounting has a role in each of these outcomes. Bonus depreciation does not reduce the income tax expense for financial accounting and thus does not reduce a company's effective tax rate, mitigating the responsiveness to the incentive. The reason that Section 199 is a deduction and was not implemented as a rate cut is, it seems, in part due to the fact that with a rate cut, companies with large deferred tax assets are required to write those assets down and value them using the new, lower tax rate.

There are currently large amounts of cash held overseas by U.S. multinationals. The reluctance to repatriate these earnings leads to more debt in the U.S., lower payouts to shareholders, and quite possibly less investment in the U.S. and less efficient investment in foreign jurisdictions. Research indicates that the disincentive to repatriate foreign earnings due to the relatively high U.S. corporate statutory tax rate is exacerbated by financial accounting effects.

It is important to recognize that financial accounting can affect responsiveness to tax policies. However, the fact that some firms with deferred tax assets would have to write-down the value of those assets if corporate rates are reduced should not stop the U.S. from lowering the corporate tax rate. Even this sub-set of companies will benefit in the future from lower rates, assuming these companies become profitable.

A few caveats to this testimony are in order. The above discussion deals only with corporate income taxes. Corporations pay many other types of taxes (e.g., value added taxes in other countries) that contribute to their tax burden. In addition, many businesses operate in a non-corporate form. How these companies are affected by corporate tax reform is important. For

[10] Graham, J., M. Hanlon, and T. Shevlin (2011) "Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions" *Journal of Accounting Research* 49.

example, if bonus depreciation is eliminated and the corporate tax rate reduced, those operating under a non-corporate form will not receive the benefit of the lower rate. The same is true for small C-corporations if only the top corporate rate is reduced. Moreover, the discussion above highlights financial accounting considerations which are generally only important for publicly traded firms or private firms that are large enough to have either publicly traded debt or other stakeholders that demand GAAP-based financial statements. Firms that are not required to prepare financial accounting statements will not have financial reporting incentives.

Thank you for inviting me to participate in this hearing. I look forward to your questions.

Chairman CAMP. Mr. Neubig, you are recognized for 5 minutes.

STATEMENT OF TOM S. NEUBIG, NATIONAL DIRECTOR, QUANTITATIVE ECONOMICS AND STATISTICS, ERNST & YOUNG LLP

Mr. NEUBIG. Thank you for the opportunity to testify.

I was an economist at the U.S. Treasury's Office of Tax Analysis from 1980 to 1990 during the development of the 1986 Tax Reform

Act. Financial accounting issues were not very important then, but over the last 25 years I have seen their importance grow, not only at the Federal level but also in terms of State tax policy and tax policy in other countries.

In 2005, President Bush's Advisory Panel on Federal Tax Reform outlined a business cash flow tax that allowed first year 100 percent write-off of capital investment, like bonus depreciation. One might have expected that this plan, which many of my economist brethren claim results in a zero effective tax rate for new capital investment, would have received strong support from the business community, but it did not. This led me to consider a number of reasons why many economists often predict the effects of tax reforms much differently than the business community.

Although I am not an accountant, in testimony before the Select Revenue Measure Subcommittee in 2006, I noted the importance of financial accounting rules when many corporate executives evaluate alternative tax reform proposals. I will restrict my comments to several reasons why many corporations may prefer a lower corporate tax rate to more targeted tax reductions.

I will use accelerated tax depreciation as one example, since its repeal has been proposed in combination with lowering the corporate tax rate in several recent tax reform plans.

Also, a number of countries have moved towards economic depreciation to partially finance their reduction in their corporate tax rates.

Timing of taxes matters, and particularly for cash constrained firms accelerated depreciation can provide important cash flow benefits. Accelerated deductions provide benefits similar to an unsecured zero interest rate loan from the Federal Government. At today's historically low interest rates, the value of accelerated tax deductions is relatively modest for corporations with access to capital markets.

Many corporate tax executives, as Dr. Hanlon noted, focus not only on their cash tax liabilities but also on their reported financial statement effective tax rates and reported book earnings. Temporary book-tax differences, such as accelerated depreciation and many other provisions, do not affect the total financial statement effective tax rate, which is based on the total accrued tax expense, both current and deferred.

A lower corporate tax rate and accelerated depreciation both reduce the economic effective tax rate on tangible business capital investments, but a lower corporate tax rate also reduces many other tax distortions, including the double tax on corporate equity, the bias toward corporate debt, taxable income shifting across tax jurisdictions, the lock-in effect on corporate capital gain realizations, the lock-out effect on foreign dividend repatriations, and also reduces the tax on corporate entrepreneurship and innovation.

A number of reports emphasize the necessity of combining permanent expensing with repeal of interest deductibility in order to prevent negative effective tax rates. In 1982, Congress scaled back accelerated depreciation as part of its deficit reduction efforts due to what were considered excessive tax benefits from combining an investment tax credit with accelerated depreciation and interest deductibility.

The 1982 Tax Act was a key starting point for the 1986 tax reform process. The base broadening in 1982 enabled the lower individual income tax rates to continue to be indexed for inflation while also reducing the deficit. It was clearly a tradeoff between base broadening versus lower tax rates, which continued in 1984 and then culminated in the 1986 Tax Reform Act.

Finally, I would like to point out a recent study by two Treasury economists. A report found that only 50 to 60 percent of corporations and only 30 to 40 percent of pass-through businesses took advantage of the recent bonus depreciation rules. The study notes that while accelerated depreciation in theory reduces the cost of investment, in practice various factors limit the use of bonus depreciation and its relative value.

Financial statement accounting is one of those factors that influence a company's business decisions and which economists generally don't include in their tax modeling.

In addition to financial accounting, tax risk and uncertainty, compliance burdens and other non-income taxes also affect business decisions. Financial accounting is one of several reasons why many corporations may prefer a permanently lower corporate tax rate to more targeted tax incentives.

I would be happy to answer any questions about my testimony.

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

[The prepared statement of Mr. Neubig follows:]

Testimony before the House Committee on Ways and Means

Hearing on
"Interaction of Tax and Financial Accounting on Tax Reform"

Thomas S. Neubig[1]
February 8, 2012

Chairman Camp, Ranking Member Levin, and distinguished members on the Committee, thank you for the opportunity to testify today on corporate tax reform and the interaction of tax and financial accounting.

I am the National Director of Ernst & Young LLP's Quantitative Economics and Statistics practice. I was an economist at the U.S. Treasury's Office of Tax Analysis from 1980 to 1990, during Treasury's development of the 1984 tax reform proposal, the President's 1985 tax reform proposal, and the enactment of the Tax Reform Act of 1986. I was the Director and Chief Economist of the Office of Tax Analysis between 1986 and 1990. Since 1990, I have worked on business tax policy issues at the federal, state and global level for both private and public sector clients.

I testified on corporate tax reform before the Ways and Means Select Revenue Measures Subcommittee in 2006, where I commented on the important effects of financial accounting on a variety of tax policy issues. Although I am not an accountant, I noted the importance of financial accounting rules when many corporate executives evaluate alternative tax reform proposals. Financial accounting considerations are one of the reasons why many economists view the effects of tax reforms differently than the business community. This has also led me to ask whether most current economic models might understate the potential benefits of a lower US corporate income tax rate.

Given the breadth of the topic of corporate tax reform, I will restrict my comments to the reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions. I will use the example of accelerated tax depreciation. Its repeal was proposed in combination with lowering the corporate tax rate by President Obama's Fiscal Commission (Simpson-Bowles) and in Senator Wyden and Coat's tax reform legislation. Moving toward economic depreciation has been used by many other countries to help partially finance their reduction in corporate tax rates.[2]

In 2005, President Bush's Advisory Panel on Federal Tax Reform outlined a Growth and Investment Tax Plan for a business cash-flow tax—essentially an expensing proposal that

[1] Principal, Ernst & Young LLP. The views expressed in this testimony are my own, and do not necessarily reflect the views of Ernst & Young LLP or its clients.
[2] Michael P. Devereux, "Developments in the Taxation of Corporate Profit in the OECD Since 1965," Oxford University Centre for Business Taxation, WP 07/04, December 2006. Nine of the 15 OECD countries studied that reduced their corporate tax rate between 1982 and 2004 also broadened their tax base by reducing the amount of accelerated depreciation.

allows for a first-year 100% write-off of capital investment.[3] One might have expected that this plan—which many economists claim results in a zero effective tax rate for new capital investment—would have received strong support from the business community, but it did not.

Why the tepid response from the corporate community? Several years ago, the Tax Council Policy Institute asked multinational corporations to rank a range of alternative tax reform options. According to the survey, the clear favorite was lowering the corporate tax rate to 25 percent compared to other incremental or fundamental tax reforms.[4]

With economists and the business community differing in their response to the 2005 Advisory Panel's expensing option, many observers wonder why the disconnect. Here are seven reasons why many corporations may prefer a lower corporate tax rate to accelerated tax depreciation or other targeted tax incentives.

1. **A lower corporate tax rate would lower corporations' financial statement effective tax rate and increase book net income for most corporations. Accelerated depreciation offers only a timing benefit, and doesn't reduce corporations' financial statement effective tax rate or increase reported book profits.**

Most economists don't think reported book effective tax rates matter. Investors are assumed to be savvy enough to see that accelerated depreciation reduces current tax liability, which lowers the present value of current and future taxes, and thus increases the value of the firm. Timing of taxes matters and for a growing firm accelerated depreciation can offer lower taxes long into the future and for cash-constrained firms accelerated depreciation can provide important cash-flow benefits. Accelerated depreciation provides benefits similar to an unsecured zero-interest rate loan from the government.[5] At today's historically low interest rates, the value of accelerated depreciation is relatively modest for corporations with access to the capital markets.

Many corporate tax executives focus on their cash tax liabilities and the net present value or internal rate of return when evaluating individual projects[6], but many also factor in their reported financial statement effective tax rates and reported book earnings.[7] Temporary book-tax differences, such as accelerated depreciation, do not affect the total

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[3] The President's Advisory Panel on Federal Tax Reform, Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System, November 2005.
[4] Tax Council Policy Institute, The U.S. International Tax Regime: Confronting the challenge of the Evolving Global Marketplace, February 10-11, 2005, Final Report, p. 90.
[5] Tom Neubig, "Expensed Intangibles Have a Zero Effective Tax Rate....NOT!," Tax Notes, September 10, 2007
[6] John Graham and Campbell Harvey, "How Do CFOs Make Capital Budgeting and Capital Structure Decisions," Journal of Applied Corporate Finance, Vol.15, No. 1, Spring 2002.
[7] John R. Graham, Michelle Hanlon, and Terry Shevlin, "Real Effects of Accounting Rules: Evidence from Multinational Firms' Investment Location and Profit Repatriation Decisions," Journal of Accounting Research, Vol. 49, No. 1, March 2011.

financial statement effective tax rate, which is based on total tax expense (both current and deferred). Accelerated depreciation in the initial years reduces current tax expense while increasing deferred tax expense, but the total tax expense remains unchanged.

Thus, many corporate tax executives value permanent book-tax differences higher than temporary book-tax differences. They also value the permanent benefit of a lower corporate tax rate more than a temporary, cash-flow benefit.[8] Reducing the corporate tax rate would immediately lower corporations' financial statement effective tax rates, thereby increasing their reported after-tax book profits.

A lower corporate marginal tax rate would also immediately reduce corporations' deferred book tax liabilities and assets—a welcome development for companies reporting deferred tax liabilities. In their 2010 financial statements, 31 of the top 50 US public corporations were in a net deferred tax liability position (19 were in a net deferred tax asset position).[9] The 50 companies' total deferred tax liabilities were $465 billion, compared to net deferred tax assets of $396 billion (after valuation allowance). Accelerated depreciation accounted for almost half of the total deferred tax liabilities of the top 50 public companies.[10]

Corporations with a net US deferred tax liability position would have a double benefit from a lower US corporate tax rate: 1) a reduction in their financial statement effective tax rate on current earnings, plus 2) a reduction in their net deferred tax liability, both of which would result in higher reported book earnings. Many corporations with a deferred tax asset would favor a permanent lower future corporate tax rate on their future profits, even if there was a one-time adverse financial accounting effect in the year of enactment.

When Ohio enacted legislation phasing down its corporate income tax rate on June 30, 2005, a number of public corporations reported higher profits due to the future tax rate reductions in their 2005 second quarter financial results. Several of the top 50 US companies reported a reduction in their deferred tax assets due to the reduction in the United Kingdom corporate tax rate from 28% to 26% enacted in 2010.

[8] Jesse Edgerton, "Investment, Accounting and the Salience of the Corporate Income Tax," Federal Reserve Board of Governors Finance and Economics Discussion Series Staff working paper 2011-20. Edgerton finds that investment tax credits, which affect accounting profits, had more effect on investment than accelerated depreciation, which does not affect accounting profits.

[9] Tom Neubig, Chester Abell and Morgan Cox, "DTAs, DTLs and Corporate Tax Rate Reduction," Tax Notes, July 25, 2011.

[10] The 2010 findings are consistent with those of James M. Poterba, Nirupama S. Rao and Jeri K. Seidman, "Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Changes," National Tax Journal, March 2011, 64 (1), pp. 27-58. They found that a sample of large corporations were in an overall net deferred tax liability (DTL) position every year from 1993 to 2004, a majority of the firms were in a net DTL position, and accelerated depreciation was the largest DTL.

2. A lower corporate tax rate would reduce the tax distortion on many margins of tax decision making, while accelerated depreciation or expensing reduces the tax distortion on only two margins.

Accelerated depreciation or expensing lowers the tax wedge on tangible capital investments, which can result in higher capital investment and higher wages for American workers. Expensing would also eliminate the wedge between some intangible assets that are expensed and other assets that are depreciated or amortized. Alternatively, with the same level of revenue, a lower corporate tax rate could lower the tax wedge and tax distortion across many different margins of business investment decisions.

A lower corporate tax rate would lower the tax wedge on tangible capital investments. In addition, a lower corporate tax rate would:

- Reduce the tax distortion between corporate capital, which is subject to tax at both the corporate and shareholder levels, and non-corporate capital, which is taxed once at the owners' individual income tax rate;
- Reduce the tax distortion between corporate debt, where interest is deductible, and corporate equity investment, where dividends and retained earnings are not deductible;
- Reduce taxable income shifting across jurisdictions due to the high US statutory tax rate relative to other countries' lower tax rates;
- Reduce the lock-in effect on corporate capital gain realizations and lock-out effect on repatriation of Controlled Foreign Corporations' foreign source earnings;
- Reduce the tax on corporate entrepreneurship and innovation; and
- Encourage foreign capital investment and economic activity in the United States.

A number of reports state that a territorial system of international taxation could put increased pressure on transfer pricing.[11] Transfer pricing and other tax arbitrage issues are important when marginal tax rates differ significantly across countries or types of activity.

After Japan's new legislation lowers its top corporate tax rate to 38.0% on April 1, 2012, the United States will have the highest top statutory corporate tax rate among the 50 largest economies, at 39.1%, including the average state income tax rate. The average top corporate tax rate for the other top 30 world economies, weighted by their Gross Domestic Product, is 29.5% in 2012. Our top 30 major trading partners' average corporate tax rate is 27.5%, weighted by total exports and imports. The average corporate tax rate in the top 30 economies where there is the most US foreign direct investment is 22.4%.

[11] 2005 President's Advisory Panel, p. 242. The President's Economic Recovery Advisory Board (PERAB), The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation, August 2010, p. 89-90.

These corporate tax rate differentials affect both taxable income shifting as well as the location of real economic activity and investment decisions.[12]

3. **Permanent expensing of capital investment is unlikely to occur without a counterbalancing loss of interest deductibility. A lower corporate marginal tax rate could occur with continued interest deductibility.**

A number of reports emphasize the necessity of combining permanent[13] expensing with repeal of interest deductibility to prevent negative economic effective tax rates. "Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."[14]

In 1982, Congress scaled back accelerated depreciation as part of its deficit reduction efforts due to what were considered excessive tax benefits from combining an investment tax credit with both accelerated depreciation and interest deductibility. There were concerns about wasteful tax-driven investment expenditures, tax arbitrage and large revenue losses. The 1982 Tax Act was one of the key starting points for the 1986 Tax Reform process. The base broadening in 1982 enabled the lower individual income tax rate brackets to continue to be indexed for inflation while also reducing the deficit. It was clearly a trade-off between base-broadening versus lower tax rates, that was repeated in the 1984 Act as well as the 1986 Tax Reform Act, which further scaled back accelerated depreciation to the current Modified Accelerated Cost Recovery System and repealed the investment tax credit.

When comparing expensing versus a lower corporate tax rate, a more meaningful comparison would be permanent expensing without interest deductions versus a lower corporate tax rate with interest deductions. In that comparison, expensing would only help a small fraction of corporate investment: equity-financed tangible investments.

4. **Corporations invest to earn above-normal returns, not just the "normal" or risk-free return. A lower corporate tax rate applies to the entire return to capital, while accelerated depreciation or expensing reduces the tax rate on only the risk-free return.**

Economists distinguish between four different returns to investors:

1) a "normal" or risk-free return for deferring consumption, or a "return to waiting";
2) an expected risk premium;

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[12] Robert Carroll and Thomas Neubig, The Economic Benefits of Reducing the US Corporate Income Tax Rate, Ernst & Young LLP report, September 2011.
[13] The combination of interest expense deductions with permanent expensing would cause greater economic distortions than with temporary investment tax incentives.
[14] 2005 President's Advisory Panel, p. 164. 2010 PERAB report, p. 71 and 73.

3) a return due to entrepreneurial skill, a unique idea, a patent or other specific factors; and
4) an unexpected return from good or bad luck where the actual return differs from the expected return.[15]

The 2005 Advisory Panel report stated "Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions."[16] Academic economists argue that in competitive markets businesses can only earn the "normal" or risk-free return to capital on their last (marginal) dollar of investment. They argue that anything earned above the risk-free return, the so-called "super-normal" return or "rent", has no economic effects, even if taxed at high tax rates. An important caveat is that taxes on super-normal returns can affect the location of investment in a global economy. Companies don't invest just to earn a risk-free return; they expect to earn returns to justify their risk-taking, specialized factors and competitive positioning.

Economic proponents of expensing point out that under a business cash flow tax profits above the risk-free return would be taxed. They argue that taxing "rents" is equivalent to a lump-sum tax. My colleague, Bob Cline, and I did an analysis of an Australian proposal for a 40% "super profits" tax on the mining industry.[17] It included a new 40% cash-flow tax, with expensing of new capital investment, in addition to the Australian 30% corporate income tax. A report prepared for the government argued that since super profits have no economic effects and since minerals aren't mobile, there would be no adverse economic effects. We pointed out that capital investment and the engineers are globally mobile, mineral extraction can be deferred until a future date, and companies care about their total tax burden, even on so-called "super profits", so adverse short-term, medium-term and long-term effects should be expected. The Australian super profits tax proposal was eventually scaled back significantly.

While many economists focus on the "marginal" investment, e.g., the last laptop computer purchased, companies make investments that are large, discrete, finite, risky, and also include substantial entrepreneurial and innovative efforts. When entering a market or expanding existing operations, companies look at their total after-tax return. While a company might earn a risk-free return from the time-value of money from accelerating depreciation deductions, companies invest to earn significantly higher returns on their total investment. A lower corporate tax rate would reduce the tax on all corporate income—both the normal risk-free return income as well as the return to risk-taking, entrepreneurial skill and innovation.

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[15] William M. Gentry and R. Glenn Hubbard, "Distributional Implications of Introducing a Broad-Based Consumption Tax," National Bureau of Economic Research Working Paper 5832, November 1996.
[16] 2005 Advisory Panel, p. 150.
[17] Thomas S. Neubig and Robert J. Cline, A critique of the economic theory and modeling underlying the Australian resource super profits tax proposal, Ernst & Young report, June 2010.

5. A lower corporate tax rate applies to all types of future income, while targeted incentives generally lower the cost of certain inputs.

Proposals for expensing would lower the economic effective tax rate for depreciable property, land and inventories. But, recent studies report that business investment in intangibles—research and development, copyrights, computerized databases, development of improved organization structures, and brand equity—is now as large as the spending on tangible capital.[18] Many of these intangible assets have high rates of return, well in excess of a "normal", risk-free rate of return, and in many cases can be developed in alternative locations within a global organization.

The current tax rules require the amortization of many intangible assets, but in some cases allow the equivalent of expensing through the deduction of wages in the creation of certain self-constructed intangible assets. In the case of certain intangible assets, such as advertising and research and development, expensing is allowed due to the lack of good information about the depreciable life and depreciation pattern of the intangible asset and the administrative issues that would otherwise be involved.

Expensing would benefit depreciable and capitalized investments, but would provide no incremental benefit to many intangible assets that are currently expensed. A lower corporate marginal tax rate, on the other hand, would benefit income from all tangible and intangible investments. Several European countries, most recently the United Kingdom, are moving to a lower corporate tax rate on certain types of intangible income (so-called patent box or intellectual property regimes), reflecting the power of a lower corporate tax rate on future income, even when those countries have other incentives, such as R&D tax credits or super-deductions, to lower the cost of the inputs.

6. Many companies would not receive the full benefit of expensing, and many have not used bonus depreciation.

Many companies would not benefit from the full effect of expensing, because expensing would create or add to tax losses for many companies. Unless the government provided immediate cash refunds, these companies would only realize a fraction of the potential benefits that expensing might offer.

Two recent studies by US Treasury Department economists report that between 2002 and 2009 many companies did not take advantage of the temporary bonus depreciation rules.[19] Only 50% to 60% of C and S corporations used bonus depreciation for eligible investments, while only 30% to 40% of partnerships and sole proprietorships used bonus

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[18] Carol Corrado, Charles Hulten, and Daniel Sichel, "Intangible Capital and US Economic Growth," The Review of Income and Wealth, 2009, 55:3, pp. 661-685.

[19] John Kitchen and Matthew Knittel, "Business Use of Special Provisions for Accelerated Depreciation: Section 179 Expensing and Bonus Depreciation, 2002-2009," mimeo, November 2011. Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002-2004," US Department of the Treasury, Office of Tax Analysis Working Paper 98, May 2007.

depreciation for eligible investments. The use of Section 179 expensing ranged from 60% to 80%.

The study notes that many firms are in a tax net operating loss position or have loss carryforwards, which reduce the cash-flow tax benefits of bonus depreciation and expensing. In addition, 31 of the 47 states that impose a corporate income did not fully conform to the federal bonus depreciation provisions in 2010, which increased companies' compliance costs and reduced the total tax benefit. The study notes that while accelerated depreciation in theory reduces the cost of investment, "in practice various factors limit the use of bonus depreciation and its relative value".

7. **A lower corporate tax rate reduces the value of financial statement deferred tax assets and liabilities. Expensing leaves large deferred tax liabilities that could be increased by future tax increases.**

Economists' assertion that expensing creates a zero effective tax rate on the risk-free return only holds if tax rates remain unchanged over the life of the investment. If tax rates increase in the future, then the effective tax rate would be higher. If tax rates decreased in the future, then the economists' effective tax rate would fall below zero.

Expensing would create large deferred tax liabilities. Some economists might argue that these could later be taxed at higher rates without adverse economic effects since the investments had already been made. This is the same argument that many economists use for estimating the future economic benefits of moving to a consumption tax (either a value-added tax or business cash flow tax), since the shift can be financed by imposing taxes on old capital (existing investments), which they argue has no adverse economic effects.

Some economists argue against a reduction in the corporate tax rate since it would provide a "windfall" to "old capital". Accelerated depreciation has been cited as providing a bigger "bang-for-the-buck" than a lower corporate tax rate.[20] Instead, some economists propose focusing any favorable tax rules on "new" investment. Of course, most "new" investment is actually replacing depreciating "old" investment, rather than increasing the total capital stock. Attempting to limit favorable tax treatment to "incremental new" activity (e.g., R&D tax credit, new jobs tax credit) involves significant complexity, unintended consequences, and limited incentive effects. Business executives don't distinguish between "new" and "old" capital. Policy analysts haven't distinguished between "new" and "old" "human capital" when payroll or income tax rates are changed.

Lowering corporate income taxes will be beneficial to companies that have made "old" investments in the United States which are contributing to today's US jobs, as well as to

[20] U.S. Treasury Department, Office of Tax Policy, Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century, December 2007, p. 50. Treasury states that the United States has relatively generous depreciation allowances for equipment. "In the OECD, only Greece and Italy have more generous depreciation allowances." p. 9.

those same companies making future replacement and incremental new investments in the United States.

Conclusion

Financial statement accounting is one of several factors that influence business decision making, and is often not taken into account in some economists' proposals for tax reform and their modeling. The positive effects of a lower corporate income tax rate compared to the negative effects of corporate base broadening will be underestimated without understanding these other effects. These other effects include tax risk and uncertainty[21], compliance burdens, and other non-income taxes that affect business decisions.

Fortunately, the tax accounting academic community is starting to weigh in on tax policy and the effects of financial accounting on business investment decisions. I know from my days at the Treasury Department how much potential damage a solo tax policy economist can do, without the benefit of working with good tax lawyers and knowledgeable industry and business executives. We need to add the benefit of tax accountants and even behavioral economists to fully capture the effect of the different types of incentives and responses to changes in tax policy.

These seven reasons help explain why many corporate executives have not stood up with many economists to support permanent expensing and business cash-flow tax proposals. It is why many corporations, but not all, would prefer a permanently lower corporate tax rate over accelerated depreciation. If accelerated depreciation were changed, it would be important for the US tax depreciation rules to be updated to reflect the economic realities of the 21st century.[22]

Most of the corporate tax community would prefer to see the United States join other countries in significantly lowering its corporate income tax rate. How a lower corporate tax rate would be financed matters, but I hope that future modeling of US corporate tax reforms will take into account more of the benefits of a lower corporate tax rate.

That concludes my testimony. I would be happy to answer any questions about my testimony.

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[21] Ernst & Young, Tax risk and controversy survey: A new era of global risk and uncertainty, 2011.

[22] Testimony of Thomas S. Neubig before the Senate Committee on Finance Subcommittee on Long-Term Growth and Debt Reduction, "Updating Depreciable Lives: Is There Salvage Value in the Current System?", July 21, 2005.

Chairman CAMP. Mr. Heenan, you are recognized for 5 minutes.

STATEMENT OF TIMOTHY S. HEENAN, VICE PRESIDENT, TREASURY AND TAX, PRAXAIR, INC.

Mr. HEENAN. Good morning. Thank you for inviting me today. I appreciate it.

I would like to just start by commending you, Chairman, for tackling—and the rest of the committee for tackling this important topic of tax reform. We support the efforts and appreciate the time to talk about it here today.

I would like to just start to give a little bit of a background about Praxair, not maybe a household name. We sell air. We sell the components in air. We have a diverse customer mix. We can sell to a food and beverage company for the nitrogen in your potato chip bag or the fizz in your soda. We also sell to big companies, steel companies, who use tons and tons of gases. So a very diverse customer group.

We have about $11 billion in sales worldwide, and we are the largest industrial gas producer here in the United States.

Importantly, we spend about $2 billion a year on new capital investment. We go through a very rigorous process. We sit at a table with the senior leaders on each new project, and they tend to be big projects, and we discuss capital investment, and we compare projects around the world. And for us cash is king.

And to answer the question that was posed, in what way does financial accounting affect our business investment decisions, our answer is simple. It really does not affect our decisions. For us, it is about cash. Cash is king.

You know, earnings will follow the cash. If we get more cash, we have more to invest, and the earnings will follow. So we do not focus on financial accounting.

It is important to focus on earnings for other decisions in the business, but on the investment decisions, cash is king. So we use sort of a net present value cash flow model, and we don't vary from it.

I can tell you, Thursday this week we will go through 10 projects, and not one of those projects is going to say anything about earnings. All of them will talk about internal rate of return, which is a cash flow model we focus on.

So while I support tax reform I think that we really have to take a close look at the targeted deductions that we may eliminate that pay for that tax reform. And specifically, you know, many folks here that have been testifying have mentioned accelerated depreciation. Under the current U.S. rules, that is a very important factor that helps influence our investment decisions. So if we are going to remove accelerated depreciation in favor of a lower rate, we really need to weigh the two very closely to see what it is going to do to investment decisions for companies like Praxair.

So thank you, and I would be happy to take any questions you might have.

Chairman CAMP. Well, thank you.

[The prepared statement of Mr. Heenan follows:]

WRITTEN TESTIMONY OF TIMOTHY S. HEENAN
VICE PRESIDENT OF TREASURY AND TAX
PRAXAIR, INC.

BEFORE THE

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

HEARING ON

THE INTERACTION OF TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

FEBRUARY 8, 2012

TIMOTHY S. HEENAN, PRAXAIR, INC.

TESTIMONY BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE INTERACTION OF TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

FEBRUARY 8. 2012

Good morning Chairman Camp, Ranking Member Levin and Members of the Committee. My name is Timothy Heenan. I am the Vice President of Treasury and Tax for Praxair, Inc., an American multinational and the largest industrial gases company in North and South America with 2011 sales of $11 billion. The company manufactures, sells and distributes atmospheric, process and specialty gases, and high-performance surface coatings. Praxair products, services and technologies bring productivity and environmental benefits to a wide variety of industries including aerospace, chemicals, food and beverage, electronics, healthcare, manufacturing, metals, among others. Praxair is headquartered in Danbury, Connecticut and its primary research and development facility is located in Tonawanda, New York. Praxair employs about 10,000 people in more than 500 facilities across the United States. My testimony today is based on my experiences working as a senior tax and treasury professional at Praxair for the last seven years and before that as a tax advisor for Ernst & Young.

I would like to thank this Committee for the opportunity to appear at today's hearing on the Interaction of Tax and Financial Accounting on Tax Reform. I would also like to thank the Chairman for his leadership and taking the important first steps toward comprehensive tax reform and the goals of rate reduction and simplification. As a threshold observation, U.S. competitiveness and job creation depend on the U.S. being an attractive place to invest. In this, our corporate tax code plays a significant role.

Today's hearing is focused on how accounting rules affect how publicly traded companies evaluate tax policy. The answer to this question, however, depends on who you ask: If a company's tax director is asked this question, he or she may prefer a lower effective tax rate at the expense of preserving certain "tax expenditures" since a lower rate will increase the company's accounting earnings per share ("EPS"). This should not come as a surprise since most tax directors are measured on their company's effective tax rate. If, however, this question is asked to the individuals who make the company's investment decisions, it is my experience that they will likely be much more focused on cash flow as opposed to accounting EPS. This response will be based on the recognition that cash flow is the key factor in an investment decision. In encouraging cash flow, timing of deductions, such as accelerated depreciation, play a critical role.

Praxair is a capital intensive manufacturer which has operations in over forty countries. Each year, Praxair's various business units from around the world compete with each other for limited funds for capital projects. Projects are selected for funding based on the project's future cash flow using a net present value model. Various factors are used to calculate a project's future cash flow, including the tax profile of the country where the project will be executed. Cash flow is determined by a combination of a country's tax rate, special deductions, and timing items such as accelerated depreciation. Projects yielding a higher cash flow are selected over projects yielding a lower cash flow. Under the current U.S. tax rules, accelerated depreciation, in particular, has a significant impact on Praxair's investment decisions.

Praxair's capital expenditures cannot be deducted in the year they are incurred. Rather, such costs are capitalized and deducted over time. It is important to note that these costs include more than the cost of machinery and equipment, they also include costs associated with labor and engineering. For financial statement purposes, Praxair deducts these costs pro-rata over the life of its projects. The U.S. tax code currently allows for "accelerated depreciation," permitting Praxair to deduct depreciation costs faster than for financial statement purposes. As a result, Praxair can deduct more of the cost of a capital asset in the first years of the asset's life. Shortening the capital recovery period of a U.S. project improves the company's cash flow and makes new domestic investments much more attractive. Better cash flow means more U.S. investment. More investment means greater

American competitiveness and more jobs. On the contrary, when the cash flow of U.S. projects decrease, new capital investments in foreign jurisdictions that offer both lower tax rates and accelerated depreciation become more attractive, thereby shifting capital investment abroad.

Under accounting rules, a tax rate reduction coupled with the elimination of timing items such accelerated depreciation will positively impact a typical company's financial statements by increasing its accounting earnings per share (EPS). That outcome may appeal to a company's tax director, whose performance is largely evaluated on his or her firm's effective tax rate. However, increased EPS does not equate to increased cash flow, which is the sole factor we use to evaluate investment decisions. A lower tax rate will benefit cash flow, but in promoting investment, accelerated depreciation is perhaps a more powerful tool than lower overall tax rates. This is because lower tax rates reward both old and new investment—whereas accelerated depreciation is targeted by only rewarding new investment, which is precisely what we need to restore our competitiveness and economic strength. As the Committee explores rate reduction, I encourage the Committee to weigh the cash flow benefits of a rate reduction versus any potential cash flow harm from eliminating tax expenditures, such as accelerated depreciation. In conducting this analysis, I encourage the Committee to consult with individuals at companies that are making investment decisions, including, but not limited to those firms' Chief Financial Officers and Treasurers.

Chairman CAMP. Thank you all for your excellent testimony.

Now we will move into a question time; and, Mr. Fryt, Mr. Schichtel, and Mr. Heenan, I have a question for all of you. You were invited here today because you do represent capital-intensive businesses that could be asked to consider trading off a substantial amount of tax benefit if there was a comprehensive reform plan put forward that could alter pretty dramatically the corporate tax rate and reduce it somewhat drastically. The committee wants to understand better how businesses such as yours evaluate those tradeoffs that will be part of tax reform.

Now, I understand that we are not talking about details today, but especially with respect to choosing the right base-broadening measures, could a revenue-neutral reform package that reduces the corporate rate to 25 percent and moves to a territorial system, could that improve the competitiveness of your companies?

And if you each could take a few moments to answer that.

Mr. FRYT. My answer would be yes. At 25 percent, I think that is close to the OECD average, which is about 25 percent right now; and given our international competition, that is about where we need to be at a minimum. You talk about base-broadeners and the tradeoff. There certainly is, as I mentioned in my prepared remarks, and that is something that we take into consideration. The cash flow effects are detrimental. There is no question about it. But lowering a tax rate overall to something around 25 percent, I think, would be well received.

Chairman CAMP. Mr. Schichtel.

Mr. SCHICHTEL. I agree with Mike, a resounding yes. I think if we can get to a 25 percent rate, or something close to that that is in line with the rest of the developed world, you will find the vast majority of the business community coming out in support of it. I know it is a challenge to get there.

From our perspective as a company, our health and growth is tied inextricably to the growth and health of the overall economy. No question about it. That is the biggest driving factor in how well we do over the long run. Our view is that a significantly lower rate and a simpler Tax Code will redound to the benefit of the entire economy, will encourage overall more growth and development, and that will in turn increase the returns that we have to our shareholders and the opportunities that we have out there.

Chairman CAMP. Mr. Heenan.

Mr. HEENAN. I would like to give you an answer yes or no, but, really, I have been doing this a long time and the devil is in the detail. And, in our view, clearly all tax expenditures are not created equal. And, you know, to just focus on accelerated depreciation, a tax rate will affect both our old business and our new investment, and so we have a large—we are the largest industrial gas company in the U.S. We will certainly benefit from a rate reduction.

But to your specific question on investment decisions, that is a future question. A rate benefit is not going to impact our future decision. And so when I look at something like accelerated depreciation, that is very focused on new investment. New investment will bring growth and jobs.

So, I think we just have to be very cautious as to which tax expenditure we are using, and we are particularly focused on accelerated depreciation because we think it has a special place in promoting new growth, and we think with that will come jobs.

Chairman CAMP. But if the right base-broadening measures were chosen, do you think a revenue-neutral package that reduced the rate to 25 percent would help the competitiveness, including a territorial system?

Mr. HEENAN. Well, I can clearly say if accelerated depreciation remains the same and everything else goes, we could——

Chairman CAMP. From your point of view, I am asking your opinion. So if the right base-broadening measures were chosen, from your point of view, that it would be something that would increase the competitiveness of——

Mr. HEENAN. Absolutely.

Chairman CAMP. The other—just to follow up, could you envision a package, each, the three of you, being designed that would lead employers to invest more and hire more American workers?

Mr. FRYT. Absolutely. I think the package—well, I described in my prepared remarks the ideal one—maybe not a practical, but the ideal one would be some rate close to the OECD rate with 100 percent expensing. I think you would see tremendous new investment, additional global expansion, U.S. expansion, and job growth, absolutely.

And even if you went with the base-broadeners that you were talking about, Chairman Camp, if you got down to a rate of around 25 percent I think there is no doubt in my mind that also would increase growth.

Chairman CAMP. Thank you.

Mr. Schichtel.

Mr. SCHICHTEL. I would love to keep our tax incentives like accelerated depreciation. I would love to see expensing extended as part of an overall tax reform that lowered the rate to 25 percent. But I don't see how that is possible in a revenue-neutral fashion. I think for the short term, until we do have corporate tax reform, I think expensing, extending bonus depreciation is tremendously important and impactful. Certainly from our vantage point and our C suite's vantage point—because I get calls all the time—it is tremendously important.

That being said, if we all put everything on the table and we start working towards a targeted rate and a simpler code, I think we will see more growth, and for us that will definitely result in more jobs and more investment.

Chairman CAMP. All right.

I have a question for Ms. Hanlon and Mr. Neubig.

In Congress, we measure revenue neutrality by looking at cash taxes over a 10-year period without using a discount rate. And that is very different how public companies calculate book earnings under GAAP, and it is even very different how public companies calculate cash flow benefits. But if this committee succeeds in designing tax reform legislation that is revenue neutral over a 10-year period the way Congress measures it but that in the aggregate increases companies book earnings, do you think that such a tax reform package would lead to more economic activity being located here in the United States and therefore more jobs for American workers?

Ms. Hanlon, why don't I start with you?

Ms. HANLON. I guess the main thing I would say to that is that if you would, you know, remove the mitigating effect of financial accounting there seems to be no negative effect that would come from that. So to the extent that doing the tax side of it would increase jobs and investment, then releasing the mitigating effect from accounting could only help those incentives.

Chairman CAMP. All right.

Mr. Neubig.

Mr. NEUBIG. I think the companies are going to be looking at a lot of different measures of taxes. And you mentioned that although it might be revenue neutral over a 10-year period from a government scoring standpoint it might be actually higher total taxes on the corporate community. I think there would certainly be concern about that having some adverse effect. There are certainly lots of benefits from a lower corporate tax rate, but they are going to be looking at the total tax burden in the U.S. So they impact the other——

Chairman CAMP. I am sorry, we are having microphone problems.

Mr. NEUBIG [continuing]. Other tax base issues. So it really is the whole tax reform package that they will be looking at.

Chairman CAMP. And to the two of you again, some commentators say that cash is king and that investors are sophisticated enough to sort of look through the differences between cash flow and book earnings. And how do you respond to the arguments that investors look through book earnings and see only cash?

Ms. Hanlon, why don't you start? Then I will go to Mr. Neubig, briefly.

Ms. HANLON. This is a great question. It has been asked many times in accounting workshops when we present research on earnings management, for example.

So I think the first thing to recognize is that accounting earnings are used for two purposes, both equity markets and contracting purposes. So, for example, debt contracts and compensation contracts and the extent to which those are written based on accounting numbers, you will see managers respond to those same incentives. And the equity markets and these contract writers they are not stupid or not savvy enough, I wouldn't say, in using accounting earnings, because accounting earnings is generally kind of like a scorecard. In other words, there is research that shows that accrual accounting earnings can predict future cash flows better than current cash flows. So it is reasonable for these people to use accounting earnings.

And, finally, the other thing is that investors may be savvy, but they are still only human. So there is a long line of behavioral finance research that shows investors have limited attention and limited processing ability to process very complicated information like you would find in an annual report of a complicated company.

Chairman CAMP. All right.

Mr. NEUBIG. There are differences across the different companies. And accelerated depreciation and the cash flow——

Chairman CAMP. Maybe if you could borrow somebody else's microphone.

Mr. NEUBIG [continuing]. Cash-constrained companies deal with an economic downturn. There are an awful lot of cash-constrained companies that can certainly benefit from the cash flow benefits from a number of the timing provisions. And so I think not all companies are alike. There are going to be a number of companies, as Dr. Hanlon noted, that do look specifically at the financial statement earnings and book earnings. I found that in terms of my discussions with a number of corporate executives. But, also, there are a number of corporations that do the type of project evaluations looking at the cash flow benefits.

I would say that at the current time for companies that have access to capital markets interest rates are at a historic low. And to the extent that accelerated depreciation really is a zero interest rate loan from the Federal Government, the benefits of accelerated depreciation at the current time are modest for those that have access to capital.

Chairman CAMP. All right. Thank you.

And, Ms. Hanlon, just finally, you mention in your testimony the important point that some of the analysis that we have been talking about today doesn't really apply to closely held businesses.

Could you just explain how closely held businesses might analyze tax reform differently than publicly held companies?

Ms. HANLON. Yes. There is a long line of literature in the accounting research that examines this exact book-tax tradeoff. And often what we will find, if we can get the data, we will line up public companies and private companies and essentially find that private companies are much more responsive to the tax incentives and tax reporting incentives than are public companies. And the idea is that the public companies have this financial accounting constraint. So it is probably true that private companies will respond to these incentives more than public companies will.

Chairman CAMP. Thank you very much.

Mr. Levin is recognized.

Mr. LEVIN. Except for the last few questions, we have been really discussing broader issues of tax reform and not book and tax accounting issues. We may be relieved by that, because we need to look at it. They are not easy issues, and you are going to have to, I think, have a few seminars with us on that subject as we look at these broader issues. So, it is really the broader issues that have been mostly discussed here, and let me just say a word about that.

There is no doubt we need to look at tax reform. There is no need, as I said earlier, to look at it with care and not simply grab ahold of a specific figure without looking at its consequences.

Because, according to the Joint Tax analysis, when we asked them, they said, if the rate were reduced to 28 percent, half of that reduction would come from ending accelerated depreciation. So when people say they want the rate dramatically reduced but not at the expense of—expense in accelerated depreciation, that doesn't really fit; and it was interesting in the testimony of the first two of you that you referred to that.

For example, in testimony—you know this well, Mr. Fryt—you said, our investors applaud capital incentives like expensing, because our after-tax cash flow on a new capital investment can be up to 35 percent less than it would be otherwise in the first year. And of course that evens out. But it is kind of a broad embrace of the importance of that.

And then I just—Mr. Schichtel, your testimony, if I might—you know it well. I will just read it. Because this is important for us to have a full, intelligent discussion of this vital issue. And this is on page 3:

Given the capital intensity of our business, however, we rely even more on—let me just read above.

Like most companies, we are strongly influenced by tax incentives that improve our reporting metrics, such as our reported income, effective tax rate, and our earnings per share. Items like the research credit and the Section 199 domestic production incentives are differences that permanently reduce our taxes paid and concomitantly our effective tax rate, thereby encouraging new investments.

And let me just indicate, I was looking as we were reading over your testimony last night at Marty Sullivan's analysis of winners and losers if there were a reduction in the rate to 30 percent with slower depreciation, repeal of the domestic production credit, and repeal of the research credit. This is his analysis, and I think all of us need to look at this and do other analyses. And it is really interesting, and it is not very surprising.

The industries that benefit from that—and I will just read a few that apply to you, I guess—securities, insurance, retail trade—these are winners. Bank holding companies, real estate, other services, it diminishes as I am going down the line. Wholesale. Mining is essentially even, as is construction.

And then those who are losers: food manufacturing, utilities, other manufacturing, chemicals, metals, minerals, and machinery manufacturing, transportation, Internet—I don't quite understand that but—agriculture, technical services, computer and electronics very dramatically. Transferred equipment very dramatically. And electrical products most dramatically.

So I think since the testimony has really mostly focused on these larger issues and not on the technical stuff that was headlined in the announcement of our hearing, I think your testimony today does underline the importance of our looking deeply into this issue. When we say everything is on the table, that doesn't really settle what is left on the table, right? In a sense, it is somewhat easy to say, put everything on the table. We do that all the time here. And the real issue becomes what is taken off and what is left.

So we welcome your testimony, and I hope that today's hearing is another step towards our comprehensively looking at these issues so that we can come out with a proposed revision of the Tax Code that very much keeps in mind what our objectives are.

And I go back to what I said in the opening. I do think that with the return of understanding of the importance of manufacturing we need to look at tax reform in terms of how we promote a continued growth in services, in agriculture, and the like but also in the industrial sector of the United States. And, Mr. Heenan, that is where you come from; and I think that somewhat motivates your—I won't say hesitation. I think it is kind of a well-rounded response.

Thank you.

Chairman CAMP. Thank you.

Mr. Johnson is recognized for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Fryt, how low would we have to get the rate before you guys could take over the Postal Service?

Mr. FRYT. Do I have to answer that question?

Mr. JOHNSON. Well, you are doing a good enough job right now. I have got a place out in New Mexico where you deliver to the door and the Postal Service doesn't even come.

Mr. FRYT. Well, if you ever have a problem, just give me a call, please, and I'll help you.

Mr. JOHNSON. In your testimony, you say the ideal reform would lower the rate to at least 25 percent, including incentives for investments such as bonus depreciation. However, you also say you are willing to put all base-broadeners on the table for a significantly simpler and reformed corporate Tax Code with a materially lower tax rate. What rate would that be if we were to give up all the other nicks?

Mr. FRYT. It really depends, Mr. Johnson. It depends what is in the package. But, given our competition overseas, we think it would have to be something close to the OECD rate. If you get there, presuming that doesn't continue to decline, I think, as Chairman Camp asked earlier, I think it would be a good place to be.

Mr. JOHNSON. Well, does that mean R&D tax credit and those kind of things would be—we could eliminate them if we got the rate low enough?

Mr. FRYT. I am sorry, sir?

Mr. JOHNSON. If we got the rate low enough, would you go along with that?

Mr. FRYT. Yes, sir.

Mr. JOHNSON. Okay. You know, I had a meeting with some of your guys in Dallas. They said 23 percent. Do you like that number better than 25? I bet you do.

Mr. FRYT. I do like 23 better than 25. Yes, sir. If you can make that happen, that would be terrific.

Mr. JOHNSON. Mr. Schichtel, given Time Warner is a capital-intensive business, would you care to comment on that as well?

Mr. SCHICHTEL. Yes. Thank you.

We care tremendously about timing issues like accelerated depreciation. For us, it is enormous. But I think when you—well, we have crunched the numbers, and we have looked at all the different policy proposals that are out there. We clearly care about the impact on cash flow, and I think lowering the rate clearly does improve our cash flow over the long run. If you get to a low enough rate and I think somewhere around a rate that is consistent with the developed world, say 25 percent, I think it is a clear winner for us as well as the economy.

Mr. JOHNSON. And you could get rid of all the other——

Mr. SCHICHTEL. Yes.

Mr. JOHNSON [continuing]. Okay. I am glad to hear it.

Mr. SCHICHTEL. I am not delighted to. I would love to keep accelerated depreciation, but I am a realist as well.

Mr. JOHNSON. Ms. Hanlon, in his testimony, Mr. Heenan argues that promoting investment accelerated depreciation is perhaps a more powerful tool than lower overall tax rates. You, however, say with respect to targeted tax incentives such as bonus depreciation there is very little evidence that these policies have spurred any investment. Can you comment on that?

Ms. HANLON. Yeah. My statement is based on the weight of the evidence in the literature. And, basically, there are papers that will show there is a timing effect. So firms will shift the purchase of equipment to a period that is earlier, say by in December instead of January. There is also evidence that firms will purchase a different class of asset.

But what we can't tell in the literature and what is very difficult to parse out is whether these are—you know, part of it is just timing, part of it is just shifting, and some of it could just be a change in reporting. So that, in other words, when you say a certain class of asset gets a certain benefit, they might just now record different assets differently. We can't tell that in the literature, and the research that tries to look at aggregate effects really find very little. So it is just the weight of the evidence, a large sample.

Mr. JOHNSON. Have you done any studies on eliminating all the incentives and just lowering the tax rate?

Ms. HANLON. Not directly, no.

Mr. JOHNSON. Thank you, Mr. Chairman.

Chairman CAMP. Mr. Davis is recognized.

Mr. DAVIS. Thank you, Mr. Chairman. I am very interested in this discussion on both counts, having worked for many years in manufacturing before coming to the House of Representatives. First I would like to preface my question with I agree with the macro concern that Professor Hanlon talked about that a rate reduction overall is certainly more beneficial in the long term and certainly support that.

But I would like to come back into a manufacturing or operations/capital investment question on trying to balance this out inside of or underneath the umbrella of strategy.

I worked with many clients, I was discussing earlier three in particular, before some of the bonus depreciation issues came out after 9/11 and in subsequent years where they were very reluctant due to market cycles to make investment in machine tool technology and other systems that would be very helpful to them. This is particularly smaller businesses, under $100 million manufacturing firms, but surprisingly a number of my clients in the Fortune 500 had that same experience on a reluctance-based on market cycle, particularly with shareholder expectations in the long term.

I guess the question that I would like to understand is how we address this issue of depreciation from a strategic standpoint within the long term. Bringing the rates down is certainly important to me from a tax perspective, but also having this incentive for investment is a bigger question.

I guess considering the long-term, if we were able to work out a mechanism, and I would like to hear thoughts from all of you, but specifically Professor Hanlon and Mr. Heenan on this, since you have both been talking about this the most, if we were able to adjust depreciation schedules within the intent of the overall tax strategy that would provide the ability, knowing that the tax liability would be the same to your company in the longer term, but to do it on a more proportional basis.

When there is a great year and the well is full of water, the idea of let's go ahead and make this capital investment to be leaned up and ready for more difficult times, being able to control costs when you have got the ability to invest in those technologies, knowing that there will be a down cycle eventually. I am thinking heavy manufacturing, the energy industry, areas that I saw that were very reluctant to get involved and make these investments. Or, say, maybe if you had a great year, a small $50 million company can invest in a couple of $800,000 machine tools and write it off in one year but know they are going to take that. Certainly there would be a lower profit, but the idea of longer term is those jobs are protected and they become more competitive.

Where this gets particularly challenging to me is looking at a lot of our international manufacturing. Contrary to a lot of the politics in Washington, we are very robust, very strong and competitive in manufacturing, but there is still this reluctance with many of the tier one and tier two producers to make these decisions, and if they could reduce it down, say, into a 2, 4, 7-year schedule, if they want to go to the longer term schedules, that is perfectly acceptable. But how would that work inside of this idea of rate reduction if we could manage that to keep things revenue neutral and what would the impact of that be from a wider standpoint?

Mr. HEENAN. Just to get on your bonus comment and make sure I understand your question, were you saying, hey, maybe we slow down depreciation a little bit and then bring bonus in and out to help encourage investment?

Mr. DAVIS. What I am talking about is allowing the manufacturing company who is getting ready to make these capital investments. And I am not talking about all asset classes. I think that would be a grave error and would just totally stir up the tax system. But some specific areas that are very critical to our strategic manufacturing economically is that the employer would simply have the ability to pick the schedule, or the company would pick the schedule that is most advantageous to them, and rather than have these kind of boom-and-bust cycles on policy, have that fit into the overall tax strategy, so that in a good year in one sector, say you can make the investment that maybe FedEx would not make based on what they are doing, or vice versa, but within those time frames.

But coming back, how would you work that as well inside of the rate structure, keeping that lower rate because of the longer term implications?

Mr. HEENAN. I think I understand your question. Just to focus on Praxair, we have, as I mentioned earlier, fairly large capital projects and these can take a couple of years before you start the process and finally sign somebody up and sell and implement it. So what we really need is a consistent process that we can follow, consistent rules. And, frankly, bonus has not been something that has been advantageous to us, because we have got—bonuses coming and going is not in the law today. We need something, whether it is the current system or another rate schedule, that we can depend on, because we have sort of a long cycle time and we have to think forward 2 and 3 years and make sure the law then is going to be the same as the law today. And if we can't, as with bonus, we are not going to model that.

When we sit around the table and make our investment decisions, we are not going to put something and say, well, you know, they may re-up bonus in a couple years. Let's throw that in here in our decision on whether to invest.

Mr. DAVIS. So that you are looking at predictability.

Mr. HEENAN. We are looking for predictability. Accelerated depreciation has been a long time in our code, and it is in our sort of model today. Bonus is not.

Mr. HERGER. [Presiding.] The gentleman's time has expired. Mr. Rangel is recognized for 5 minutes.

Mr. RANGEL. Thank you, Mr. Chairman, and thank you all for coming down and giving us this testimony.

One of you congratulated Chairman Camp for moving in this direction, and if he were here, I would congratulate him too, because what we are doing is keeping the idea alive. But it just seems to me with the outstanding representation from some of the nations and the world's most successful businesses, that while Chairman Camp has opened the door for reform, that it is going to be your responsibility to put your foot in that open door and don't let it close.

It is absolutely no profile in courage for all of us to say reduce the corporate rates and expand the base, but not my base. I came down here as a tax reformer, and, believe me, Earned Income Tax Credit, Low Income Housing Credit, whatever we can do for our veterans, whatever it is, we have allowed probably a half a trillion dollars to get involved in what they call extenders. Is there anyone here who doesn't know what the extenders are? Or those tax provisions that expire, or at least we say they are going to expire, and all they want to do is to get them in the code.

Someone said seeing tax law made is like seeing sausage made. You just don't want to see it.

Now, what I am suggesting is that if this outstanding group of corporations that you have listed, how often do you meet, this group that—what is the name of it?

Mr. FRYT. RATE, Reforming America's Taxes Equitably.

Mr. RANGEL. Yes. Because our problem here is that the lobbyists represent the best tax interests of their clients. Reform is not on their agenda. If they came back to you vice-presidents and presidents and said, what a great talk I had with Ways and Means people, we will have to give up accelerated depreciation and a whole lot of other things, but wow, would this be a fairer system, they would get fired. Their job is to broaden the gap or to create one, temporarily, but never allow it to sunset.

So what we do need are people that have the credibility that you guys have, and ladies, to get in the room and to find out what we can get away with as elected officials. Nobody is talking about getting rid of charitable organizations and churches for exemptions. There is a lot of money there. And, of course, if you talked about mortgages, you have got to narrow the amount of money, the number of deductions that are in there. Who is going to bite the bullet to get rid of them in order to have a fairer system?

I am asking FedEx and Time Warner, what can you do to get people in a room to say we are not agreeing to anything, or we are saying this will be the impact economically. How can we take this the next step? Because we need a climate—I was here until 1986. We had Tip O'Neill. All he knew was how to get along with Republicans. Why, I don't know, but that was the way Tip worked. We had Ronald Reagan, and he was blinded by party lines. And they were able, we were able to get what we thought at the time was reform.

It is difficult to talk about reform. It is a question of whose ox is being gored. So what doesn't surprise me that if you are paying 35 percent tax, what does surprise me is that you are not outraged. Outraged. Don't thank us. What are you going to do about it? Because you have got a great argument in terms of equity. But nobody is going to be out front saying that we are going to get rid of some of the darn things that we put in the code, some of which we have forgotten. And when we extend them, it is the whole package. And you can see some of the things that my colleagues are talking about just to pay for the holiday tax package. They have got imagination, but it is not good law.

So, Mr. Chairman, I was trying to negotiate with you an extended time period. I know I wasn't persuasive. But could one of you just say what you could do in terms of taking this to the next step?

Mr. FRYT. Absolutely, Mr. Rangel. First off, I would like to commend you and the efforts you have put forth in this whole effort.

Mr. HERGER. The gentleman's time has expired. Maybe, Mr. Fryt, you could respond by letter.

Mr. RANGEL. I would ask unanimous consent to let our guests——

Mr. HERGER. Mr. Nunes is recognized for 5 minutes.

Mr. NUNES. Mr. Chairman, I yield the balance of my time to Mr. Tiberi.

Mr. TIBERI. Thank you. Very interesting comments. I do want to point out just for the audience and for the record, when the former chairman mentioned that nobody is talking about getting rid of the charitable contribution, that actually in the President's prior three budgets, the President has capped the deduction on the charitable contribution at 28 percent. I just wanted to remind the gentleman from New York regarding the President's last three budgets and what he proposed. Obviously it wasn't adopted by the Congress, but there is one person in Washington who has talked about the issue in the context of reducing that charitable contribution. I wish Mr. Lewis were here, because he and I, as the chairmen of the Philanthropy Caucus, have both opposed that as cochairmen of the Philanthropy Caucus.

But to the witnesses today, starting on the left, those of you who are vice-presidents of companies dealing with tax issues, can you tell me who your major competitor is and how the current Tax Code causes you to make decisions based upon investments? Starting to my left.

Mr. FRYT. Sure. Well, the United States Postal Service. They don't pay any tax. UPS. Their tax profile is fairly similar to ours. And we have several international competitors, DHL, TNT and others. As an example, DHL's reported ETR, its effective tax rates over the last 10 years, have hovered around 20 percent vis-à-vis our 36–37 percent. That is why I say us paying at what we are right now is a real competitive disadvantage because they have additional after-tax funds that they can continue to reinvest in their global networks that we don't have.

Mr. TIBERI. And they compete with you here and abroad?

Mr. FRYT. Yes, sir.

Mr. SCHICHTEL. Well, our main competitors are the two big boys, AT&T and Verizon, as well as the satellite companies, Direct TV and Dish. And then obviously we compete globally in the capital markets for investments. And as far as the impact on the communications industry, I think Verizon and AT&T are much more similar to us than maybe even the satellite companies, although the difference isn't that large. We are all capital-intensive companies.

And for us, tax reform is more about getting this economy stabilized and growing, because that is really where our growth is going to come from.

Mr. TIBERI. So even though you don't compete—I am trying to get more of an answer from you. I don't want to put words in your mouth, but let me tell you what I am trying to do and then maybe you can answer.

Even though you don't have a, quote-unquote, international competitor, you are competing internationally for capital.

Mr. SCHICHTEL. Yes.

Mr. TIBERI. So the Tax Code impacts you how with respect to that?

Mr. SCHICHTEL. Well, I think if you look at some of the analysis and research that has been done, companies with lower effective tax rates do have an advantage when it comes to garnering investment from the global capital markets. So from our vantage point, that clearly is an issue. Also from just the perspective of raising capital and also being able to invest more and grow our business, an economy that is more robust is going to help us on both fronts.

Mr. TIBERI. So because capital is fungible and it can go anywhere in the world, it is going to go where——

Mr. SCHICHTEL [continuing]. It is going to go where they believe the highest return is at.

Mr. TIBERI. On their investment.

Mr. SCHICHTEL. Yes.

Mr. TIBERI. So even though you are a company that is investing in the United States in terms of jobs, and more jobs in Ohio—thank you very much, that was just announced—even though you are a domestic company, domestic jobs, that international competition in terms of tax rate is very important to the growth of your business in America.

Mr. SCHICHTEL. It is. And it is also very important to our customers. Our highest growth area is in the commercial services arena and our customers, small, medium and large, they do compete intensively in the global markets, and our success is tied to their success.

Mr. TIBERI. Thank you. Praxair?

Mr. HEENAN. Good morning. You know, I think in the U.S. we have—we are competing against Air Products, a U.S.-based multinational. Outside the U.S. we have Air Liquide and Linde, French and German companies. And when we look at the U.S., we are all—when we are doing business here, we are all competing at the same rate, but, as you said, you know, capital can move.

So when we look at the foreign projects, you know, what we really want and I think we have today, maybe not perfectly, is to have a level playing field on the tax rates offshore. So if we are looking at a project in Mexico or France or Germany, we want to be on a level playing field with our competitors so that we can win our share of those projects. We are headquartered in Danbury, Connecticut. We have our R&D in Tonawanda, New York. That offshore growth comes back here to the U.S. So it is important for us to remain competitive on the offshore projects.

Mr. TIBERI. Thank you, Mr. Chairman.

Mr. HERGER. Mr. Brady is recognized for 5 minutes.

Mr. BRADY. Well, thank you all for being here today. First, I appreciate the chairman holding this hearing. Secondly, I think the draft proposal on territorial and lower rates, the way it was laid out, has been a very positive and helpful movement toward fundamental tax reform. All the witnesses today have really opened up a lot of questions on how we move forward in doing it, doing it with the most pro-growth impact, weighing both the book and the accounting and tax-type requirements you are under. So I could ask all of you about a dozen questions.

I wanted to ask our two business representatives from FedEx and Time Warner, both of you rightly make the case that in addition to lowering the corporate tax rate, that there is a need for capital investment incentives. And you are willing to put everything on the table; but recognize, looking at the last 40 and 50 years, the single strongest correlating driver for new jobs is private business investment. You are building buildings, buying software, new equipment and technology, jobs along Main Street, growth.

So my goal is at the end of the day, I want the lowest possible tax rate, but I want the strongest possible pro-growth Tax Code, one that allows us to have the largest economy in the world, not until China catches us or someone else, but for the next 100 years.

So I want to ask, as you are willing to put everything on the table, which I think is very important, what are the strongest, looking at the cost of capital in investment, what is the strongest capital investment incentive that ought to be considered to remain in the Tax Code?

Mr. FRYT. From our perspective, I think 100 percent expensing permanent, on a permanent basis, would be extremely strong. Investment tax credit can be crafted in a similar manner. There were some issues with that in the past. But expensing works quite well. It doesn't address the financial reporting-type issues that Ms. Hanlon was talking about earlier, but it still affects the cash flow, and it has a tremendous impact on our environment and other companies like us.

Mr. BRADY. So 100 percent expensing would be the top.

Mr. FRYT. Yes.

Mr. BRADY. Mr. Schichtel.

Mr. SCHICHTEL. For us the biggest driver when it comes to investments is a growing economy. So I think if we can get there, all else, all other problems will eventually improve and rectify and remedy.

As far as immediate sort of short-term policy, clearly bonus depreciation expensing is tremendously important right now. We are being hit by the reversal of prior year benefits from bonus depreciation just as our economy is struggling to pick up a little bit of momentum. I think now is not the time to have those reversals take full effect.

I think overall, if you can get to a low enough rate, it will encourage growth and it will more than make up for the loss of some of the tax incentives, including even accelerated depreciation. But that requires us getting to really a much more meaningfully lower rate, somewhere around 25 percent.

Mr. BRADY. Clearly, we know what we can do to get to 28 percent. Getting down that final three points will be a thoughtful discussion.

With what little time I have left, can I ask the other witnesses your thoughts on the strongest pro-growth Tax Code?

Mr. HEENAN. Yes, just a little bit different than the profiles of some of the other companies. As I mentioned earlier, bonus depreciation really isn't helpful for us because it comes in and out. If it were to become a permanent fixture in the Tax Code, we would put that into our decisions.

Mr. BRADY. Which is what we are seeking, permanent tax provisions rather than temporary ones.

Mr. HEENAN. Right. But I think we recognize that that would be extraordinarily expensive and we need revenues. So the current provision like that is accelerated depreciation, so that would be the one I think that, practically speaking, you might be able to keep. If you go to a permanent bonus structure, you are going to have a very costly solution there. We would be happy to take it, but I think it would really cost too much for the country.

Mr. BRADY. We are running short.

Mr. NEUBIG. When tax policy analysts look at permanent bonus depreciation or permanent 100 percent first-year write off, they generally argue you would need to repeal the interest deduction in order to prevent negative effective tax rates. So you would need to think about not only expensing, but also the impact on the interest deduction.

Mr. BRADY. Thank you.

Mr. HERGER. Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I want the audience and the witnesses to recognize that this is a day in which we have all gathered here with sober faces for holy pictures. We are all for tax reform. Everybody in this room is for tax reform. We are on the Ways and Means Committee. We do tax reform, right?

Now, Mr. Johnson has asked you, have you studied how low you could get the tax rate if you eliminated business tax expenditures, and none of the witnesses—all of the witnesses said they haven't. So I just want to enter—I am going to ask unanimous consent to enter into the record the study from Joint Tax, dated 27 October, 2011, which talks about what you would really have to do if you are serious here.

[The information follows:]

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515–6453

OCT 27 2011

MEMORANDUM

TO: [illegible]

FROM: Thomas A. Barthold TAB

SUBJECT: Revenue Estimates

The attached tables are in response to your request for estimates of repealing or modifying corporate tax expenditures and an estimate of the lowest possible corporate income tax rate that could be enacted through legislation that is revenue neutral for C corporations in conjunction with the repeal or modification of these provisions.

The attached tables generally follow the order of Table 1 published in Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), December 15, 2010. Tax expenditures listed in that publication that primarily affect individuals or pass-through entities are excluded from the attached tables. A number of the tax expenditure items on the attached tables affect both C corporations and pass-through entities.

Table #11-1 133 provides the revenue effects of the repeal or modification of certain corporate tax expenditure provisions, including the portion that is claimed by partnerships, S corporations, and other pass-through entities. Table #11-1 134 includes only the revenues attributable to C corporations and excludes the portion attributable to pass-through entities. Table #11-1 134, which excludes revenues attributable to activities conducted in pass-through entities, shows the lowest possible corporate income tax rate that is revenue neutral for C corporations. In both tables, not all provisions are estimated at this time although the estimates do include almost all of the major corporate tax expenditure provisions.

As we have previously reported to you, it is not always obvious what tax rules would be applicable when certain tax expenditures are eliminated. In the attached tables we have made some judgments. As another example, we have assumed that elimination of the tax expenditure related to the geological and geophysical costs of oil and gas companies would result in those costs being amortized and recovered over a seven-year period (Table #11-1 133, item II.20.).

Please note that these estimates are very preliminary as we continue to upgrade our models relating to corporate tax reform. Also, note that the estimated revenue effects for some of the reform provisions do not include effects of anticipatory actions that we expect taxpayers would take with sufficient advance notice of the reforms. Further, while some major interaction

Congress of the United States
JOINT COMMITTEE ON TAXATION
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TO: [redacted] Page 2
SUBJECT: Revenue Estimates

effects are included in these estimates, such as interactions with rates, we have not yet estimated all possible interactions that may exist between provisions.

Also please note that the estimated revenues attributable to C corporations are based on the current division of business entities among sole proprietorships, pass-through entities, and C corporations. Should a corporate tax reform proposal target only C corporations and leave the treatment of tax expenditures unchanged for other business entities, the revenue gains from C corporations will potentially be significantly reduced as business entities change their form or structure to minimize their tax liabilities. In addition, there are potentially significant administrative and compliance implications of partial repeal of tax expenditures that likely affect the revenue effect.

Should all of the provisions which we have estimated in the attached table be repealed, the lowest top corporate income tax rate which achieves revenue neutrality for C corporations is estimated to be 28 percent. In estimating the revenue from the repeal or modification of each tax expenditure, and determining this revenue neutral rate, we have assumed that no transition relief is provided for any revenue raising provision. We have assumed that almost all of the provisions would be effective for taxable years beginning after 2011. The estimated 28 percent tax rate could change as estimates are refined, if provisions are added or removed from the list, and as any transition relief is developed for revenue raising provisions.

Finally, there are several provisions that do not change the total value of nominal deductions permitted to the taxpayer, but rather change the years in which such deductions may be claimed. For example, limiting depreciation deductions to the alternative depreciation system rather than the MACRS depreciation system changes the timing of deductions rather than the total nominal value of the deductions. The 10-year budget estimates for such provisions are significantly larger than the long-run effects where all vintages of investment are depreciated under the new regime. Similarly, the estimate in Table #11-1 134 (itemV.18.b) regarding the repeal of the inventory valuation method of the lower of cost or market value, shows that all the revenue raised from repeal accrues prior to fiscal year 2019, with little revenue estimated to be raised in fiscal year 2019 or thereafter. Therefore, we also emphasize that while we estimate that a rate of 28 percent would achieve revenue neutrality for C corporations within the 10-year budget window, this rate would not necessarily be revenue neutral under a longer budget horizon.

Attachment: Tables #11-1 133 and #11-1 134

- Committee on Ways and Means -

ESTIMATED REVENUE EFFECTS OF CORPORATE TAX REFORM REVENUE RAISING PROVISIONS THAT REPEAL OR MODIFY TAX EXPENDITURES

Fiscal Years 2012 - 2021

[Billions of Dollars]

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
I. General Science, Space, and Technology													
1. Credit for increasing research activities (section 41)	tyba 12/31/11	*No Revenue Effect*											
2. Expensing of research and experimental expenditures	tyba 12/31/11	30.4	41.4	32.3	22.1	11.1	7.0	6.9	5.0	2.8	1.1	137.4	160.2
II. Energy													
1. Credits for alternative technology vehicles	tyba 12/31/11	[1]	[1]	[1]	[1]	---	---	---	---	---	---	[1]	[1]
2. Credit for holders of clean renewable energy bonds (sections 54 and 54C)	tyba 12/31/11	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	0.1	0.3
3. Exclusion of energy conservation subsidies provided by public utilities	tyba 12/31/11	*Presently Unavailable*											
4. Credit for holder of qualified energy conservation bonds	tyba 12/31/11	[1]	[1]	[1]	[1]	[1]	0.1	0.1	0.1	0.1	0.1	0.1	0.4
5. Credit for enhanced oil recovery costs	tyba 12/31/11	*No Revenue Effect*											
6. Repeal credits for alcohol fuels	saua DOE	*Presently Unavailable*											
7. Energy credit (section 48)	tyba 12/31/11	0.4	0.5	0.6	0.7	0.8	0.5	0.5	0.4	0.4	0.4	3.0	5.3
a. Solar	tyba 12/31/11	*Estimate Included in Item II.7.*											
b. Geothermal	tyba 12/31/11	*Estimate Included in Item II.7.*											
c. Fuel cells	tyba 12/31/11	*Estimate Included in Item II.7.*											
d. Microturbines	tyba 12/31/11	*Estimate Included in Item II.7.*											
e. CHP property	tyba 12/31/11	*Estimate Included in Item II.7.*											
f. Small wind systems	tyba 12/31/11	*Estimate Included in Item II.7.*											
8. Credits for electricity production from renewable resources (section 45)	tyba 12/31/11	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4	1.2	2.9
a. Wind	tyba 12/31/11	*Estimate Included in Item II.8.*											
b. Closed-loop biomass	tyba 12/31/11	*Estimate Included in Item II.8.*											
c. Geothermal	tyba 12/31/11	*Estimate Included in Item II.8.*											
d. Qualified hydropower	tyba 12/31/11	*Estimate Included in Item II.8.*											
e. Solar (limited to facilities placed in service before 1/1/06)	tyba 12/31/11	*Estimate Included in Item II.8.*											
f. Small irrigation power	tyba 12/31/11	*Estimate Included in Item II.8.*											
g. Municipal solid waste	tyba 12/31/11	*Estimate Included in Item II.8.*											
h. Open-loop biomass	tyba 12/31/11	*Estimate Included in Item II.8.*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
9. Credits for investments in clean coal facilities	tyba 12/31/11						Presently Unavailable						
10. Coal production credits:													
a. Refined coal	tyba 12/31/11						Presently Unavailable						
b. Indian coal	tyba 12/31/11						Presently Unavailable						
11. Credit for the production of energy-efficient appliances	tyba 12/31/11						No Revenue Effect						
12. Credit for clean-fuel vehicle refueling property	tyba 12/31/11						No Revenue Effect						
13. New energy efficient homes credit	tyba 12/31/11						Presently Unavailable						
14. Credit for investment in advanced energy property	tyba 12/31/11	0.4	0.3	0.1	0.1	[1]	[1]	[3]	[3]	[3]	---	0.9	0.8
15. Exclusion of interest on State and local government qualified private activity bonds for energy production facilities	tyba 12/31/11						Estimate Included in Item XIV.1.						
16. Deduction for expenditures on energy-efficient commercial building property	tyba 12/31/11	0.2	0.2	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	0.3	0.3
17. Repeal expensing of oil and gas exploration and development costs	cpoia 12/31/11	1.0	1.5	1.4	1.3	1.1	0.9	0.5	0.2	0.2	0.2	6.3	8.3
18. Repeal percentage depletion for oil and natural gas wells	tyba 12/31/11	0.6	0.9	1.0	1.0	1.1	1.1	1.2	1.2	1.3	1.3	4.7	10.8
19. Repeal percentage depletion for coal and hard mineral fossil fuels	tyba 12/31/11	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6	1.3
20. Increase geological and small integrated geophysical amortization period for independent producers to seven years	apoia 12/31/11	[1]	0.2	0.2	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.8	1.0
21. Amortization of air pollution control facilities	tyba 12/31/11	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8	1.3
22. Depreciation recovery periods for energy specific items:													
a. Five-year MACRS for certain energy property (solar, wind, etc.)	tyba 12/31/11						Estimate Included in Item XIV.2.						
b. 10-year MACRS for smart electric distribution property	tyba 12/31/11						Estimate Included in Item XIV.2.						
c. 15-year MACRS for certain electric transmission property	tyba 12/31/11						Estimate Included in Item XIV.2.						
d. 15-year MACRS for natural gas distribution line	tyba 12/31/11						Estimate Included in Item XIV.2.						
23. Election to expense 50 percent of qualified property used to refine liquid fuels	tyba 12/31/11						Presently Unavailable						
III. Natural Resources and Environment													
1. Special depreciation allowance for certain reuse and recycling property	tyba 12/31/11						Estimate Included in Item XIV.2.						
2. Expensing of exploration and development costs, nonfuel minerals	tyba 12/31/11	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	1.0
3. Excess of percentage over cost depletion, nonfuel minerals	tyba 12/31/11	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.9
4. Expensing of timber-growing costs	tyba 12/31/11						Presently Unavailable						

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
5. Special rules for mining reclamation reserves	tyba 12/31/11	*Presently Unavailable*											
6. Impose full tax rate on nuclear decommissioning reserve funds	tyba 12/31/11	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5	1.2
7. Exclusion of contributions in aid of construction for water and sewer utilities	tyba 12/31/11	*Presently Unavailable*											
8. Exclusion of earnings of certain environmental settlement funds	tyba 12/31/11	*Presently Unavailable*											
9. Amortization and expensing of reforestation expenditures	tyba 12/31/11	*Presently Unavailable*											
IV. Agriculture													
1. Expensing of soil and water conservation expenditures	tyba 12/31/11	*Presently Unavailable*											
2. Expensing of the costs of raising dairy and breeding cattle	tyba 12/31/11	*Presently Unavailable*											
3. Exclusion of cost-sharing payments	tyba 12/31/11	*Presently Unavailable*											
4. Exclusion of cancellation of indebtedness income of farmers	tyba 12/31/11	*Presently Unavailable*											
5. Five-year carryback period for net operating losses attributable to farming	tyba 12/31/11	*Presently Unavailable*											
6. Expensing by farmers for fertilizer and soil conditioner costs	tyba 12/31/11	*Presently Unavailable*											
V. Commerce and Housing													
A. Housing:													
1. Repeal the exclusion of interest on all State and local government qualified private activity bonds	bia 12/31/12	*Estimate Included in Item XIV. I.*											
2. Repeal the credit for low-income housing	caa 12/31/12	---	0.2	0.6	1.5	2.5	3.6	4.8	6.0	7.2	8.4	4.8	34.8
3. Repeal the rehabilitation credit	caa 12/31/12	---	0.1	0.4	0.5	0.7	0.8	0.8	0.9	0.9	0.9	1.7	6.0
4. Depreciation of rental housing in excess of alternative depreciation system	tyba 12/31/11	*Presently Unavailable*											
B. Other Business and Commerce:													
1. Exclusion of interest on State and local government small-issue qualified private activity bonds	bia 12/31/12	*Estimate Included in Item XIV. I.*											
2. 15-year recovery period for retail motor fuels outlets	tyba 12/31/11	*Presently Unavailable*											
3. Repeal the special rules for non-dealer installment sales	N/A	*Presently Unavailable*											
4. Repeal the deferral of gain on like-kind exchanges	eca 12/31/12	---	0.1	0.2	0.4	0.6	1.1	1.9	2.9	4.4	6.6	2.4	18.2
5. Expensing under section 179 of depreciable business property	tyba 12/31/11	*Presently Unavailable*											
6. Amortization of business startup costs	tyba 12/31/11	*Presently Unavailable*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
7. Reduced rates on first $10,000,000 of corporate taxable income	tyba 12/31/11						*Presently Unavailable*						
8. Exemptions from imputed interest rules	tyba 12/31/11						*Presently Unavailable*						
9. Expensing of magazine circulation expenditures	tyba 12/31/11						*Presently Unavailable*						
10. Special rules for magazine, paperback book, and record returns	tyba 12/31/11						*Presently Unavailable*						
11. Repeal the completed contract rules method	sooda 12/31/12	—	0.9	2.1	2.3	2.4	2.5	1.5	0.7	0.7	0.8	7.7	13.9
12. Cash accounting, other than agriculture	tyba 12/31/11						*Presently Unavailable*						
13. Credit for employer-paid FICA taxes on tips	tyba 12/31/11	0.7	0.7	0.7	0.8	0.8	0.8	0.9	0.9	0.9	0.9	3.6	8.2
14. Repeal the deduction for income attributable to domestic production activities	tyba 12/31/11	4.3	13.9	14.7	15.6	16.5	17.6	18.6	19.7	20.9	22.1	65.0	163.9
15. Credit for the cost of carrying tax-paid distilled spirits in wholesale inventories	tyba 12/31/11						*Presently Unavailable*						
16. Expensing of costs to remove architectural and transportation barriers to the handicapped and elderly	tyba 12/31/11						*Presently Unavailable*						
17. Ordinary gain or loss treatment for sale or exchange of Fannie Mae and Freddie Mac preferred stock by certain financial institutions	tyba 12/31/11						*Presently Unavailable*						
18. Inventory methods and valuation:													
a. Repeal last in first out	tyba 12/31/12	—	3.9	6.9	7.3	7.5	7.9	8.5	8.9	9.2	9.6	25.5	69.7
b. Repeal lower of cost or market	tyba 12/31/12	—	0.1	0.8	0.9	0.7	0.3	0.1	[1]	[1]	[1]	2.4	2.9
c. Specific identification for homogeneous products	tyba 12/31/11						*Presently Unavailable*						
19. Exclusion of gain or loss on sale or exchange of Brownfield property	tyba 12/31/11						*Presently Unavailable*						
20. Income recognition rule for gain or loss from section 1256 contracts	tyba 12/31/11						*Presently Unavailable*						
21. Net alternative minimum tax attributable to net operating loss limitation	tyba 12/31/11						*Presently Unavailable*						
22. Exclusion of interest on State and local qualified private activity bonds for green buildings and sustainable design projects	tyba 12/31/11						*Estimate Included in Item XIV.1.*						
23. Repeal MACRS and apply ADS in the depreciation of buildings other than rental housing	ppisa 12/31/11						*Estimate Included in Item XIV.2.*						
24. Repeal MACRS and apply ADS in the depreciation of equipment	ppisa 12/31/11						*Estimate Included in Item XIV.2.*						
25. Inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument	tyba 12/31/11						*Presently Unavailable*						
26. 5-year carryback of general business credits	tyba 12/31/11						*Presently Unavailable*						
C. Financial Institutions:													
1. Exemption of credit union income	tyba 12/31/11						*Presently Unavailable*						

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
D. Insurance Companies:													
1. Expand pro rata interest expense disallowance for company-owned life insurance	[2]	0.1	0.2	0.4	0.5	0.6	0.8	0.9	1.0	1.1	1.2	1.9	6.8
2. Small life insurance company taxable income adjustment	tyba 12/31/11	*Presently Unavailable*											
3. Special treatment of life insurance company reserves	tyba 12/31/11	*Presently Unavailable*											
4. Special deduction for Blue Cross and Blue Shield companies	tyba 12/31/11	0.2	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6	2.0	4.8
5. Tax-exempt status and election to be taxed only on investment income for certain small property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
6. Interest rate and discounting period assumptions for reserves of property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
7. Proration for property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
VI. Transportation													
1. Deferral of tax on capital construction funds of shipping companies	tyba 12/31/11	*Presently Unavailable*											
2. Exclusion of interest on State and local government qualified private activity bonds for highway projects and rail-truck transfer facilities	tyba 12/31/11	*Estimate Included in Item XIV.I.*											
3. High-speed intercity rail vehicle speed requirement for exempt high-speed rail facility bonds	tyba 12/31/11	*Estimate Included in Item XIV.I.*											
4. Exclusion of interest on State and local government private activity bonds for private airports, docks, and mass-commuting facilities	bia 12/31/12	*Estimate Included in Item XIV.I.*											
VII. Community and Regional Development													
1. Empowerment zone tax incentives	tyba 12/31/11	*Presently Unavailable*											
2. New markets tax credit	tyba 12/31/11	*Presently Unavailable*											
3. Repeal the District of Columbia tax incentives	N/A	*Presently Unavailable*											
4. Credit for Indian reservation employment	tyba 12/31/11	*Presently Unavailable*											
5. Exclusion of interest on State and local government qualified private activity bonds for sewage, water, and hazardous waste facilities	bia 12/31/12	*Estimate Included in Item XIV.I.*											
6. Issuance of recovery zone economic development bonds	tyba 12/31/11	*Presently Unavailable*											
7. Issuance of tribal economic development bonds	tyba 12/31/11	*Estimate Included in Item XIV.I.*											
8. Build America bonds	tyba 12/31/11	*Provision Expired*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
9. Eliminate requirement that financial institutions allocate interest expense attributable to tax-exempt interest	tyba 12/31/11	*Presently Unavailable*											
10. Disaster Relief:													
a. Gulf opportunity zone	tyba 12/31/11	*Presently Unavailable*											
b. Midwest disaster relief	tyba 12/31/11	*Presently Unavailable*											
c. National disaster relief	tyba 12/31/11	*Presently Unavailable*											
VIII. Education, Training, Employment, and Social Services													
A. Education and Training:													
1. Exclusion of interest on Sate and local government qualified private activity bonds for student loans	bia 12/31/11	*Estimate Included in Item XIV.1.*											
2. Exclusion of interest on State and local government qualified private activity bonds for private nonprofit and qualified public educational facilities	bia 12/31/12	*Estimate Included in Item XIV.1.*											
3. Credit for holders of qualified zone academy bonds	tyba 12/31/11	*Presently Unavailable*											
4. Deduction for charitable contributions to educational institutions	tyba 12/31/11	*Presently Unavailable*											
B. Employment:													
1. Repeal deduction for dividends paid to an employee stock ownership plan (ESOP)	dpa DOE	0.4	0.4	0.6	0.6	0.6	0.7	0.7	0.7	0.8	0.8	2.7	6.3
2. Deferral of taxation on spread on acquisition of stock under incentive stock option plans	tyba 12/31/11	*Presently Unavailable*											
3. Deferral of taxation on spread on employee stock purchase plans	tyba 12/31/11	*Presently Unavailable*											
4. Disallowance of deduction for excess parachute payments (applicable if payments to a disqualified individual are contingent on a change of control of a corporation and are equal to or greater than three times the individual's annualized includible compensation)	tyba 12/31/11	*Presently Unavailable*											
5. Limits on deductible compensation	tyba 12/31/11	*Presently Unavailable*											
6. Work opportunity tax credit	tyba 12/31/11	*Provision Expires December 31, 2011*											
7. Credit for retention of certain newly hired workers	tyba 12/31/11	*Provision Expires December 31, 2011*											
C. Social Services:													
1. Credit for employer-provided dependent care	tyba 12/31/11	[1]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	-0.1	-0.2
2. Deduction for charitable contributions other than for education and health	tyba 12/31/11	*Presently Unavailable*											
3. Credit for disabled access expenditures	tyba 12/31/11	*Presently Unavailable*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
IX. Health													
1. Exclusion of interest on State and local government qualified activity bonds for private nonprofit hospital facilities	bia 12/31/12	*Estimate Included in Item XIV.1.*											
2. Deduction for charitable contributions to health organizations	tyba 12/31/11	*Presently Unavailable*											
3. Credit for orphan drug research	tyba 12/31/11	*Presently Unavailable*											
4. Premium subsidy for COBRA continuation coverage	tyba 12/31/11	*Presently Unavailable*											
5. Tax credit for small businesses purchasing employer insurance	tyba 12/31/11	*Presently Unavailable*											
X. Medicare													
1. Exclusion of Medicare benefits - exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees	tyba 12/31/11	*Presently Unavailable*											
XI. Income Security													
1. Exclusion of disaster mitigation payments	tyba 12/31/11	*Presently Unavailable*											
XII. General Purpose Fiscal Assistance													
1. Exclusion of interest on public purpose State and local government bonds	tyba 12/31/11	*Presently Unavailable*											
XIII. Veterans Benefits and Services													
1. Exclusion of interest on State and local qualified private activity bonds for veterans' housing	bia 12/31/12	*Estimate Included in Item XIV.1.*											
XIV. General Corporate Tax Provisions													
1. Eliminate exclusion of interest on private activity bonds	bia 12/31/12	---	0.1	0.2	0.4	0.7	1.0	1.3	1.6	1.9	2.1	1.4	9.2
2. Repeal MACRS and apply ADS	tyba 12/31/11	19.5	56.6	82.0	91.8	95.1	96.1	79.4	72.9	67.1	63.5	345.0	724.1
XV. Reduction in Corporate Rate to 28%	**tyba 12/31/11**	**-40.5**	**-65.3**	**-71.0**	**-75.8**	**-77.0**	**-76.0**	**-77.0**	**-76.4**	**-78.2**	**-80.4**	**-329.6**	**-717.5**
XVI. Interaction With Corporate Rate Change	---	**-12.9**	**-24.7**	**-28.2**	**-28.4**	**-27.1**	**-26.8**	**-24.7**	**-23.7**	**-23.2**	**-23.3**	**-121.3**	**-243.0**
NET TOTAL		**5.6**	**33.4**	**47.3**	**45.2**	**40.3**	**41.5**	**28.3**	**24.6**	**20.0**	**18.0**	**172.5**	**304.1**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[Legend and Footnotes for Table #11-1 133 appear on the following page]

Legend and Footnotes for Table #11-1 133:

Legend for "Effective" column:

apoia = amounts paid or incurred after
bia = bonds issued after
caa = credits allocated after
cpoia = costs paid or incurred after
DOE = date of enactment
eca = exchanges commencing after
dpa = dividends paid after
N/A = not applicable
ppisa = property placed in service after
saua = sales and uses after
sooda = sales or other dispositions after
tyba = taxable years beginning after

[1] Gain of less than $50 million.
[2] Effective for contracts issued after December 31, 2011, in taxable years ending after that date.
[3] Loss of less than $50 million.

- Committee on Ways and Means -

ESTIMATED REVENUE EFFECTS OF CORPORATE TAX REFORM REVENUE RAISING PROVISIONS THAT REPEAL OR MODIFY TAX EXPENDITURES: PORTION OF REVENUE THAT IS ATTRIBUTABLE TO C COPORATIONS

Fiscal Years 2012 - 2021

[Billions of Dollars]

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
I. General Science, Space, and Technology													
1. Credit for increasing research activities (section 41)	tyba 12/31/11	*No Revenue Effect*											
2. Expensing of research and experimental expenditures	tyba 12/31/11	28.9	39.3	30.7	21	10.5	6.6	6.5	4.8	2.6	1.1	130.5	152.2
II. Energy													
1. Credits for alternative technology vehicles	tyba 12/31/11	*Presently Unavailable*											
2. Credit for holders of clean renewable energy bonds (sections 54 and 54C)	tyba 12/31/11	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]	0.1	0.3
3. Exclusion of energy conservation subsidies provided by public utilities	tyba 12/31/11	*Presently Unavailable*											
4. Credit for holder of qualified energy conservation bonds	tyba 12/31/11	[1]	[1]	[1]	[1]	[1]	0.1	0.1	0.1	0.1	0.1	0.1	0.4
5. Credit for enhanced oil recovery costs	tyba 12/31/11	*No Revenue Effect*											
6. Repeal credits for alcohol fuels	saua DOE	*Presently Unavailable*											
7. Energy credit (section 48)	tyba 12/31/11	*Presently Unavailable*											
a. Solar	tyba 12/31/11	*Presently Unavailable*											
b. Geothermal	tyba 12/31/11	*Presently Unavailable*											
c. Fuel cells	tyba 12/31/11	*Presently Unavailable*											
d. Microturbines	tyba 12/31/11	*Presently Unavailable*											
e. CHP property	tyba 12/31/11	*Presently Unavailable*											
f. Small wind systems	tyba 12/31/11	*Presently Unavailable*											
8. Credits for electricity production from renewable resources (section 45)	tyba 12/31/11	*Presently Unavailable*											
a. Wind	tyba 12/31/11	*Presently Unavailable*											
b. Closed-loop biomass	tyba 12/31/11	*Presently Unavailable*											
c. Geothermal	tyba 12/31/11	*Presently Unavailable*											
d. Qualified hydropower	tyba 12/31/11	*Presently Unavailable*											
e. Solar (limited to facilities placed in service before 1/1/06)	tyba 12/31/11	*Presently Unavailable*											
f. Small irrigation power	tyba 12/31/11	*Presently Unavailable*											
g. Municipal solid waste	tyba 12/31/11	*Presently Unavailable*											
h. Open-loop biomass	tyba 12/31/11	*Presently Unavailable*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
9. Credits for investments in clean coal facilities	tyba 12/31/11	Presently Unavailable											
10. Coal production credits:													
a. Refined coal	tyba 12/31/11	Presently Unavailable											
b. Indian coal	tyba 12/31/11	Presently Unavailable											
11. Credit for the production of energy-efficient appliances	tyba 12/31/11	No Revenue Effect											
12. Credit for clean-fuel vehicle refueling property	tyba 12/31/11	No Revenue Effect											
13. New energy efficient homes credit	tyba 12/31/11	Presently Unavailable											
14. Credit for investment in advanced energy property	tyba 12/31/11	Presently Unavailable											
15. Exclusion of interest on State and local government qualified private activity bonds for energy production facilities	tyba 12/31/11	Estimate Included in Item XIV.1.											
16. Deduction for expenditures on energy-efficient commercial building property	tyba 12/31/11	Presently Unavailable											
17. Repeal expensing of oil and gas exploration and development costs	cpoia 12/31/11	0.5	0.7	0.7	0.6	0.6	0.5	0.3	0.1	0.1	0.1	3.1	4.2
18. Repeal percentage depletion for oil and natural gas wells	tyba 12/31/11	0.3	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.7	2.3	5.4
19. Repeal percentage depletion for coal and hard mineral fossil fuels	tyba 12/31/11	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6	1.2
20. Increase geological and small integrated geophysical amortization period for independent producers to seven years	apoia 12/31/11	[1]	0.1	0.2	0.2	0.1	0.1	[1]	[1]	[1]	[1]	0.6	0.8
21. Amortization of air pollution control facilities	tyba 12/31/11	Presently Unavailable											
22. Depreciation recovery periods for energy specific items:													
a. Five-year MACRS for certain energy property (solar, wind, etc.)	tyba 12/31/11	Estimate Included in Item XIV.2.											
b. 10-year MACRS for smart electric distribution property	tyba 12/31/11	Estimate Included in Item XIV.2.											
c. 15-year MACRS for certain electric transmission property	tyba 12/31/11	Estimate Included in Item XIV.2.											
d. 15-year MACRS for natural gas distribution line	tyba 12/31/11	Estimate Included in Item XIV.2.											
23. Election to expense 50 percent of qualified property used to refine liquid fuels	tyba 12/31/11	Presently Unavailable											
III. Natural Resources and Environment													
1. Special depreciation allowance for certain reuse and recycling property	tyba 12/31/11	Estimate Included in Item XIV.2.											
2. Expensing of exploration and development costs, nonfuel minerals	tyba 12/31/11	Presently Unavailable											
3. Excess of percentage over cost depletion, nonfuel minerals	tyba 12/31/11	Presently Unavailable											
4. Expensing of timber-growing costs	tyba 12/31/11	Presently Unavailable											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
5. Special rules for mining reclamation reserves	tyba 12/31/11	*Presently Unavailable*											
6. Impose full tax rate on nuclear decommissioning reserve funds	tyba 12/31/11	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5	1.2
7. Exclusion of contributions in aid of construction for water and sewer utilities	tyba 12/31/11	*Presently Unavailable*											
8. Exclusion of earnings of certain environmental settlement funds	tyba 12/31/11	*Presently Unavailable*											
9. Amortization and expensing of reforestation expenditures	tyba 12/31/11	*Presently Unavailable*											
IV. Agriculture													
1. Expensing of soil and water conservation expenditures	tyba 12/31/11	*Presently Unavailable*											
2. Expensing of the costs of raising dairy and breeding cattle	tyba 12/31/11	*Presently Unavailable*											
3. Exclusion of cost-sharing payments	tyba 12/31/11	*Presently Unavailable*											
4. Exclusion of cancellation of indebtedness income of farmers	tyba 12/31/11	*Presently Unavailable*											
5. Five-year carryback period for net operating losses attributable to farming	tyba 12/31/11	*Presently Unavailable*											
6. Expensing by farmers for fertilizer and soil conditioner costs	tyba 12/31/11	*Presently Unavailable*											
V. Commerce and Housing													
A. Housing:													
1. Repeal the exclusion of interest on all State and local government qualified private activity bonds	bia 12/31/12	*Estimate Included in Item XIV. I.*											
2. Repeal the credit for low-income housing	caa 12/31/12	---	0.2	0.6	1.4	2.4	3.4	4.5	5.7	6.8	8.0	4.5	33.0
3. Repeal the rehabilitation credit	caa 12/31/12	---	0.1	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.7	1.3	4.4
4. Depreciation of rental housing in excess of alternative depreciation system	tyba 12/31/11	*Presently Unavailable*											
B. Other Business and Commerce:													
1. Exclusion of interest on State and local government small-issue qualified private activity bonds	bia 12/31/12	*Estimate Included in Item XIV. I.*											
2. 15-year recovery period for retail motor fuels outlets	tyba 12/31/11	*Presently Unavailable*											
3. Repeal the special rules for non-dealer installment sales	N/A	*Presently Unavailable*											
4. Repeal the deferral of gain on like-kind exchanges	eca 12/31/12	---	0.1	0.2	0.4	0.6	1.0	1.7	2.6	3.8	5.6	2.3	16.0
5. Expensing under section 179 of depreciable business property	tyba 12/31/11	*Presently Unavailable*											
6. Amortization of business startup costs	tyba 12/31/11	*Presently Unavailable*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
7. Reduced rates on first $10,000,000 of corporate taxable income	tyba 12/31/11	Presently Unavailable											
8. Exemptions from imputed interest rules	tyba 12/31/11	Presently Unavailable											
9. Expensing of magazine circulation expenditures	tyba 12/31/11	Presently Unavailable											
10. Special rules for magazine, paperback book, and record returns	tyba 12/31/11	Presently Unavailable											
11. Repeal the completed contract rules method	sooda 12/31/12	---	0.9	2.1	2.3	2.4	2.5	1.5	0.7	0.7	0.8	7.7	13.9
12. Cash accounting, other than agriculture	tyba 12/31/11	Presently Unavailable											
13. Credit for employer-paid FICA taxes on tips	tyba 12/31/11	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.5	2.1	4.8
14. Repeal the deduction for income attributable to domestic production activities	tyba 12/31/11	3.3	10.8	11.4	12.1	12.8	13.6	14.4	15.3	16.2	17.1	50.4	127.0
15. Credit for the cost of carrying tax-paid distilled spirits in wholesale inventories	tyba 12/31/11	Presently Unavailable											
16. Expensing of costs to remove architectural and transportation barriers to the handicapped and elderly	tyba 12/31/11	Presently Unavailable											
17. Ordinary gain or loss treatment for sale or exchange of Fannie Mae and Freddie Mac preferred stock by certain financial institutions	tyba 12/31/11	Presently Unavailable											
18. Inventory methods and valuation:													
a. Repeal last in first out	tyba 12/31/12	---	3.5	6.2	6.5	6.7	7.1	7.7	8.0	8.3	8.7	22.9	62.7
b. Repeal lower of cost or market	tyba 12/31/12	---	0.1	0.8	0.9	0.7	0.3	0.1	[1]	[1]	[1]	2.4	2.9
c. Specific identification for homogeneous products	tyba 12/31/11	Presently Unavailable											
19. Exclusion of gain or loss on sale or exchange of Brownfield property	tyba 12/31/11	Presently Unavailable											
20. Income recognition rule for gain or loss from section 1256 contracts	tyba 12/31/11	Presently Unavailable											
21. Net alternative minimum tax attributable to net operating loss limitation	tyba 12/31/11	Presently Unavailable											
22. Exclusion of interest on State and local qualified private activity bonds for green buildings and sustainable design projects	tyba 12/31/11	Estimate Included in Item XIV.1.											
23. Repeal MACRS and apply ADS in the depreciation of buildings other than rental housing	ppisa 12/31/11	Estimate Included in Item XIV.2.											
24. Repeal MACRS and apply ADS in the depreciation of equipment	ppisa 12/31/11	Estimate Included in Item XIV.2.											
25. Inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument	tyba 12/31/11	Presently Unavailable											
26. 5-year carryback of general business credits	tyba 12/31/11	Presently Unavailable											
C. Financial Institutions													
1. Exemption of credit union income	tyba 12/31/11	Presently Unavailable											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
D. Insurance Companies:													
1. Expand pro rata interest expense disallowance for company-owned life insurance	[2]	0.1	0.2	0.4	0.5	0.6	0.8	0.9	1.0	1.1	1.2	1.9	6.8
2. Small life insurance company taxable income adjustment	tyba 12/31/11	*Presently Unavailable*											
3. Special treatment of life insurance company reserves	tyba 12/31/11	*Presently Unavailable*											
4. Special deduction for Blue Cross and Blue Shield companies	tyba 12/31/11	0.2	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6	2.0	4.8
5. Tax-exempt status and election to be taxed only on investment income for certain small property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
6. Interest rate and discounting period assumptions for reserves of property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
7. Proration for property and casualty insurance companies	tyba 12/31/11	*Presently Unavailable*											
VI. Transportation													
1. Deferral of tax on capital construction funds of shipping companies	tyba 12/31/11	*Presently Unavailable*											
2. Exclusion of interest on State and local government qualified private activity bonds for highway projects and rail-truck transfer facilities	tyba 12/31/11	*Estimate Included in Item XIV.1.*											
3. High-speed intercity rail vehicle speed requirement for exempt high-speed rail facility bonds	tyba 12/31/11	*Estimate Included in Item XIV.1.*											
4. Exclusion of interest on State and local government private activity bonds for private airports, docks, and mass-commuting facilities	bia 12/31/12	*Estimate Included in Item XIV.1.*											
VII. Community and Regional Development													
1. Empowerment zone tax incentives	tyba 12/31/11	*Presently Unavailable*											
2. New markets tax credit	tyba 12/31/11	*Presently Unavailable*											
3. Repeal the District of Columbia tax incentives	N/A	*Presently Unavailable*											
4. Credit for Indian reservation employment	tyba 12/31/11	*Presently Unavailable*											
5. Exclusion of interest on State and local government qualified private activity bonds for sewage, water, and hazardous waste facilities	bia 12/31/12	*Estimate Included in Item XIV.1.*											
6. Issuance of recovery zone economic development bonds	tyba 12/31/11	*Presently Unavailable*											
7. Issuance of tribal economic development bonds	tyba 12/31/11	*Estimate Included in Item XIV.1.*											
8. Build America bonds	tyba 12/31/11	*Provision Expired*											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
9. Eliminate requirement that financial institutions allocate interest expense attributable to tax-exempt interest	tyba 12/31/11	Presently Unavailable											
10. Disaster Relief:													
a. Gulf opportunity zone	tyba 12/31/11	Presently Unavailable											
b. Midwest disaster relief	tyba 12/31/11	Presently Unavailable											
c. National disaster relief	tyba 12/31/11	Presently Unavailable											
VIII. Education, Training, Employment, and Social Services													
A. Education and Training:													
1. Exclusion of interest on Sate and local government qualified private activity bonds for student loans	bia 12/31/12	Estimate Included in Item XIV. I.											
2. Exclusion of interest on State and local government qualified private activity bonds for private nonprofit and qualified public educational facilities	bia 12/31/12	Estimate Included in Item XIV. I.											
3. Credit for holders of qualified zone academy bonds	tyba 12/31/11	Presently Unavailable											
4. Deduction for charitable contributions to educational institutions	tyba 12/31/11	Presently Unavailable											
B. Employment:													
1. Repeal deduction for dividends paid to an employee stock ownership plan (ESOP)	dpa DOE	0.4	0.4	0.6	0.6	0.6	0.7	0.7	0.7	0.8	0.8	2.7	6.3
2. Deferral of taxation on spread on acquisition of stock under incentive stock option plans	tyba 12/31/11	Presently Unavailable											
3. Deferral of taxation on spread on employee stock purchase plans	tyba 12/31/11	Presently Unavailable											
4. Disallowance of deduction for excess parachute payments (applicable if payments to a disqualified individual are contingent on a change of control of a corporation and are equal to or greater than three times the individual's annualized includible compensation)	tyba 12/31/11	Presently Unavailable											
5. Limits on deductible compensation	tyba 12/31/11	Presently Unavailable											
6. Work opportunity tax credit	tyba 12/31/11	Provision Expires December 31, 2011											
7. Credit for retention of certain newly hired workers	tyba 12/31/11	Provision Expires December 31, 2011											
C. Social Services:													
1. Credit for employer-provided dependent care	tyba 12/31/11	[1]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	-0.1	-0.2
2. Deduction for charitable contributions, other than for education and health	tyba 12/31/11	Presently Unavailable											
3. Credit for disabled access expenditures	tyba 12/31/11	Presently Unavailable											

Provision	Effective	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-16	2012-21
IX. Health													
1. Exclusion of interest on State and local government qualified activity bonds for private nonprofit hospital facilities	bia 12/31/12	*Estimate Included in Item XIV.1.*											
2. Deduction for charitable contributions to health organizations	tyba 12/31/11	*Presently Unavailable*											
3. Credit for orphan drug research	tyba 12/31/11	*Presently Unavailable*											
4. Premium subsidy for COBRA continuation coverage	tyba 12/31/11	*Presently Unavailable*											
5. Tax credit for small businesses purchasing employer insurance	tyba 12/31/11	*Presently Unavailable*											
X. Medicare													
1. Exclusion of Medicare benefits - exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees	tyba 12/31/11	*Presently Unavailable*											
XI. Income Security													
1. Exclusion of disaster mitigation payments	tyba 12/31/11	*Presently Unavailable*											
XII. General Purpose Fiscal Assistance													
1. Exclusion of interest on public purpose State and local government bonds	tyba 12/31/11	*Presently Unavailable*											
XIII. Veterans Benefits and Services													
1. Exclusion of interest on State and local qualified private activity bonds for veterans' housing	bia 12/31/12	*Estimate Included in Item XIV.1.*											
XIV. General Corporate Tax Provisions													
1. Eliminate exclusion of interest on private activity bonds	bia 12/31/12	---	0.1	0.2	0.4	0.7	1.0	1.3	1.6	1.9	2.1	1.4	9.2
2. Repeal MACRS and apply ADS	tyba 12/31/11	13.6	39.6	57.4	64.3	66.6	67.3	55.6	51.0	47.0	44.5	241.5	506.8
XV. Reduction in Corporate Rate to 28%	**tyba 12/31/11**	**-40.5**	**-65.3**	**-71.0**	**-75.8**	**-77.0**	**-76.0**	**-77.0**	**-76.4**	**-78.2**	**-80.4**	**-329.6**	**-717.5**
XVI. Interaction With Corporate Rate Change	---	**-12.9**	**-24.7**	**-28.2**	**-28.4**	**-27.1**	**-26.8**	**-24.7**	**-23.7**	**-23.2**	**-23.3**	**-121.3**	**-243.0**
NET TOTAL		**-5.5**	**7.6**	**14.0**	**9.1**	**3.5**	**4.5**	**-4.0**	**-5.9**	**-9.3**	**-11.0**	**30.0**	**3.8**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

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N/A = not applicable

ppisa = property placed in service after
saua = sales and uses after
sooda = sales or other dispositions after
tyba = taxable years beginning after

[1] Gain of less than $50 million.
[2] Effective for contracts issued after December 31, 2011, in taxable years ending after that date.

Mr. MCDERMOTT. Now, that study suggests that roughly half of the cost of a 7-point reduction, that is from 35 down to 28, would come from the repeal of accelerated depreciation. Yet all the companies have said this is very important, don't take away our accelerated depreciation. So you want to retain that. So that means you can only finance about a 3 percent reduction, 3.5 percent.

This report says that if you are going to bring it down to 28 percent, you are going to have to come up with $960 billion, of which $506 billion comes from the depreciation reduction. And I wonder what you would actually support, because, as Mr. Rangel suggested, tax reform in 1986 occurred after Ronald Reagan came in in 1981 and played golf with Tip O'Neill and Rostenkowski for 5 years, and it was before the global economy had really taken hold. So we are talking about a new world that we are trying to reform now than the one they were reforming in 1980.

So give me your views of what we should do. What are the things that are most important that you are willing to give up or shift off on to somebody else?

Mr. NEUBIG. Yes, Congressman McDermott. We looked at the Joint Committee on Taxation's revenue estimate from October and we looked at the provisions they estimated and scored in terms of base broadening, and they represented $209 billion out of the total corporate tax expenditures of $545 billion. So it was only 40 percent that they actually scored. There was another $185 billion of non expiring non-international corporate tax expenditures that they had not yet estimated.

So I am actually relatively optimistic that when you really take a hard look, that you can get down to 28 percent and even possibly 25 percent.

When I look at the 1986 Tax Reform Act and I look at the base broadening that occurred from tax expenditures, it was only 60 percent of the base broadening. Forty percent of the corporate base broadening in 1986 was not from tax expenditures. I think the tax staffs at Treasury and elsewhere, if they look hard, will be able to find additional base broadeners beyond just the tax expenditure list.

Mr. MCDERMOTT. Do you have that list, that 189 billion you talk about? Can you tell me what are the pieces in there we would have to get rid of?

Mr. NEUBIG. I can't. I don't have those with me. But we have gone through the entire JCT revenue estimating list, and they have lots of provisions that are not yet estimated and we have linked that to the tax expenditure list, and 40 percent of the estimated tax expenditures have not yet been estimated.

Mr. MCDERMOTT. I would appreciate and I think everybody on the committee would appreciate if you would give us what your estimate is. Anybody else have any ideas how to do this?

Mr. HEENAN. I think I would just like to maybe echo Member Levin's comments. Sort of a quick-fix answer is difficult to give. I do think we have to look line-by-line at each of the expenditures and balance that. We need to weigh it against the benefits of a tax rate reduction. And certain expenditures are going to be more important towards growth, and that will equal jobs, and we will want to retain those. And others I think we can look at and throw away.

So I think everything should be on the table, and we have to have a very serious conversation about which ones we want to take out and which ones we want to keep.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Mr. HERGER. Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman. I want to try and get three quick questions in, so no speeches, I will just start with the questions.

Try to think of these questions in terms of jobs. We all want tax reform and we want to energize the economy, but we want to get people jobs here, of course, in the United States. So Ms. Hanlon and Mr. Neubig, there are numerous provisions in the Tax Code that have the effect of providing preferential treatment to particular business behaviors or particular sectors of the economy. Do you agree that the primary objective of tax reform should be to address these kinds of distortions in tax law?

Mr. NEUBIG. Well, I think tax reform really should have the goal of trying to make our tax system much more pro-growth, simpler and fairer. In 2010, the House as part of the expiring provisions included a provision, that was not ultimately enacted, that required the Joint Committee on Taxation to look at all of the expiring tax provisions and do an analysis in terms of the cost-benefit analysis, and who the beneficiaries were. And I think it is that type of analysis that really is important in terms of looking at all these provisions that Congress has previously enacted. Some of them very well may be worth keeping as part of tax reform. Others, if a thorough analysis has been done, may be outdated and should be eliminated.

Ms. HANLON. I agree with Tom. I think the fairer, simpler approach would be the best approach to take. And what I hear most companies saying actually is that they are willing to make these trade-offs, they are willing to put things on the table. They would rather not, but they are willing to do it if it would get them to a lower rate.

We conducted a survey of tax executives and we asked them point blank, we said, does the U.S. corporate tax rate hinder your competitiveness? And almost 80 percent of them said "yes," unequivocally. So I think these things are very important, and I think a permanent lower rate, a stable tax structure that is predictable, I think that is the best way to go.

Mr. REICHERT. So the cost-benefit analysis, a thorough review of pro-growth policies, a simpler Tax Code and a fairer Tax Code equals jobs. Would that be accurate? I see nodding heads, but I see Ms. Hanlon hesitating.

Ms. HANLON. I am not hesitating.

Mr. REICHERT. Just say "yes."

Ms. HANLON. It certainly wouldn't hurt job creation. That is for sure.

Mr. REICHERT. Okay. The second question, according to Mr. Fryt's written testimony, since 95 percent of the world's population and 70 percent of its purchasing power is today outside the United States, it goes without saying that global markets are a critical component of the future growth and success of the United States businesses. How does the success of U.S. global businesses impact jobs in the United States?

Mr. FRYT. I think we are a great example of that, Mr. Reichert. Also in my written testimony I included some statistics about our growth since 1989 when we first got into the international—started growing our global network in earnest, and our U.S. team member count, for example, has grown from 56,000 members to 245,000 members today. It is symbiotic. Our global growth and U.S. growth have increased in tandem as our global network has grown, and we have seen that with our customers as well.

As you pointed out, 75 percent of the world's purchasing power is outside the United States today. That is a huge market and it is increasing. And that seems to me to be something that we need to tap into very effectively in this country to address even some of our revenue issues.

Mr. REICHERT. Anyone else like to comment?

Mr. HEENAN. Yes. I would reiterate those comments. Praxair, as I mentioned earlier, our headquarters are in Danbury, Connecticut, our R&D is in Tonawanda New York. When we grow globally, when we win projects globally, we get jobs here. Those folks are working on those projects. It is not as good as a project here in the U.S. in terms of how many more jobs you get, but it is adding jobs. So global competitiveness is critically important.

Mr. REICHERT. One of the things we struggle with here in this committee and Congress is we want to see United States trade, right? Ninety-five percent of our market, as we said, is outside this country. We can't all buy American here in the United States. We want other countries to buy American.

My time is up but I want to ask your help. Please deliver the message that trade is good for our global economy. The global economy good for the United States economy, equals jobs. Thank you. I yield back.

Mr. HERGER. Mr. Boustany is recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman. I want to clarify something that came up during Dr. McDermott's line of questioning, and that is the Joint Tax analysis that was done. Mr. Neubig pointed a couple things out, but I think this bears emphasis, reemphasizing these facts about that specific report.

First and foremost, the estimates are not complete, and, secondly, they are not comprehensive. In fact, only 60 out of 150 measures have been scored, and those are preliminary, and that gets us to a rate of 28 percent. So I am optimistic that we can actually get to a lower rate once we have a full analysis of all these measures. So I think we need to keep that in mind, that the Joint Tax analysis is not comprehensive at this stage, and incomplete, and our committee will have to continue to work to get to that point.

Professor Hanlon, we have all been very concerned about the vast number of temporary provisions in the Tax Code and the uncertainty it has created. Oftentimes these get renewed retroactively. It creates a lot of problems certainly from a compliance standpoint. But I would like you to elaborate on how do you deal from a financial accounting standpoint with these, and talk about some of the problems that therein lie with these temporary measures.

Ms. HANLON. The temporary provisions I think cause similar difficulties on the tax side and the book side in a way that they are just unpredictable. So it is hard for companies to plan. It is hard for them to make long-term investments given these fits and starts in the Tax Code. And the accounting just will fall out in the sense accounting just accounts for whatever happens.

But, again, it is hard for them to predict what that effective tax rate will be, and they are benchmarked often on that effective tax rate to other companies and so forth. So I think it is just unpredictable for them. It is hard to make investment decisions when things are in flux like that.

Mr. BOUSTANY. Thank you. And, gentlemen, you all are looking at this from the private sector. You have to deal with this. Could you comment on investment decisions and just the general uncertainty that arises as a result of these temporary provisions?

Mr. SCHICHTEL. Uncertainty is definitely a huge impediment to investment and to I think rational growth and overall development of the economy. It is very difficult for my boss, Irene Esteves, the CFO, and for our COO and CEO to figure out what we are going to do over the long term, and try to figure out how to analyze the impact of tax policy from both a book and tax perspective, much less explain it to our investors and our analysts. So it is always an issue that is brought up each quarter on our earning calls, and it is always brought up by the analysts when our investment relations folks are meeting with them.

Mr. MCDERMOTT. Would the gentleman yield?

Mr. BOUSTANY. I will yield to you.

Mr. MCDERMOTT. My understanding that the Joint Tax study that I talked about and that you responded to, the chairman said that they should only analyze domestic tax expenditures, not international ones, because he intended to use the international ones for reform of international tax structure. I don't know that there is a single domestic tax expenditure still left on the table, unless you do.

Mr. BOUSTANY. We need to recognize that we have incomplete information at this time, and just to proceed cautiously based on that. Thank you.

Mr. Neubig, in your testimony you pointed out in the growth of intangible assets, and this is clearly a new area or an expanding area that we need to be looking at as we go forward, clearly lowering the corporate tax rate would bring down effective rates for both classes of assets, tangible and intangible.

Elaborate a little bit on the difficulties in applying appropriate tax policies to intangible assets. Can you further elaborate on that?

Mr. NEUBIG. Well, I think the economy has clearly changed from 1986. In addition to globalization, what we have seen is a very significant increase in the amount of intangibles in terms of the programming, the copyrights, the patents, the R&D. Recent Federal Reserve Board economic studies showed that investments in intangible assets were as large as the investments in property, plant and equipment. When you look at the companies, they are concerned about both intangible investments and their tangible investments.

So a lower corporate tax rate is a positive effect for both of those investments. In fact, the really high returns that are earned by the U.S. companies that are doing that type of R&D, they will benefit significantly from a lower corporate tax rate. It has also the benefit of trying to keep those intangibles in the U.S. versus offshore.

Mr. BOUSTANY. Thank you. Anybody else want to comment on that issue?

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

Mr. Neal is recognized.

Mr. NEAL. Thank you very much, Mr. Chairman. The common theme this morning of the testimony that has been offered is really twofold. You are certainly asking for a lower rate, but, just as importantly, you are asking for greater certainty on how we go forward.

I just have been reading Bruce Bartlett's book, and I always find how liberating it is for former staffers to leave the Hill and then to write what they deem to be a more truthful version of events. And David Stockman, as we all know, has taken the same position, divorcing himself from what commonly happens here in terms of embracing theology as opposed to the reality of trying to administer government.

Mr. Schichtel, you indicated that the U.S. has lost 46 Fortune Global 500 company headquarters between 2000 and 2011. Why do you think those companies specifically moved outside of the United States? And perhaps just as importantly, were tax considerations the only reason for those companies leaving?

Mr. SCHICHTEL. I don't think taxes are the only factor or the only driver. I do believe that lower tax jurisdictions and the ability to produce greater returns for their shareholders have played a huge role in driving a lot of companies overseas.

Mr. NEAL. And the other panelists?

Mr. NEUBIG. Congressman Neal, I was the author of that analysis of the Fortune Global 500. I don't think we found any U.S. companies actually leaving the U.S. That is talking about the number of companies that happen to be in the top 500 around the globe.

What we are seeing is there are an awful lot of large companies from the BRIC countries that now are among the top 500, and they are now larger than a number of U.S. companies. So it wasn't that companies were actually leaving, at least in terms of this particular study. It is that we are definitely in a global environment where our U.S. companies are competing much more with companies from other countries, not only in Europe, but also in China, Brazil and India.

Mr. NEAL. All right. Production can happen anywhere now, right? How about the other panelists?

Mr. FRYT. Mr. Neal, I know there have been instances. I think the Chrysler merger a few years ago with Daimler-Benz was driven at least in part by tax considerations, and, as you know, that was one company that did end up with headquarters overseas. And certainly in the nineties, early 2000s, we saw some expatriations.

Some of that was driven by tax considerations. Perhaps not all of it, but I do think it was a major consideration.

Mr. NEAL. Mr. Heenan?

Mr. HEENAN. I echo the comments. The rules now in terms of leaving the United States are pretty harsh. I think Congress has taken care of that movement for tax purposes offshore, and it is more, as Mr. Neubig said, you just have offshore companies are getting bigger is what you are seeing.

Mr. NEAL. Ms. Hanlon?

Ms. HANLON. I would agree with all these things. I think tax is one factor. The research is quite clear that investment is attracted to lower tax rates, but it is only one factor. There are a lot of other things that companies consider. Acquisitions do happen generally where the foreign acquirer will acquire the U.S. company. Oftentimes because of the tax considerations you wouldn't want to acquire—a U.S. company wouldn't want to acquire a foreign—it would be hard for them to acquire a foreign company and then pull that foreign company into the U.S. tax system. And this also depends on the type of business, what is the investment, how much tax drives where the investment goes based on the tax rates. Some companies just have to go where their customers are, but more intangible-based companies can move around more easily. So taxes will be a more important driver for those types of companies.

Mr. NEAL. Mr. Neubig, maybe you could speak to the phenomena of Japan in the sense that stagnation has paralyzed that economy for decades. If we were sitting here just 15 years ago, the argument we are currently making about China would have been the argument that we were making about Japan. Are you arguing that it is their tax rates that have kept them from growth?

Mr. NEUBIG. There are a lot of similarities. In the 1980s, Congress was facing not only intense competition from Japan, but also large deficits. I was impressed in 1982 and 1984 leading up to the 1986 Tax Reform Act, that Congress did address the deficits. It did show that there could be some tax increases, which set up I think the right dynamic for a revenue-neutral corporate and individual tax reform in 1986.

Clearly Japan's high corporate tax rate, that now is going to fall below the U.S. as of April 1st, I think was a factor in terms of the Japanese companies not being as successful in the world markets, in addition to all the other problems that occurred in their lost decade.

I think a lower corporate tax rate can definitely be helpful in terms of economic growth. But when I look at the top 50 economies in the world, the U.S. as of April 1st will have the highest combined corporate tax rate.

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

Mr. Price is recognized.

Mr. PRICE. Thank you, Mr. Chairman. We are all here interested in not just tinkering with the number to tinker with the number. We are interested in getting our economy growing as rapidly as possible so that people can get back to work and realize the benefits of their labor and their own dream. I would suggest that the deficit spending at the current level is a huge drag on the economy, but that is not the topic for the discussion today. The topic is tax policy. And I want to focus on hopefully three issues very quickly. One is the rate, two is the cost of compliance, and three on a potential alternative.

We talk about the corporate rate being the highest in the industrialized world after April 1st. That is just astounding. All we are doing is punishing businesses who are trying their best just to stay in business here. So that is a disincentive to expand or to create a business here.

I am not so certain that getting to 25 or 28 percent or whatever the OECD average is, isn't just a break even, isn't just a wash. If folks are looking at their balance sheet and they are saying well, if it is 25–28 percent, and that is the average of OECD countries, industrialized nations, then everything else being equal doesn't make a whole lot of difference.

Wouldn't it be better for us to have a much lower rate than the average of the OECD countries, Mr. Fryt?

Mr. FRYT. I couldn't agree with you more, Mr. Price. Actually the most destructive tax that can be levied from an economic growth standpoint is the corporate income tax. OECD has a good study on that. In an ideal state, you just take it to zero. You would get rid of it. Make the business community more productive.

But to your point of 25 percent, if that is what it was, you know, you have to add to that the State rate as well, 3 to 4 percent, so you are at 28–29. But at least it is a lot closer than where we are today. Maybe good old American ingenuity can bridge that gap. I don't know. But it is a fair point.

Mr. PRICE. I have great faith in American ingenuity if we don't stifle it from here, and that is one of the concerns that I have.

Isn't zero percent really the greatest pro-growth rate for business and job creation?

Mr. FRYT. I would argue it is.

Mr. SCHICHTEL. I agree.

Mr. PRICE. Come on down. MIT?

Ms. HANLON. Yes, I think the lower the better.

Mr. PRICE. And zero percent would be the most pro-growth policy we could have as it relates to business.

Ms. HANLON. Yes.

Mr. NEUBIG. I think there are important government services that are provided—the highways, the airports, defense—and so I am not so sure a zero rate is what would necessarily be the best.

Mr. PRICE. But for pro-growth policies as it relates to businesses, isn't zero percent the best?

Mr. NEUBIG. Again, I think businesses are looking at more than just the tax rate. They are looking at all the factors that will make the American economy successful. So I guess I am not convinced that a zero rate is the optimal rate.

Mr. PRICE. Well, let me ask you then about the cost of compliance, the cost of compliance of our current code. Do you have any sense about what that is and how that challenges you in your business?

Mr. NEUBIG. It clearly is very significant. And in addition to the 39.1 percent marginal statutory rate, you have also got to factor in the very high cost of compliance and the cost of uncertainty in our current U.S. tax system. I don't have the exact figures. I know some other academics have made those estimates. But you clearly have a benefit by simplifying and making more certain the code, that in combination with a lower corporate tax rate and those simplifications, could be very significant.

Mr. PRICE. Do you have a sense about the magnitude of the cost of compliance? Is it another percent? Is it another 10 percent?

Mr. NEUBIG. I have seen some estimates that the efficiency costs, including compliance costs, could be as large as the entire corporate income tax.

Mr. PRICE. As large as the tax itself. Astounding. So which brings me to the alternative. What would a consumption tax, doing away with the business tax, what would a consumption tax do for your businesses and for job creation and the economy? Mr. Fryt, do you have any thoughts on that?

Mr. FRYT. From a very high level, I think a consumption tax is probably preferred to the corporate income tax because the corporate income tax in effect penalizes work, productivity. A consumption tax penalizes consumption. Whether it is realistic or not is a different——

Mr. PRICE [continuing]. Or incentivizes savings and allows consumers to make their own choices, things like that.

Mr. FRYT. Correct.

Mr. SCHICHTEL. I agree with Mike's overall statement, but I think it requires a great deal of study and analysis because of the impact on prices and the impact on consumers, consumers that have limited discretionary income to buy our services as well as others. Also there is an element of regressivity that would need to be addressed. But overall it certainly should be something that is considered.

Mr. PRICE. Thank you, Mr. Chairman.

Mr. HERGER. Mr. Smith is recognized.

Mr. SMITH. Thank you, Mr. Chairman, and thank you to our panel today.

It is always interesting as we try to work with these issues, I don't think anyone is pretending that they are simple or that we have got an easy answer here. But I do want to reflect a little bit on, I guess, the interrelated nature of a lot of these businesses. I won't ask whether Time Warner uses FedEx or UPS. That is not what I am getting at here.

Mr. SCHICHTEL. We do use FedEx.

Mr. SMITH. You do. Okay. Nonetheless, is there any concern—knowing that FedEx, for example, is a consumer of manufactured products and that the manufacturing industry domestically has a bias in favor of the R&D tax credit, I would understand—is there any concern that maybe the products or services that you use within your own companies and outside your own companies would have an adverse impact if we don't get this right?

Mr. FRYT. Absolutely, Mr. Smith, and I think you have put your finger right on one of the pressure points here, is that our current Tax Code has so many different provisions that attempt to direct economic activity one way or another. My personal feeling is we leave it up to the economy and the business community and try and minimize that as much as possible.

You mentioned about manufacturing having R&D or 199. In effect, FedEx is part of the manufacturing business as well, but we are not generally categorized as a manufacturer. But we are in the distribution chains for a lot of manufacturers, but we don't qualify for 199, for example. Why did that line get drawn quite that way? But it is those kinds of issues, I think you are exactly right.

Mr. SMITH. Anyone else?

Mr. SCHICHTEL. I think you are right. I mean, all of our businesses are interconnected in one fashion or another. It just depends on the degree of separation. That being said, I agree with Mike here as far as the complexity and the inability to predict what is going to come from all these various different tax policies, and also a very real concern as far as fairness.

You have a situation here, if we can move away from this level of complexity and all of the different provisions, you can have a situation where fairness really fits in nicely with the overall free enterprise market and let the economy decide, let markets decide where things should go.

Mr. SMITH. Mr. Heenan.

Mr. HEENAN. I think our sole focus should be about growth and how do we get growth and jobs. So I think sometimes there is a difference between equal and fair, and we should be focusing on growth. So while I think lower tax rate certainly for us would put more cash in our pocket to spend on new investments, some of the targeted tax expenditures that are out there may have a bit more leverage than a lower tax rate. So we have to look at that very closely and we ought to do it. What is right, I think, is what promotes growth and jobs, and that might not be equal, but it is probably fair for the country overall.

Mr. SMITH. Okay. Thank you. I yield back.

Mr. HERGER. Mr. Kind is recognized.

Mr. KIND. Thank you, Mr. Chairman. I want to thank the panelists for your testimony today. It is always very illuminating and interesting. Let me just raise a couple of concerns and get your reaction on a few things.

Sometimes we are not really comparing apples to apples. I think everyone is in agreement that the goal should be to try to expand the base, lower the rates, and simplify the Tax Code. And if the goal is 25 percent, according to the OECD countries, that doesn't take into consideration the VAT systems that they have in place right now to supplement lost revenue from the lower corporate rates. There is no discussion about a possible VAT in this country in order to obtain that lower level. So if we are going to do this in a deficit-neutral fashion, we are going to need a way to pay for it as well.

Here is one of the concerns I have been raising consistently. The best we can do on the corporate side, eliminating every tax expenditure, every tax credit, is moving from 35 to 28 percent rate. Would that be sufficient, Mr. Fryt and Mr. Schichtel, a 28 percent rate and eliminate every expenditure on the corporate side? Would that be enough to make us more competitive globally?

Mr. FRYT. I don't think it would, Mr. Kind.

Mr. KIND. Mr. Schichtel.

Mr. SCHICHTEL. I agree with Mike.

Mr. KIND. Well, then we are going to need to figure out a way to pay for the additional 3 percent to get to 25. If the proposition here is that we are going to go to the pass-through side, where a majority of entities are structured in this country, I don't think they are going to be that enthusiastic for pass-through entities, small business owners, S corps, individuals, to pay a higher tax rate in order to pay for lower corporate tax rates in this country. That ain't going to sell politically in this country.

So we are going to have to find a different revenue source, then, in order to get to the 25 percent rate if the goal is to make this deficit neutral. That is where it is going to get difficult. And that is why you don't have a detailed plan from the majority on what specifically they are proposing, because they know they are going to have to get into those weeds immediately overnight and the political push-back is going to be tremendous.

Now, I wanted to pick up on what Mr. Price was addressing, because I think it is very intriguing. Here are the numbers from last year. The Federal Government collected total revenue of roughly $2.3 trillion from all the revenue sources. Of that, $181 billion was on the corporation side. Roughly 7 percent of Federal revenue was collected on the C side. That is roughly 1.2 percent of GDP. So we are tying ourselves up into knots trying to figure out a way to lower the rates when we are talking about roughly 7 percent of total Federal revenue to begin with.

Maybe we should explore further, just eliminating the corporate rate entirely. But we are going to have to pay for it, and that again is going to be the rub of how we do it.

Mr. Price talked about the consumption tax. I don't want to do it in a regressive fashion. My fear is that a consumption tax is going to be very regressive. It is going to hurt low-income families that have to spend every dollar that they earn through that consumption tax. So maybe there is a different way that we could maintain progressivity and pay for it through some form of wealth tax.

I don't know how many of you had a chance to see the New York Times op-ed page today, but David Miller I thought wrote a very interesting article. Did anyone see Mr. Miller's article today? It is called "The Zuckerberg Tax."

Now, Zuckerberg, obviously, is going to get about $28 billion worth of shares, most of which he will never pay a dime of tax on. And what Mr. Miller is advocating is why not mark to market those shares a given year and have him pay taxes on it, rather than waiting until it is realized, which may never occur in his lifetime, and if he passes it on to his heirs, they may never realize those gains from the shares. This I think is one of the reasons why we have huge wealth disparity in our country, because it favors those who are accumulating wealth through shares primarily that never get realized. They are able to borrow off those shares in order to maintain their living standards.

So maybe there is a way for us to explore trying to eliminate the corporate tax rate entirely, given the small percentage of revenue it ultimately brings to the country, helping our country be more competitive, but keep progressivity in the Tax Code and make it fair, and start exploring ways to tax wealth to a greater extent to pay for lower or no corporate tax rates in this country.

Now, what I am recommending would probably put you guys out of business. You guys would lose your jobs as far as corporate tax is concerned. But what I am hearing from you is the lower the better, and maybe zero might be ideal. That would be a real game-changer around here, rather than us going through this kabuki dance with these hearings with no detailed proposals because of what that is ultimately going to look like.

And then further my last concern is, listen, if we even get to 28 percent by eliminating all the expenditures on the C side, what is that going to do to domestic manufacturing, who rely very heavily on depreciation for R&D, for 199 manufacturing tax credit. Is that going to help domestic manufacturing or hurt domestic manufacturing if we take those expenditures away from them, and will that leave us less competitive in our ability to make things and invent things and create things and to grow things in our own country here?

So those are some of the issues that we are raising. And maybe you guys can help us try to figure out a way of supplementing lost corporate tax revenue and get to a zero rate, but let's keep it progressive and fair ultimately.

Chairman CAMP. The gentleman's time has expired. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman, and thank you for holding this hearing. As a CPA who used to practice in this area, this has been a real delight to have you all here this morning. I am not sure I have had this much fun in the year that I have been on the panel. So thank you.

Chairman CAMP. I am glad the gentlewoman is redefining fun.

Ms. JENKINS. This is good stuff. And since the focus of the hearing has been on those areas of book and tax differences and where they diverge, do you all have some suggestions as far as reform goes to address that, because it appears what we have been talking about to this point has been to move towards having less differences in book tax, and you all have touched on it briefly.

So can everyone on the panel just let me know your thoughts on the idea of book tax conformity?

Mr. FRYT. To some degree I think there is some benefit there. I would caution about going to the extreme and putting control of the tax revenues in the hands of accountants, FASBs, with all due deference to the CPA, ma'am. But to the extent you get simplification out of that process, yes, I would agree with that.

Ms. JENKINS. Okay.

Mr. SCHICHTEL. I agree that I certainly wouldn't want to see control ceded to the FASB as well as efforts to achieve conformity with GAAP and international standards, because I don't think they are necessarily reflective of real economic lives. I think when you look at different industries and different classes of assets, the lives that we have for tax purposes are much more consistent with reality than what you see from a GAAP reporting perspective.

Mr. SCHICHTEL. But I do believe that if we move towards greater reform in a low enough tax rate that some of the differences—the large differences between book and tax would have to be eliminated in order to fund that. And that consistency probably would be beneficial overall.

Ms. HANLON. This is a great question.

I think one thing to notice is that book-tax differences, when we talk about them in this arena, it is not that all of them cause problems, it is just that the permanent kind are better than the temporary kind because that allows you also to increase your accounting earnings.

I have done a lot of research on book-tax conformity, actually, and I think it is a bad idea. The first thing is accounting is very conservative in their rules, so that means we make expenses, we accrue expenses very early before they actually happen in cash flow, for example, bad debt expense and so forth; and I think the Tax Code generally has not favored such treatment.

Also, there is a lot of evidence in the literature that book-tax conformity would reduce the information that is contained in financial accounting earnings. The rules are set up for two different purposes, and basically accounting earnings are made—the rules are set in order to inform stakeholders. And the evidence based on the 1986 Tax Reform Act, when a certain set of reforms were required to increase their conformity, the international evidence and several other studies basically show that the information that is in accounting earnings will go down if you conform those earnings.

I also share the concern about who would make the rules after the conformity would happen, if it would be Congress, FASB, or the International Accounting Standards Board; and I think that would be very hard for the U.S. to handle, the International Accounting Standards Board determining our tax base.

So I think there is a lot of reasons why book-tax conformity wholesale is a bad idea. I think there are certain things that are different between book and tax that we could look at, but I think wholesale book-tax conformity is not a good idea.

Mr. NEUBIG. I would agree with Dr. Hanlon's comments.

Just as an example, the discussion about moving to IFRS has impacted in terms of some of the discussions about U.S. tax reform. Because if you move to IFRS then LIFO would not be allowed, and so it would automatically eliminate the current ability of some firms to use last-in, first-out accounting. There clearly are different goals for the accounting rules. As the tax writing committee you have different goals, including revenue, that are your objectives.

Mr. HEENAN. I agree with most of what was said before me.

I think really the accounting rules are there for something completely different than what our tax rules should be there for, our tax rules. It is to get revenue, but it should be done in a manner that promotes growth, investment, jobs, and those are just two completely different worlds, and so I would encourage us to keep them separate.

Ms. JENKINS. Okay. I have just a few seconds left, so could businesses just quickly talk about—we talked about reforms and the challenges to reforms. Could you just briefly talk about if we do nothing the cost of inaction to your business if we keep the status quo?

Mr. FRYT. Personally, I don't think that is a good option. I don't think the status quo is where we want to be.

Mr. SCHICHTEL. I think we are seeing the results in the economy as far as what happens if you do nothing. I think taxes, although it is not going to be the only factor that drives economic growth, it is tremendously important. And I think our lackluster growth and difficulty in coming out of the recession are in part due to our overall tax structure and lack of competitiveness.

Ms. JENKINS. Thank you.

I yield back.

Chairman CAMP. Mr. Paulsen, is recognized for 5 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman.

I have really enjoyed the testimony this morning, and I think it just follows on the heels of a full year of hearings we have had on tax reform.

And the message has been pretty clear from the folks here today, as well as the folks that have testified in the past, about the need to provide certainty for companies that are investing their capital on a 5-year and a 10-year and a longer horizon, rather than dealing with these temporary tax extensions or provisions or extenders that can create a lot of difficulties not only for the companies planning but the accounting side of the equation as well. And the U.S. is trying to play catch-up now to make sure we have got a Tax Code that is competitive along with a fairness and a simplicity component. And it is important to focus on the competitive side and the pro-growth side. So here is my question.

I know that the United Kingdom in particular is moving with tax reform as well. Other countries are doing this. They have kind of staggered, kind of moved forward slowly, lowering their tax rates. Are we better off to sort of just rip the Band-Aid off, do this fast, lay out where we are going to be in the long term and take the pain, if you will, of what might be the effect in the short term of a year of some of the changes that will be out there? Or should we phase it in? Should it be gradual, as the United Kingdom or other countries might be doing? Which is the way to go?

Mr. FRYT. I think there is a tension there from a business perspective, from my business's perspective. And I think from our economy's perspective it is better off doing it quickly, making a large-scale reduction in a corporate rate. There are some arguments to the other side that you save some revenues by ratcheting it down slowly over time, and maybe that helps you get to a revenue-neutral equation or solution.

Mr. PAULSEN. Mr. Schichtel.

Mr. SCHICHTEL. I agree. I think resetting the baseline, do it once and then move forward provides the predictability. There may be some items that you want to look at as far as transition rules, but I think overall it is time to just do it and do it now.

Mr. PAULSEN. Mr. Heenan.

Mr. HEENAN. I mentioned earlier we spend $2 billion in capital. We look at our projects; and, if we miss, it is a big deal. If we spend $2 million in the wrong place, it is a big deal.

I commend Chairman Camp for taking on this difficult task. I would just say this is a big deal, and if we miss on how we do this we are going to regret it. So I agree that we should move quickly, but I think we really have to be cautious in looking at the specific expenditures and the specific way we do this. We don't want to miss on this one as a country.

Mr. PAULSEN. Mr. Neubig.

Mr. NEUBIG. I guess two points. Phasing down the corporate tax rate is what has been done in Canada and the United Kingdom. If the alternative is not doing a lower corporate tax rate I think phasing down would be much preferable.

In the case of the United Kingdom, they have a parliamentary system; and they have announced that they are going to get to a 23 percent corporate tax rate by 2014, 2015. One interaction in terms of the financial accounting rules is they have not officially enacted the 23 percent rate. They are doing the reduction from 28 to 26 and now to 25 in the current year on an annual basis; and part of that is an interaction with the book accounting. Because when you lower the corporate tax rate there are effects in terms of deferred tax assets and deferred tax liabilities.

It is a benefit in terms of companies with deferred tax liabilities. A majority of the top 50 companies have deferred tax liabilities, so they would benefit.

There are some companies that have deferred tax assets from loss carry forwards and some types of compensation. A lower corporate tax rate would reduce the value of those deferred tax assets. And so they have decided instead of you going from 28 to 23 in one fell swoop they were going to announce it, but they are going to enact it through Parliament over the next 4 years.

Mr. HEENAN. If I could just add one quick comment that just came to mind.

You know, one of the things about a—if we announced today a phased-in process, I think we have to be cautious about is does it really give us certainty. Other countries have announced phase-ins and the economy turns south or the revenues aren't there and the phase-in becomes a freeze.

So going back to the certainty theme, the challenge of a phase-in is are we going to be convinced as businesses that that is going to be there in 2, 3, 4, 5 years? Will the phase-in really happen or will we sort of put it on hold when revenue needs overweigh the tax reduction?

Mr. PAULSEN. Mr. Schichtel, did you want to close?

Mr. SCHICHTEL. I think the one-time, non-cash impact from repricing our deferred tax liabilities and deferred tax assets will be largely a nonevent from the investor and market perspective. What they will look at is the long-term impact on cash flows and operations.

Mr. PAULSEN. Thank you, Mr. Chairman.

I yield back.

Chairman CAMP. Thank you.

Mr. Stark is recognized.

Mr. STARK. Thank you, Mr. Chairman. Thank you for the hearing, and thank the witnesses very much for their participation.

I wanted to ask Professor Hanlon if she knew how much she and I had in common.

Ms. HANLON. No I don't, but I would like to hear it.

Mr. STARK. Well, you will. If you dig out the 1953—long before you were born—catalog of the Sloan School you will find at the very bottom of the list my name as a teaching assistant. Now, you got there through a resume that is of accomplishment in academia that is outstanding. I got there in a somewhat different manner.

Up until 1953, MIT had a perfect record of placing its graduates with General Motors and General Electric and all the companies. But they came to the end of the list in about September, and one Stark was still unemployed. Well, they solved that problem. They said, we will make him a teacher.

And I must say you have improved the appearance of the Sloan School magnificently and made accounting look a lot more attractive than I remember it being from whatever was next to the window. And I want to thank you.

But, in some more seriousness, I am concerned about some of the issues that we create tax expenditures for and their usefulness. And I am going to ask you—you may not know now, but you may know someplace in your literature—has anybody done any study as to the usefulness of whatever is created through these tax expenditures?

And I give as the example the idea that Orville Redenbacher got the R&D tax credit to develop microwave popcorn. Now, you could make a case if it doesn't stick in your teeth that maybe that was a good help to society.

But, in all seriousness, I would love it if you know of or could dig out in the accounting research if anybody has done a study on what the actual usefulness, seriously, to society has been in many of these tax expenditure areas. And if you would be willing to spend a few minutes of your spare time and dig out something like that, I would sure love to have it.

Ms. HANLON. I can certainly look at that for you.

But I think the one thing that has been looked at in the literature is in an R&D study, for example, when they look at the data they might see what looks like an increase in spending. But what has been looked at is, is that really more R&D that results in more products or is it, say, a rise in the input prices.

And there is actually one study that shows that all the increase in R&D spending actually goes to salaries R&D. So it is not more R&D. It is just paying the engineers more. You know, whether the input providers actually demand a higher price for the inputs when they know that the other party has an R&D credit.

So that part has been looked at, and there is some mixed evidence on it. But I don't know of a study, because that would take a researcher, you know——

Mr. STARK. Okay. I just thought you might have come across it.

I would add that there are people who I think would have advantage of it. I hung around in the tax area with a guy named Steve Jobs probably before you were born, and he didn't really pay much attention. I mean, he would take advantage, and he came to this committee to get some tax relief for giving computers away, but that didn't stop him from developing the iPhone and all these gadgets my kids want regardless of whether or not he got the investment tax credit. He was just an innovative guy.

And I suspect that is true of most innovators. They are going to go ahead and develop these things whether or not they get the

R&D tax credit, so that perhaps we are not getting much bang for our buck in that area.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman.

One of the most frustrating things for me out here is the uncertainty. And it seems like there is a lot of taxes that are short term. In fact, we miss a lot of deadlines and go back and reinstate tax incentives, et cetera, et cetera. So just to make sure I am not the only one that feels that way, my question for Ms. Hanlon is, do you think this instability in the Tax Code creates a problem, both a book and a tax problem?

Ms. HANLON. Yes, I would agree that unpredictability and the uncertainty creates a lot of problems for companies when they try to make these long-term investments. I think a stable tax policy would be a lot better from both the tax and the accounting side.

Mr. BERG. Well, I think I heard kind of those comments. I mean, whatever it is, if it is fair, if it is reasonable, hopefully lower, flatter, keep it there, and then we can make business decisions around that. So—and I know this has been a long hearing. My question, maybe if we could just go through and if there are some specifics that you could relate to the committee where you see the temporary nature of taxes creating a problem or the fact that certain incentives have expired and then gone back in and reinstated, if there is any specifics that anyone on the panel would have.

Mr. Fryt, could you?

Mr. FRYT. I think the biggest one in that regard right now for us, some of these extender—we actually have several of the extenders that apply to us, but the biggest one is probably expensing bonus depreciation, and that does have an impact. You know, if we had that in there permanently, or any of these—permanency and certainty I agree with you is almost paramount, as long as it is a good code, but it is very important to us.

Beyond that, I don't know that I would have any further comment.

Mr. BERG. Again, I am just kind of looking for other examples that you see day in and day out that, again, are—you know, as we talked about, may be creating more cost and problems than really the incentive or disincentive was worth in the first place.

Mr. SCHICHTEL. Definitely. It comes up all the time.

I had a conversation with my old boss, who is now our president and chief operating officer, about some activities that do qualify for the Section 199 domestic production credit; and he was absolutely delighted and said, fantastic, we are going to bake this into our investment analysis and the return analysis.

And I had to caution him and say, wait a minute. I think we need to be careful. You probably can count on it for the next couple of years. Beyond that, I am not so certain.

Those types of issues come up all the time. Whatever we do, it needs to be permanent and consistent to allow my boss and the CEO and the rest of the team to make business decisions that are based on something that they can understand and count on.

Mr. BERG. I believe that is one of the reasons why there is a lot of money sitting on the sidelines right now. People run their analysis, but they can only see clearly 1 year out or 2 years out and so have to put so much risk in the remaining 8 years or however long they do their analysis that it drives it from being a potential good investment to too much uncertainty.

Mr. NEUBIG. Well, it is not just on the business side. A number of commentators have commented that we really have almost an entirely temporary tax system with so much expiring at the end of 2012, tax rates not only for the top income earners but throughout the entire tax schedule, including number of tax credits that are also going to be significantly changed. So it is a very important issue. When there was the possible expiration at the end of 2010 there was clearly activity that was occurring in late 2010 in anticipation of the rates and other things might be changing.

Mr. HEENAN. I just echo all the same comments. I mean, certainty is going to help us a lot.

Mr. BERG. I just have a rhetorical question. Is it better to address those issues that are coming up December, 2012, sooner or December 31st of 2012?

You don't need to answer that. I am assuming done in a logical process where people can engage in the debate makes more sense.

I will yield back, Mr. Chairman.

Chairman CAMP. Thank you.

Mrs. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman.

Now that all the questions have been asked and people have said how much fun they have had, I do start to question some of my colleagues about what their definition of fun is. But it has been very educational to have you all here today. Mr. Berg has been running in and out, in and out, and he comes in and asks my question last minute. Since I am the last one here, Mr. Chairman, it does not seem fair.

But, anyway, all that aside, this has really been very helpful, and much of your written testimony has also been helpful.

But I do want to add or just tag on to what Mr. Berg has said about the stability; and I want to go to one of the statements that you made, Mr. Fryt, that I thought was really very interesting. You said you wanted to compete on the merits of business and not on the Tax Code. So let me just take that a little further and ask you, with these temporary tax incentives, how you see those as affecting competitiveness.

Because I will say, just as a sidebar, between the hearings that we have had in this committee this year, which have been very, very helpful, and then those business roundtables that we have had, I have a number of businesses say that, because of the complexity of the Tax Code, that not always are they aware of maybe some of those opportunities that they could possibly have and, therefore, they are not as competitive with someone else because either there isn't that competition naturally in there for them or they don't know about it.

Could you talk about, especially since you have made that statement, Mr. Fryt, about how the temporary tax incentives do affect competitiveness?

Mr. FRYT. You have hit a hot-button issue in our company. I cannot tell you how many times my CEO, CFO, and others in the executive management decisionmakers have lamented what my CEO likes to call an arcane Tax Code with all of these temporary extenders that come in and out and special provisions here that apply to us or maybe don't apply to us and apply to others.

Overall, there is no question in my mind they would like to be unburdened from all of that, do their business, conduct their business, take all of those, if we can, reduce the tax rate as far as we can, so that they don't have to pay attention to any of that, pay the revenue that is appropriate, whatever is decided, and move on. That is our feeling.

Mrs. BLACK. Thank you.

Mr. Schichtel.

Mr. SCHICHTEL. I agree.

My title really could be changed to chief tax translator. It is a big part of what all tax directors do. And I think the complexity becomes even more of a challenge for medium-sized companies that may not have all of the resources that we have.

Clearly, from a financial perspective, the compliance burden, the difficulty in dealing with all of it are a huge drag. I just went through another budget season, and it is always painful. And everyone is frustrated that we have to spend so much just to comply with the law, not even optimizing, I am just talking basic compliance. And then every time we have a transaction the level of risk and uncertainty and complexity in the law, it is just enormous. And, really, should tax be a high-risk area just because of the complexity and difficulty in applying laws? It certainly makes doing transactions more difficult, and I can't imagine what it is like for companies that don't have the kind of resources that we have.

Mrs. BLACK. Ms. Hanlon.

Ms. HANLON. I would agree with all these statements. I think the complexity takes a lot of time.

As Tom was saying earlier with the compliance costs, they are very high. And I also agree with the small business. I think small businesses have a very hard time with complexity. They don't have the internal tax departments. And what they really should be doing is focusing on their business, but instead they spend a lot of time worrying about how should they compensate themselves, how should they structure their business, where should they structure their business, in the U.S. or somewhere else, because of the Tax Code. And I think making a more simple, more fair system would help the U.S.

Mrs. BLACK. Thank you.

Mr. Neubig, do you have a comment?

Mr. NEUBIG. Well, again, I think this is another example of where oftentimes the economists don't give lower corporate tax rates the full benefit that would happen if there was a broader base and lower corporate tax rate. That uncertainty, complexity, and how lower corporate tax rates affect so many different business decisions really is very powerful. So when people talk about the bang for the buck in terms of a lower corporate tax rate, sometimes they worry about a lower corporate tax rate applying to old capital.

But I think they really are missing so much of the power of a lower corporate tax rate that would also be simpler and more predictable.

Mrs. BLACK. Thank you, Mr. Chairman; and if I just may make one final comment, since there are very few of us.

What I continue to think about as we look at the complexity and the costs of the business, I think about how the service or the product—the cost of the service or the product is raised because of this complexity, and how ultimately it is the end user that has the cost borne.

Thank you. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Well, I very much want to thank all of our witnesses for a very good hearing this morning and for all of your time, all of your effort, all of your testimony. I appreciate it very much.

I do just want to clear up a couple of items.

There has been some question about a Joint Committee on Taxation estimate. I just for the record want to note I did not request the estimate. And, also, of the 90 remaining items, virtually all of them are domestic items.

I just think we want to have the record to be clear on that.

But, again, thank all of you for being here.

This hearing is now adjourned.

[Whereupon, at 11:30 a.m., the committee was adjourned.]

[Member Submissions for the Record follows:]

INSERT MISSING MEMBER SUBMISSION HERE

[Submissions for the Record follows:]

American Council for Capital Formation

Tax Reform: Possible Consequences of Trading Accelerated Depreciation for Corporate Income Tax Rate Reduction

By
Margo Thorning, Ph.D.
Senior Vice President and Chief Economist
American Council for Capital Formation

Testimony submitted for the record for the hearing on
"Interaction of Tax and Financial Accounting on Tax Reform"
Committee on Ways and Means
U.S. House of Representatives
February 8, 2012
Executive Summary

Determinates of U.S. Investment: Over the past three decades economics and finance experts have examined the question of whether financial variables such as cash flow and cash stocks have a significant effect on investment. Numerous economic analyses and surveys have concluded that financial factors are important in determining investment levels. For example, a 1998 empirical analysis by Professors Gilchrist and Himmelberg concludes that for the average firm in their sample, cash flow and cash stocks raise the overall response of investment to an expansionary shock by 25% relative to a baseline case where financial frictions (capital market imperfections) are zero.

Accelerated Depreciation, the Cost of Capital, U.S. Investment and Jobs: If accelerated depreciation for equipment is repealed and replaced with economic depreciation which is generally longer than the current Modified Accelerated Cost Recovery System (MACRS), the cost of capital for new equipment will rise and investment is likely be as much as $191 billion lower in 2015 compared to the baseline. Each $1 billion decline in investment is associated with a loss of 23,300 jobs.

Bonus Depreciation and U.S. Investment: Since the 4th quarter of 2007, which marks the beginning of the recession, through the 4th quarter of 2011, U.S. equipment investment has increased by 3.4%. Given the weakness of consumer demand during this period (real personal consumption expenditures increased only 1.8% during the past 4 years) it seems likely that accelerated and bonus deprecation have played a major role in sustaining investment in equipment.

Conclusions: As policymakers contemplate fundamental tax reform they need to weigh carefully the possible consequences of eliminating accelerated depreciation in return for a lower corporate income tax. It may be well to consider "paying for" corporate income tax rate reductions with cuts to entitlements for upper income individuals rather than eliminating proven investment provisions such as accelerated depreciation. Another option would be to move toward a consumed income tax where all investment is expensed.

Tax Reform: Possible Consequences of Trading Accelerated Depreciation for Corporate Income Tax Rate Reduction

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Introduction

Chairman Camp, Ranking Member Levin, and members of the Subcommittee, my name is Margo Thorning, senior vice president and chief economist, American Council for Capital Formation (ACCF),* Washington, D.C. I am pleased to submit this testimony for the hearing record to outline some possible economic impacts from eliminating accelerated depreciation and reducing the corporate income tax rate.

The American Council for Capital Formation represents a broad cross-section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Democratic and Republican administrations, former members of Congress, prominent business leaders, and public finance and environmental policy experts. The ACCF is celebrating over 30 years of leadership in advocating tax, regulatory, environmental, and trade policies to increase U.S. economic growth and environmental quality.

Background

The majority of the witnesses presenting testimony at the February 8th hearing conclude that many in the corporate community would support giving up accelerated depreciation for new investment in exchange for a reduction in the corporate income tax rate because of the impact the income tax rate reduction would have on their financial statements. For example, testimonies by Thomas Neubig of Ernst & Young LLP and Michelle Hanlon of the Massachusetts Institute of Technology state that accelerated depreciation offers only a

**The mission of the American Council for Capital Formation is to promote economic growth through sound tax, environmental, and trade policies. For more information about the Council or for copies of this testimony, please contact the ACCF, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2302; telephone: 202.293.5811; fax: 202.785.8165; e-mail: info@accf.org; website: www.accf.org* timing benefit while a lower corporate tax rate would reduce a company's effective tax rate and increase book net income reported to shareholders (see http://waysandmeans.house.gov/UploadedFiles/NeubigTestimony78FC.pdf and http://waysandmeans.house.gov/UploadedFiles/HanlonTestimony78FC.pdf).

Given the fragility and uncertainty of the U.S. economic recovery and continued high unemployment rate (currently 8.3%), it seems to me that the key question should be "What will giving up accelerated depreciation and reducing the corporate income tax do to U.S. investment and job growth?" rather than "How will financial reports to shareholders be impacted?" In my testimony I present an alternative perspective, suggesting that the positive impact of accelerated depreciation on cash flow is likely to be an important determinant in the level of investment in new equipment and thus on the prospects for strong U.S. economic recovery.

What Determines U.S. Investment?

Over the past three decades, economics and finance experts have examined the question of whether financial variables such as cash flow and cash stocks have a significant effect on investment. Some studies conclude that cash flow is mainly relevant for situations in which capital market imperfections exist and access to external debt and equity is costly.

Numerous other economic analyses and surveys have concluded that financial factors are important in determining investment levels. For example, a 1998 empirical analysis by Professors Gilchrist and Himmelberg concludes that for the average firm in their sample, cash flow and cash stocks raise the overall response of investment to an expansionary shock by 25% relative to a baseline case where financial frictions(capital market imperfections) are zero.[1] They note that "Consistent with theory, small firms and firms without bond ratings show the strongest response to financial factors.... Because bond-rated firms account for 50% of aggregate manufacturing investment, our results suggest that the overall amplification of manufacturing investment {from cash flow and cash stocks} is somewhat less that 25%."

Similarly, a recent analysis of a large number of Swedish firms during the 1989-2005 period concludes that cash flow has a significant impact on investment and the effect is particularly strong for constrained firms, especially during recessions.[2]

A survey of senior financial executives by the Manufacturer's Alliance in December, 2006 found that cash flow was the most important factor affecting the level of investment, followed by expected profits and projections of market growth (see Table 1).[3]

[1]Simon Gilchrist and Charles Himmelberg, "Investment, Fundamentals and Finance", NBER Working Paper 6652, see http://www.nber.org/tmp/22969-w6652.pdf

[2] Ola Melander, "The Effect of Cash Flow on Investment: An Empirical Test of the Balance Sheet Channel", see http://www.riksbank.se/upload/dokument_riksbank/kat_publicerat/workingpapers/2009/wp228.pdf

[3] Donald Norman, "The Puzzle of Manufacturing Sector Investment", Manufacturers Alliance/MAPI, see http://www.palgrave-journals.com/be/journal/v43/n2/pdf/be200810a.pdf

Accelerated Depreciation, the Cost of Capital, U.S. Investment and Job Growth

If accelerated depreciation for equipment is repealed and replaced with economic depreciation which is generally longer than the current Modified Accelerated Cost Recovery System (MACRS), the cost of capital for new equipment will rise and investment is likely to decline, relative to the baseline forecast. The benefit of MACRS is its positive impact on cash flow, which occurs immediately as the investment is put in place. In an increasingly uncertain world in which markets, demand and production costs can shift almost overnight, the rapid payback from MACRS depreciation substantially reduces the risk premium for investment in equipment. Having the benefit of MACRS reduces the risk premium and the hurdle rate required to make new investment attractive. While a lower corporate income tax rate would also make investment attractive, if MACRS is repealed, it seems likely that the slower payback period will raise the hurdle rates and slow the productivity enhancing investment in new equipment.

- **Has Bonus Depreciation Helped to Stimulate the U.S. Economy?**

Michelle Hanlon's testimony states that there is "little evidence" that targeted tax code provisions such as bonus depreciation (100% write off for new investment in the last quarter of 2010 and 2011 and 50% for 2012) have spurred aggregate investment.[4] Her testimony provides no empirical evidence for this claim and a look at the recent strength of equipment investment suggests otherwise. Since the 4th quarter of 2007, which marks the beginning of the recession, through the 4th quarter of 2011, U.S. equipment investment has increased by 3.4%, from $1,121 billion to $1,160 billion. Given the weakness of consumer demand during this period (real personal consumption expenditures increased only 1.8% during the past 4 years), it seems likely that accelerated and bonus deprecation have played a major role in sustaining investment in equipment.

- **Repeal of MACRS, U.S. investment and job growth**

When evaluating a prospective investment, business analysts typically add a risk premium to the firm's cost of capital, ranging from 0 to 50 % and higher. Assuming that the repeal of accelerated depreciation increases the risk premium added to the firm's cost of capital by 30% to 40 % and using conservative estimates of the elasticity of investment in response to changes in the cost of capital, it seems likely that U.S. investment in equipment could decrease by 5% to 15% over 2012-2016 period compared to the baseline forecast. As a result, U.S. equipment investment, which averaged $1.1 trillion in 2011, could decline by between $60 billion and $180 billion in 2013 and by $64 billion to as much as $191 billion in 2015. This decline in investment would make it harder to restore strong job growth. ACCF research shows that each one billion dollar decrease in

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[4] http://waysandmeans.house.gov/UploadedFiles/HanlonTestimony78FC.pdf

investment is associated with 23,300 fewer jobs and conversely each $1 billion increase in investment raises employment by the same amount (see Figure 1).

Are U.S. Depreciation Schedules More Generous than our Trading Partners'?

The testimony presented by Tom Neubig of Ernst & Young LLP states that moving toward economic depreciation has been used by many OECD countries to help partially finance their reductions in corporate tax rates.[5] However a 2007 international comparison of depreciation and corporate tax rates for energy investments in the U.S. and 11 of our major trading partners showed that U.S. firms faced slower depreciation allowances than our competitors.[6] The study, prepared for the ACCF by Ernst & Young LLP, found that in most countries and for most energy investments, the net present value of depreciation deductions was larger in other countries than in the U.S. (see Appendix II of the ACCF report). In addition, our trading partners have lower effective tax rates and lower corporate income tax rates for energy investments than does the U.S. (see Table 7 and Appendix I, Table 2).[7]

How would Switching to a Consumed Income Tax Impact U.S. Investment, Economic and Job Growth?

Over the years, many economic analyses have estimated that if the U.S. switched to a consumed income tax in which all investment was expensed, investment and economic growth would be enhanced. In an attempt to understand how such a system would have impacted the U.S. economy had it been in place in the 1991-2004 period, Dr. Allen Sinai, president and chief global economist of Decision Economics, used his large scale macroeconomic model to simulate the impact of a consumed income tax. The simulation modeled a system in which all saving is tax exempt, all new investment is written off in the first year, and interest expense is not tax deductible. The consumed income tax simulation shows strong increases in GDP, investment, employment, and federal tax receipts. If this tax system had been in place from 1991–2004, GDP would have been 5.2 percent higher every year, consumption and investment would have been greater, and employment higher by over 500,000 jobs per year (see Table 2).

Conclusions

As policymakers contemplate fundamental tax reform, they need to weigh carefully the possible consequences of eliminating accelerated depreciation in return for a lower corporate income tax. As many practitioners will remember, the cut in the corporate rate to 34% in 1986 only survived five years, so there is no guarantee that a future rate cut will endure. It may be well to consider "paying for" corporate income tax rate reductions with cuts to entitlements for upper income individuals (as suggested in the

[5] http://waysandmeans.house.gov/UploadedFiles/NeubigTestimony78FC.pdf
[6] http://www.accf.org/media/dynamic/8/media_82.pdf
[7] Ibid.

Bowles/Simpson tax reform plan) rather than eliminating proven investment provisions such as accelerated depreciation. Another option would be to move toward a consumed income tax where all investment is expensed.

Table 1. Drivers of U.S. Investment
Number of Respondents (Percent of Respondents)

	Very Important 5	4	Important 3	2	Not Important 1	Average Score
Cash Flow	28 (55)	16 (31)	7 (14)	0 (0)	0 (0)	4.4
Expected Profits	25 (50)	16 (32)	9 (18)	0 (0)	0 (0)	4.3
Projections of Market Growth	19 (37)	19 (37)	12 (24)	1 (2)	0 (0)	4.1
Capacity Utilization	18 (35)	17 (33)	10 (20)	4 (8)	2 (4)	3.9
Current Profits	13 (26)	9 (18)	24 (48)	2 (4)	2 (4)	3.6
Labor Cost Trends	7 (14)	15 (30)	13 (26)	10 (20)	5 (10)	3.2
Tax Treatment of Investment/Depreciation	2 (4)	9 (18)	17 (34)	19 (37)	3 (6)	2.8
Outstanding Debt	2 (4)	13 (25)	11 (22)	16 (31)	9 (18)	2.7
Commodity Price Trends	2 (4)	9 (18)	14 (28)	12 (24)	13 (26)	2.5
Competitors' Investments	3 (6)	5 (10)	13 (25)	20 (39)	10 (20)	2.4
Long-Term Interest Rates	0 (0)	7 (14)	16 (31)	20 (39)	8 (16)	2.4

Source: Manufacturers Alliance/MAPI, Business Outlook Survey, ER-611e, December 2005.

Table 2: International Comparison of the Effective Tax Rate on Selected Energy Investments, 2006

	Electric Generation					Electric Transmission & Distribution Lines		Pollution Control Equipment	Petroleum Refining	
	Gas	Coal	Nuclear	Combined Heat & Power Generation	Self-Generated Electricity	Transmission Lines	Distribution Lines	Discharge Modification	Crude Unit (Distillation Unit)	Fluid Catalytic Cracking Unit
United States	26.7%	30.8%	26.7%	30.8%	26.7%	27.5%	31.7%	23.4%	21.6%	21.6%
Brazil	25.7%	22.0%	N/A	25.7%	17.1%	33.5%	33.5%	13.0%	19.9%	19.9%
Canada	13.5%	13.5%	13.5%	13.5%	13.5%	30.3%	30.3%	18.1%	15.8%	15.8%
China	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	25.0%	22.1%	22.1%
Germany	28.3%	28.3%	25.1%	28.3%	28.3%	31.4%	31.4%	19.5%	19.8%	17.1%
India	16.6%	16.6%	16.6%	16.6%	16.6%	16.6%	16.6%	0.0%	15.5%	15.5%
Indonesia	18.4%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	25.0%	22.1%	22.1%
Japan	25.5%	25.5%	25.5%	25.5%	27.1%	30.6%	30.6%	21.3%	20.4%	20.4%
Rep of Korea	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	-9.7%	-9.7%	-9.7%
Malaysia	4.8%	4.8%	4.8%	4.8%	4.8%	3.9%	3.9%	1.8%	7.1%	7.1%
Mexico	12.7%	12.7%	12.7%	12.7%	12.7%	20.1%	20.1%	2.6%	19.0%	19.0%
Taiwan	14.9%	14.9%	14.9%	14.9%	14.9%	14.9%	14.9%	-18.8%	10.2%	10.2%

Source: "International Comparison of Depreciation Rules and Tax Rates for Selected Energy Investments", Prepared for the American Council for Capital Formation, Ernst and Young, May 2007.

Table 3: Corporate Income Tax Rates, 2006

Country	Tax Rate
United States	39.3%[9]
Brazil	34.0%
Canada	36.1%
China	33.0%
Germany	38.3%
India	30.0%
Indonesia	30.0%
Japan	39.7%
Rep of Korea	35.0%
Malaysia	28.0%[10]
Mexico	29.0%
Taiwan	25.0%

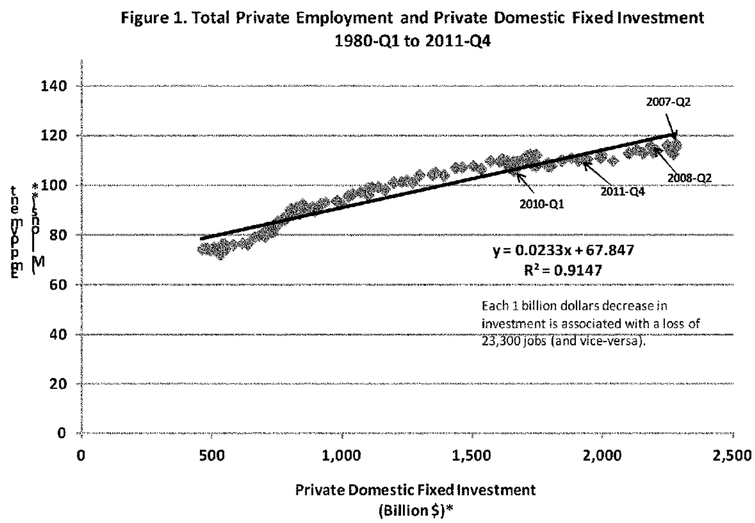
Source: OECD and Ernst & Young Corporate Tax Guide

Source: "International Comparison of Depreciation Rules and Tax Rates for Selected Energy Investments', Prepared for the American Council for Capital Formation, Ernst and Young, May 2007.

Table 4 **Economic Impact on the United States of Switching to a Consumption Tax in 1991**
Expensing business investment, removal of the business and personal interest deduction, and tax exemption of savings

	Average 1991–1995	Average 1996–2000	Average 2001–2004
Real GDP—level (billions of 96$)			
Base	7,085.8	8,499.6	10,113.1
Simulation of consumption tax	7,203.2	8,890.0	10,637.7
(Difference in level)	117.5	390.5	524.6
(Percent change in level)	1.7%	4.6%	5.2%
Business capital spending, total (billions of 96$)			
Base	684.2	1,092.0	1,599.6
Simulation of consumption tax	824.9	1,495.6	2,168.8
(Difference in level)	140.7	403.5	569.2
(Percent change in level)	20.6%	37.0%	35.6%
Consumption (billions of 96$)			
Base	4,761.7	5,717.2	6,746.3
Simulation of consumption tax	4,773.3	5,843.4	7,021.5
(Difference in level)	11.6	126.1	275.3
(Percent change in level)	0.2	2.2	4.1
S&P 500 Price Index			
Base	449.1	1081.9	1803.2
Simulation of consumption tax	557.4	1370.5	2123.4
Difference	108.4	288.6	320.2
(Percent difference in level)	24.1%	26.7%	17.8%
Employment (millions of persons)			
Total payrolls, base	111.8	125.8	138.5
Total payrolls, simulation of consumption tax	111.8	129.3	140.9
(Difference in level)	0.0	3.6	2.4
Productivity (annual percent change)			
Nonfarm business, base	1.5	2.7	2.3
Nonfarm business, simulation of consumption tax	2.6	2.8	2.8
Difference	1.1	0.1	0.5
Total federal tax receipts			
Base	6,210.5	8,853.2	9,179.3
Simulation of consumption tax	5,745.5	8,821.0	9,607.7
(Difference in level)	-465.0	-32.2	428.5

Source: Margo Thorning, "U.S. Capital Formation: How the U.S. Tax Code Discourages Investment" (Lewisville, Tex.: Institute for Policy Innovation, forthcoming), using data from Allen Sinai, "Macroeconometric Model Simulation With the Sinai-Boston Model of the U.S. Economy," unpublished study, 2001.



* Seasonally adjusted at annual rates, BEA.
** End of quarters, BLS

American Enterprise Institute

Statement Submitted for the Record

House Committee on Ways and Means

Hearing on

"The Interaction of Tax and Financial Accounting on Tax Reform"

Wednesday 08, 2012

Aparna Mathur[1]

Resident Scholar in Economic Policy Studies

American Enterprise Institute

Submitted February 22, 2012

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

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I. INTRODUCTION

Chairman Camp, Ranking Member Levin, and Members of the Committee, my name is Aparna Mathur, and I am a Resident Scholar at the American Enterprise Institute. Thank you for the opportunity to provide testimony on the important topic of tax reform.

This hearing on the interaction of tax and financial accounting attempts to gauge how publicly-listed companies in compliance with financial accounting rules respond to tax policy. More specifically, what would be the impact of a corporate tax reform on the investment decisions of these companies. When we talk about corporate tax reform, there are mainly two types of major reforms that are discussed. The first is a reduction in the headline corporate tax rate. The second is a reform of the various deductions and credits that are allowed under the tax code, which are often discussed in the context of revenue raising.

While reducing statutory rates would provide a benefit to existing investments and improve the valuation of the company from the point of view of the shareholders, expanding expensing and accelerated depreciation provisions would generate returns over the lifetime of the company by improving cash lows and thereby enhancing firm value. Both types of reforms are critical to firms that are deciding what new investments to undertake and which activities will generate the highest return. In economic terms, the user cost of capital, or the implicit annual cost of investing in physical capital, is determined by not only the headline corporate tax rate, but also other factors such as the rate of depreciation as well as the interest rate. Therefore, any changes to either the tax rates or the provisions affecting the return from capital, would lead to a change in the user cost, which would affect physical capital investments by firms.

In the second section of this submitted record, I clarify the distinction between statutory, effective average and effective marginal corporate tax rates from the point of view of an investor deciding where to locate production in a global economy. Then in the third section I will proceed to describe how accelerated depreciation and expensing provisions offer as many, or more, benefits to the overall economy for each dollar of foregone revenue than statutory rate cuts.

II. STATUTORY, EFFECTIVE AVERAGE, AND EFFECTIVE MARGINAL TAX RATES

As is widely acknowledged, high statutory corporate tax rates in the U.S. make investments in the U.S. uncompetitive relative to other OECD economies. This has a negative effect on profitability and revenues in the U.S. as the limited availability of capital, or the lack of high quality capital and machinery, makes it tougher for workers to be productive. In research that we have done at the American Enterprise Institute, we show that this lower productivity of workers then translates into lower wages for the poor and middle class workers, employed in manufacturing jobs.[i] This is the reason why despite the fact that the U.S. has one of the highest statutory corporate tax rates in the OECD (at 39.2 percent if we include state and local taxes), the U.S. collects some of the lowest corporate tax revenues in the OECD.

In Table 1 in the Appendix, we show the distribution of corporate tax rates in the OECD for the year 2011. The top national statutory corporate tax rates in 2011 among the 31 members of the Organization for Economic Cooperation and Development (OECD) ranged from 8.5 percent in Switzerland and 12.5 percent in Ireland to 35 percent for the U.S. Hence within the OECD countries, the U.S. has the highest statutory rate of taxation at the national level. The picture changes only marginally when we add the sub national corporate tax rates to the top national rate. In the case of the United States, the average top statutory rate imposed by states in 2011 added just over 4 percent (after accounting for the fact that state taxes are deducted from federal taxable income)—for a combined top statutory rate of 39.2 percent. Among all OECD countries in 2011, the United States' top statutory combined corporate tax rate was the second highest, after Japan's at 39.5 percent. In 2012, the United States will be left with the highest national and combined corporate tax rates in the world when Japan introduces a planned 5 percentage point reduction to its top rate.[ii]

The argument has often been made that the statutory tax rate is an imperfect measure of tax competitiveness because it does not take into account the breadth of the tax base[iii]. While the statutory or headline rate may be an important factor for firm profitability, firms ultimately base decisions about where to locate investments and capital using some estimate of their future economic returns from that investment. These returns are a function of not just the headline rate, but tax depreciation and expensing rules, research and development tax credits, the interest deductibility provision, and others. Thus the effective tax rate, which takes into account all these provisions, is an important factor in firm investment decisions. Research in economics has shown that capital flows from high tax to low tax countries, and that effective tax rates are responsible for driving these flows.[2]

Countries that substitute high rates for a narrow base, such as the United States, will appear more uncompetitive on the basis of statutory rates alone. "Effective" tax rates resolve this issue by taking into account tax offsets, the present value of depreciations, and other deductions that narrow the base.[iv] There are two principle ways to measure effective tax rates. As it turns out, the United States is nearly as uncompetitive based on these measures as it is based on statutory rates alone.

One way to measure these effective tax rates is by means of the "effective average tax rate" (EATR). The simplest way to understand the effective average tax rate is by means of an example. The United States has a federal statutory rate of 35 percent plus approximately 4 percent from States and municipalities for a combined rate of 39 percent. It then allows for deductions from depreciation allowances, debt financing, loss offsets and expensing, which cause the actual tax liability to be reduced. For example, suppose a corporation is planning to build a new plant. The new plant is expected to generate \$100 in profits over its lifetime, and the total amount of deductions is \$50. In other words, for \$100 in profits the corporation is only taxed on \$50. As a result, its taxable income is \$50, and its tax liability is 39 percent of \$50 or \$20. In this example, the effective average tax rate on the plant's income would be \$20/\$100 or 20 percent. A firm would find the EATR useful when deciding which country to invest in with a new plant. Countries with high EATRs would lose, while capital would flow to the low EATR jurisdictions.

[2] Gordon, Roger H. & Hines, James Jr, 2002. "**International taxation**," Handbook of Public Economics, in: A. J. Auerbach & M. Feldstein (ed.), Handbook of Public Economics, edition 1, volume 4, chapter 28, pages 1935-1995 Elsevier.

Another related concept is the effective marginal tax rate (EMTR). This shows the tax liability on an additional dollar of investment. So, it would be particularly relevant for the scaling of projects. For instance, once a firm decides to build a plant, the EMTR would capture the tax liability on the marginal or additional investment of adding a machine to the production line. Suppose the machine costs $50. If the firm can deduct 50 percent of the cost of this machinery, and the firm expects a return of $66 over the lifetime of this machinery, then the marginal effective tax rate would be 0.39* ($66-$25)/$66 or 24 percent.

In work with Kevin Hassett at AEI, we used the methodology described in a 1999 paper by Michael Devereux and Rachel Griffiths for calculating the effective average and effective marginal rates for investments in plants and machinery. Intuitively, the EMTR in this methodology is calculated as that tax rate which makes the post-tax returns from the investment equal to the cost of the investment. In other words, the firm breaks-even on the last or marginal investment after allowing for taxes. The EATR is calculated as the difference between the pre- and post-tax economic profits expressed as a fraction of pre-tax economic profits. Hence when a firm is deciding between locating a plant in one of two locations, it will compare the EATR to see what the average post-tax return is likely to be in both locations, and move to the location with the lower EATR. On the other hand, when it has to decide whether to expand the scale of its project, it has to look at the EMTR on the marginal investment.

Table 2 shows that relative to the other OECD countries, the U.S. EATR is nearly 10 percentage points higher than the average for all the OECD countries. Therefore, not only is the U.S. much worse when we look at the statutory headline rate-it scores equally badly when we compare effective average tax rates. Further, the U.S. is only second in the OECD when we use the EMTR to rank countries.

As a check on our results, we compared our relative rankings to those obtained by the World Bank for a study done in 2009. The World Bank approximates the effective rate using an alternative methodology. This approach considers a representative company in a typical year of operation and computes the taxes it would pay if located in different countries as a percent of its financial income using standardized financial accounting (a "book" measure of effective tax rate). In Table 3, we show the effective rates computed by the World Bank using the book method. While the actual value of the rates computed varies under our methodology relative to the World Bank methodology, as we may expect, there is little improvement in the U.S. position relative to other countries.

A few papers, such as one by Kevin Markle and Douglas Shackelford, use actual tax liability data to approximate measures of the effective average and marginal rates.[3] The advantage of tax liability data is that it can account for all the different types of deductions, allowances and credits that may be specific to each company or industry. However, a disadvantage of this approach is that any firm's actual tax liability may be a function of it's specific tax planning strategies, whether it's a multinational with tax haven operations, whether it's more or less profitable than other firms and so on. Therefore, tax liabilities may be firm-specific rather than country-specific. However, even using this measure, the paper concludes that Japanese firms faced the highest effective average tax rates over this period followed by U.S.

[3] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1770391

multinationals. Further, while EATRs have been falling for the last two decades worldwide, the ordinal rank from high-tax countries to low-tax countries has changed little.

The United States' is currently underperforming in global tax comparisons. The United States' top statutory tax rates will soon be the highest in the OECD, and the U.S. effective average and effective marginal tax rates are far above the OECD average. Any effort at corporate tax reform is therefore incomplete without a push towards addressing not only the high statutory rates, but also the relatively high effective average and marginal rates. These rates are the best indicators for capital investors of their true tax liability-much more so than the statutory rates. For instance, by our calculation, for the U.S., the statutory rate is nearly 10 percentage points higher than the effective average rate and nearly 17 percentage points higher than the effective marginal tax rate. This would be comforting if it were not for the fact that relative to other OECD countries, the U.S. is one of the worst performers on this score. The average effective tax rate for all OECD countries excluding the U.S. is 20.5 percent, while the effective marginal tax rate is 17.5 percent. The corresponding values for the U.S. are 29 percent and 23.6 percent. Therefore, while much media attention has been focused on the statutory rates, reforming effective rates should clearly be an area of urgent concern for policy makers as well.

In the final section, I provide a preliminary analysis of how effective tax rates are affected by either rate cuts or the introduction of permanent expensing provisions.

III. AN ANALYSIS OF THE IMPACT OF EXPENSING AND STATUTORY RATE CUTS ON EFFECTIVE CORPORATE TAX RATES

The most common refrain from tax-reform proponents is "Lower the rates; broaden the base" This mantra is repeated emphatically and often. However, it ignores one of the lowest hanging fruits for corporate tax reform, namely, the immediate expensing of business investments. In this section, I briefly sketch a few of the benefits of allowing expensing, and then I attempt to compare the effect of expensing on marginal tax rates to the effect of statutory rate cuts.

Expensing benefits businesses by increasing the present value of the deductions that are allowed for investment costs. Whereas under depreciation provisions, investment costs must be deducted over time, under expensing investment costs are deducted immediately. With full expensing, the value of the deduction will exactly offset the present value return on the investment over its lifetime, so the effective marginal tax rate on investment will be zero. This will cause more investment to be undertaken, an expanded capital accumulation in the economy, and in the long run greater growth. The benefits of expensing are comprehensively described in a 2010 Center for American Progress/Brookings Institution paper by economist Alan Auerbach from UC Berkley[v]; a Treasury Department Background Paper on business taxation from 2007;[vi] and the forthcoming book on the "X-Tax" by my colleague Alan Viard and Robert Carroll from PricewaterhouseCoopers.[vii]

For each dollar of revenue lost, expensing can sometimes provide more investment than statutory rate cuts since it only applies to new investments, not existing ones. In the long run, the cost of expensing would be negligible according to estimates by economists Gordon, Kalamokidis, and Slemrod (2004).[viii] The main costs from expensing will likely come from transition relief for existing investments. Given the benefits of lowering effective rates, which I describe above, it is illuminating to see how even partial expensing can provide substantial decreases in effective marginal tax rates.

In Table 4, I use a calculator of effective marginal tax rates published by the Congressional Budget Office in 2007 to analyze the effect of a 50% expensing provision compared to a 10 percentage point statutory rate cut. Whereas the effective tax rate model that I describe above is extremely valuable for doing cross-country analysis, the CBO calculator is better suited to analyzing specific tax code changes for the United States. Compared to current policy, a statutory rate cut from 35% to 25% would lower the EMTR on total business investment from 24.2% to 20.8%. If we keep the current 35% top statutory rate and allow 50% expensing of business investment, then the EMTR for total business investment falls from 24.2% to 16.6%.

If the goal of policy is to spur investment in the United States and raise revenues, we need to focus on lowering effective rates, rather than simply reducing the top rate. Therefore, the provision of expensing (or accelerated depreciation) is a valuable tool and should not be left out of the policy debate.

TABLE 1: 2011 TOP STATUTORY CORPORATE INCOME TAX RATES

Country	Central Govt.	Combined
Switzerland	8.5	21.2
Ireland	12.5	12.5
Germany	15.8	30.2
Canada	16.5	27.6
Czech Republic	19.0	19.0
Hungary	19.0	19.0
Poland	19.0	19.0
Slovak Republic	19.0	19.0
Chile	20.0	20.0
Greece	20.0	20.0
Iceland	20.0	20.0
Slovenia	20.0	20.0
Turkey	20.0	20.0
Estonia	21.0	21.0
Korea	22.0	24.2
Luxembourg	22.1	28.8
Israel	24.0	24.0
Austria	25.0	25.0
Denmark	25.0	25.0
Netherlands	25.0	25.0
Portugal	25.0	26.5
Finland	26.0	26.0
United Kingdom	26.0	26.0
Sweden	26.3	26.3
Italy	27.5	27.5
New Zealand	28.0	28.0
Norway	28.0	28.0
Australia	30.0	30.0
Mexico	30.0	30.0
Spain	30.0	30.0
Japan	30.0	39.5
Belgium	34.0	34.0
France	34.4	34.4
United States	35.0	39.2
Average Excluding U.S.	23.3	25.1

SOURCE: OECD

TABLE 2: EATR, EMTR, and Statutory Rates

	2010 EATR	2010 EMTR	2010 Statutory Combined
Australia	22.2%	17.0%	30.0%
Austria	20.8%	18.2%	25.0%
Belgium	22.3%	13.9%	34.0%
Canada	25.5%	23.4%	29.5%
Chile	13.9%	11.5%	17.0%
Czech Republic	18.4%	18.1%	19.0%
Denmark	19.9%	16.5%	25.0%
Finland	20.7%	17.3%	26.0%
France	27.5%	23.8%	34.4%
Germany	24.2%	20.7%	30.2%
Greece	17.9%	13.4%	24.0%
Hungary	15.7%	13.4%	19.0%
Ireland	10.9%	9.7%	12.5%
Iceland	-	-	15.0%
Italy	24.3%	22.6%	27.5%
Japan	33.0%	30.5%	39.5%
Korea	18.1%	13.6%	24.2%
Luxembourg	20.1%	13.9%	28.6%
Mexico	28.4%	27.7%	30.0%
Netherlands	19.4%	15.1%	25.5%
New Zealand	-	-	30.0%
Norway	24.2%	22.1%	28.0%
Poland	16.2%	14.1%	19.0%
Portugal	18.3%	12.2%	26.5%
Slovak Republic	19.2%	19.3%	19.0%
Spain	27.5%	26.3%	30.0%
Sweden	18.5%	12.6%	26.3%
Switzerland	15.4%	10.9%	21.2%
Turkey	13.1%	7.3%	20.0%
United Kingdom	22.3%	18.8%	28.0%
United States	29.0%	23.6%	39.2%
Average Excluding U.S.	20.5%	17.2%	25.5%

TABLE 3: Comparison with World Bank Calculations

	2009 EATR	2009 World Bank EATR Estimate
Australia	22.2%	25.9%
Austria	20.8%	15.7%
Belgium	22.3%	4.8%
Canada	27.1%	9.8%
Chile	13.9%	
Czech Republic	19.4%	7.4%
Denmark	19.9%	21.9%
Finland	20.7%	15.9%
France	27.5%	8.2%
Germany	24.2%	22.9%
Greece	18.6%	13.9%
Hungary	16.6%	16.7%
Ireland	10.9%	11.9%
Iceland	-	6.9%
Italy	24.3%	22.8%
Japan	33.0%	27.9%
Korea	18.1%	15.3%
Luxembourg	20.1%	4.1%
Mexico	26.5%	
Netherlands	19.4%	20.9%
New Zealand	-	30.4%
Norway	24.2%	24.4%
Poland	16.2%	17.7%
Portugal	18.3%	14.9%
Slovak Republic	19.2%	7.0%
Spain	27.5%	20.9%
Sweden	18.5%	16.4%
Switzerland	15.4%	8.9%
Turkey	13.1%	8.9%
United Kingdom	22.3%	23.2%
United States	28.9%	27.6%
Average Excluding U.S.	20.6%	15.9%

TABLE 4: COMPARISON OF 25% STATUTORY RATE TO 50% EXPENSING

EMTR (percent)	CURRENT LAW	SCENARIO 1	SCENARIO 2
	no expensing 35% rate	**50% expensing** 35% rate	no expensing **25% rate**
Total business investment	24.2%	16.6%	20.8%
Corporate	26.3%	17.8%	20.9%
Non-Corporate	20.6%	14.6%	20.6%

[i] http://www.aei.org/papers/economics/fiscal-policy/taxes/spatial-tax-competition-and-domestic-wages/
[ii] http://online.wsj.com/article/BT-CO-20101222-702799.html
[iii] *See* Jane G. Gravelle and Thomas L. Hungerford, ''Corporate Tax Reform: Should We Really Believe the Research?'' *Tax Notes*, Oct. 27, 2008, p. 419, *Doc 2008-18748*, or *2008 TNT 209-18*; and Aviva Aron-Dine, ''Fiscally Responsible Corp. Tax Reform Could Benefit the Economy,'' *Tax Notes*, Aug. 18, 2008, p. 691.
[iv] These calculations are done for midsize companies. This is the approach used by the World Bank in its annual *Doing Business* reports. According to the World Bank *Doing Business* 2011 report, the U.S. book effective tax rate in 2009 was quite high by global standards, ranking 162nd out of 183 countries (89th percentile), and was also high by comparison to OECD member countries, ranking 3rd highest out of 30 (90th percentile). The book effective rate places the United States a little better than the statutory rate does, but not much.
[v] Auerbach, Alan J. *A Modern Corporate Tax*. DC: *Hamilton Project/CAP*, December 2010.
[vi] U.S. Department of the Treasury, "Background Paper." Paper presented in the Treasury Conference on Business Taxation and Global Competitiveness, U.S. Department of the Treasury, July 23, 2007.
[vii] Carroll, Robert, and Viard, Alan D. *Progressive Consumption Taxation: The X Tax Revisited*. DC: The AEI Press, forthcoming.
[viii] Gordon, Roger, Kalambokidis, Laura, and Slemrod, Joel. "Do we *now* collect any revenue from taxing capital income?" *Journal of Public Economics* 88 (2004): 981-1009.

Association for Financial Professionals

Association for Financial Professionals®

February 22, 2012

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives
1100 Longworth House Office Building
Washington, DC 20515

Dear Chairman Camp:

The Association for Financial Professionals (AFP) [1] welcomes the opportunity to provide you and the Members of the Committee on Ways and Means (Committee) with our thoughts on the issues addressed at the February 8, 2012, hearing on the interaction between tax and financial accounting on tax reform. AFP's Financial Accounting and Investor Relations Task Force[2] (Task Force) is pleased to offer our feedback based on input we continue to receive from our members. We hope that our comments will add to the discussion and we welcome the opportunity to discuss them in greater detail with your staff.

The Task Force supports the Committee's mandate to evaluate the current corporate tax structure and make recommendations for improvement. Most AFP members agree that corporate tax reform is needed. We applaud your willingness to look at all aspects of the taxing policy, including the accounting rules, when considering your options. However, AFP's longstanding position is that Congress and the accounting standards setters should act independent of each other.

Article 1 of the Constitution gives Congress, among other powers, the power to collect taxes and make the laws necessary to ensure the execution of that task. Similarly, the accounting standard setters are charged with establishing and improving standards of financial accounting and reporting to provide decision-useful information to investors and other users of financial reports. While the two processes often complement each other, they clearly have different objectives.

Legislation should focus on tax reform in terms of the overall economic impact to industries, innovation, employment, and the national debt. The rules governing the accounting for taxes

[1] AFP represents approximately 16,000 finance and treasury professionals from over 5,000 corporations, including the Fortune 1,000 and the largest middle-market companies. Our membership includes a significant number of corporate treasurers who are responsible for the protection and management of corporate cash, cash flow requirements and corporate investments; and controllers and CFOs, who are responsible for their corporate accounting, financial reporting and regulatory compliance.

[2] AFP's FAIR task force, a subcommittee of the Government Relations Committee, monitors the activities of the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), the Securities and Exchange Commission (SEC) and other government and standard-setting entities that affect corporate accounting, financial reporting and investor relations.

created by the Financial Accounting Standards Board is a convention to report those legislatively enacted tax rules consistently. Thus, any changes Congress makes to the tax code that warrants an accounting change will be subsequently taken up by the Financial Accounting Standards Board (FASB) for their independent review and due process.

While the topic of your hearing was on the impact of corporate tax reform and accounting, a great deal of time was spent discussing corporate tax reform as it pertains to the current tax rules on repatriated earnings. AFP's longstanding position on taxing repatriated foreign earnings is that Congress' action should include permanently reducing the tax rate to a percentage that would incent companies to return foreign earnings to the U.S.

Because companies can currently choose when to repatriate foreign earnings, and therefore when to pay U.S. taxes on those earnings, the lost tax revenue or opportunity cost of this tax treatment is extremely low. In fact, a reduction in the current tax rate would likely increase tax revenue in the U.S. both in the short- and long-term because there would no longer be such a strong incentive to keep those funds offshore to avoid paying the high U.S. taxes. Additionally, the likely inflow of capital into the U.S. would stimulate capital investment and hiring, contributing to economic recovery in the short run and economic growth in the long-term.

Recently, AFP conducted a membership survey soliciting their views on taxation of cash that is repatriated from overseas operations. Twenty-six percent of survey respondents indicate that their organizations made fewer investments in U.S. operations as a result of the tax placed on cash repatriated from U.S operations. Two-thirds of respondents that work at organizations that have non- U.S. based operations indicate that the tax on repatriated foreign earnings at current rates have little to no impact on the decision to continue and/or establish operations outside of the U.S. Conversely, nearly two-thirds of survey respondents from similar organizations state that the same tax has discouraged their organization from repatriating cash back to the U.S. and using it to invest in corporate growth (i.e., capital investments, hiring more workers, research & development).

A majority of financial professionals tie a reduction in the taxes imposed on repatriated cash from overseas operations to increased capital investment and employment in the U.S., with a greater impact resulting from a permanent reduction in the tax. Sixty-one percent of survey respondents link even a temporary reduction on the tax levied against repatriated cash to greater capital investment and/or hiring in the U.S. However, seventy-four percent of the respondents foresee a similar positive outcome from a permanent tax adjustment.

As you know, President Obama recently announced his plans surrounding corporate tax reform. AFP applauds the Obama Administration's willingness to examine all options when deciding the best course of action needed to repair our nation's current tax system. We strongly encourage White House staff to work with your Committee to consider comprehensive changes that would incent companies to bring back their foreign earnings and invest those resources in the U.S. A tax policy that continues to harm the competitiveness of the U.S. will only encourage companies to further expand their investment and hiring in other countries. Therefore, AFP strongly encourages changes to the corporate tax system that would incent companies to return foreign

[redacted]

earnings to the U.S. Without such an incentive, many companies will either continue to build cash balances outside of the U.S. or invest their cash in the foreign country where it was earned, generating no stimulus to the domestic economy.

AFP applauds the Committee's willingness to examine all options, to include the financial accounting and reporting impact, when deciding the best course of action needed to repair the current tax system. We appreciate the opportunity to provide our thoughts on this topic.

If you have any questions about our comments, please contact AFP's Director of Accounting and Financial Reporting, Salome J. Tinker, CPA at 301.961.8871 or sjtinker@AFPonline.org or AFP's Director of Government Relations and Public Policy, Jeanine Arnett, at 301.885 or jarnett@AFPonline.org.

Respectfully submitted,

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Center for Fiscal Equity

Comments for the Record

House Committee on Ways and Means

Hearing on the Interaction of Tax and Financial Accounting on Tax Reform

Wednesday, February 8, 2012, 10:00 AM

By Michael G. Bindner

Center for Fiscal Equity

Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit these comments for the record to the House Ways and Means Committee. Our comments are in the context of our tax reform plan, which has the following four elements:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We have no proposals regarding environmental taxes, customs duties, excise taxes and other offsetting expenses, although increasing these taxes would result in a lower VAT. As we have no proposals in these areas, we will ignore the financial accounting implications of these taxes.

The impact of VAT adoption on financial accounting is well documented, with a wealth of working models in every other OECD nation to draw upon. The complexity of any financial accounting depends on the complexity of the VAT itself. Broader based taxes require simpler accounting structures and will be generally more stable, with exceptions yielding complexity in reporting and accounting and inviting more complexity as entrenched interests demand more benefits to further game the system.

Accounting for Employee-paid Old Age and Survivors Insurance will be no more complicated than current law, while accounting for the income surtax will be greatly simplified. The only complexity will be accounting for sales to a qualified ESOP, which will continue to be tax exempt. If surtax rates remain stable, the only source of complexity will be annual adjustments for inflation.

American competitiveness is enhanced by enacting a VAT, as exporters can shed some of the burden of taxation that is now carried as a hidden export tax in the cost of their products. Accounting systems in a VAT system will also have to account for zero rating at the border and the treatment of imports as entirely taxable to the importer. The NBRT will also be zero rated at the border to the extent that it is not offset by deductions and credits for health care, family support and the private delivery of governmental services. As it is similar to a VAT, it will begin with the same base, but will require additional accounting structures to take into account the exclusions which make it more like an income tax and less like a VAT. These exclusions are the reason for a separate tax.

Accounting for a continued health insurance exemption is well developed. Accounting for services to retirees will be more complicated. While purchases for health care would be VAT and NBRT exempt, base medical wage costs would also be exempt for NBRT purposes, but not necessarily for the VAT, unless these services are contracted, in which case VAT would be collected by the vendor and the NBRT would be embedded in their costs. NBRT offsets for employer provision of social and educational services will follow similar rules, although services provided by non-profits will be VAT exempt, although the NBRT will still be embedded in any contribution.

Establishment of personal accounts as an offset for Old Age and Survivors Insurance will require complex accounting rules, however the benefit of such accounts is that the majority of these funds will be invested with the employer and accounting rules should be only slightly more complex than those required to deal with non-employee investors, although procedures to avoid older retirees spending down all of their assets and the creation of annuities for non-employee widows will add complexity.

Consolidation of the child tax exemption, the child tax credit and the EITC, while making them refundable, will aid both taxpayers and employee companies, who will simply report credits paid to each employee with their tax filing, with a copy to each employee, so that the government may also send a copy which employees can compare to verify honest employer reporting and payment. This should be no more complex than current accounting to process W-2 and 1099 forms.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit. The accounting system must be able to capture this event when it occurs. It must also be able to adjust changes to NBRT and VAT rates and for Child Tax Credit adjustments for inflation, as well as expansions used for counter-cycle stimulus.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals. Relying on a separate personal income surtax for higher income individuals also reduces complexity for employers, who would not have to include systems to calculate surtaxes on higher income employees and dividend payees internally.

Our proposal seeks to bring long term stability to the tax debate, including consensus on who pays the income surtax and by how much. As the invited witnesses stated, stable tax policy is the best way to help firms minimize complexity in accounting for tax reform (although once the national debt is entirely paid off and overseas military commitments either ended or entirely funded by host countries, provisions to collect funds for the income surtax can be suspended when the surtax sunsets.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Contact Sheet

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Committee on Ways and Means
Hearing on the Interaction of Tax and Financial Accounting on Tax Reform
Thursday, February 8, 2012, 10:00 AM

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

Equipment Leasing and Finance Association

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Written Submission of William G. Sutton, CAE
President and CEO of the Equipment Leasing and Finance Association
before the U.S. House Committee on Ways & Means
Hearing on the Interaction of Tax and Financial Accounting on Tax Reform
February 21, 2012

Chairman Camp, Ranking Member Levin and distinguished members of the committee, I write to provide additional information to members of the House Committee on Ways & Means as a follow-up to your hearing on the interaction of tax and financial accounting on tax reform held February 8, 2012. This submission discusses how equipment financing is influenced by tax and accounting policies and highlights proposed changes being considered to lease accounting standards by the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB) that will impact the treatment of equipment leases.

Background on ELFA

The Equipment Leasing and Finance Association (ELFA) is the trade association that represents companies in the $628 billion commercial equipment leasing and finance sector, which includes financial services companies and manufacturers engaged in financing capital goods. This represents over half of the estimated $1.2 trillion U.S. annual expenditure for capital equipment acquisition. ELFA members are the driving force behind the growth in the commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Its over 550 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packagers and investment banks, as well as manufacturers and service providers. ELFA has been equipping business for success for more than 50 years. For more information, please visit www.elfaonline.org.

ELFA members provide credit every business day to nearly every business and state and local government sector in the country. ELFA members finance the acquisition of all types of capital equipment, including commercial and corporate aircraft; rail cars and rolling stock; trucks and transportation equipment; vessels and containers; construction, agriculture and off road equipment; medical technology and equipment; IT hardware, software and capitalizable services; emergency communications; public transit; police and emergency vehicles; school buses; energy management and conservation equipment; and virtually every other type of equipment.

Business Use of Leases

Generally, leases are transactions involving equipment or other property acquired by a lessor and leased under an executory contract to the lessee. Leasing is such a pervasive activity in U.S. business that all companies lease equipment and real estate, some to greater extents than others, as a means to acquire the use of an asset without the burdens of ownership. Equipment financing can help mitigate the uncertainty of investing in a capital asset and may enable a business to achieve its desired return, increase efficiency, save costs and apply capital to more pressing needs of its operations. Our members offer flexible choices that can work with the diverse objectives of most businesses.

Leasing equipment provides advantages to both lessors and lessees. As owners, lessors have the ability to utilize significant tax credits, grants and accelerated depreciation deductions. Lessees can take interest payments as business tax deductions, create greater certainty in budgeting by setting customized rent payments to match cash flow, gain the ability to avoid equipment obsolesce, and provide services relating to installation, maintenance, de-installation and disposal of the equipment. The tax treatment under the Internal Revenue Code and the accounting treatment under current GAAP for lessees generally match, as rents are expenses for book purposes and rents are tax-deductible expenses for tax purposes. Only when there are uneven rents are there timing differences, but they are usually minor. The tax and accounting method treatment of leases make leases desirable for both lessors and lessees to utilize in their strategic business planning.

Proposed Changes to Lease Accounting Standards

A major convergence project currently under consideration by the IASB and FASB makes significant changes to GAAP for lessees by accelerating lease expenses for book accounting purposes. As proposed, leases would be capitalized resulting in an accounting asset and liability on balance sheets. Rent expense will be replaced by the straight line amortization or depreciation of the asset and imputed interest on the liability. This recasting of the lease transaction will produce a front ended expense pattern that will cause non cash book expenses generated by the executory lease contract to depress book earnings and equity capital. It will also cause a temporary difference for income taxes and create a significant deferred tax asset. The loss of capital from the front ended book expense pattern and the resulting deferred tax balance will in essence cause a permanent reduction in equity capital unless the lessee discontinues its leasing activities, which is virtually impossible for most companies.

This proposed change in GAAP would distort the financial presentation readers of financial statements will observe, giving the impression that the lessee is undercapitalized and has a deferred tax asset that may never be recovered in the future. A number of organizations and other stakeholders, including the ELFA, have recommended the proposal be revised so that the reported lease cost is equal to the average rent expense as under current GAAP so that the accounting reflects the economic effects of the lease. The most-effected industries are retail, transportation and banking--all key industries in the US economy. The loss of equity and the resulting deferred tax asset created by the proposed accounting will undoubtedly change lessee behavior (for example the first year cost under a 10 year lease will be 28% higher than under current GAAP) causing them to make uneconomic decisions. Investors will be confused by the new accounting and share prices may be impacted.

Additionally, the current proposed revenue recognition rules ignore tax benefits in lease investments, distorting the earnings pattern. Tax benefits are as much a part of revenue as cash from rents, yet taxes are ignored. The result of this is already evident, as no large leveraged leases have been closed since the project began as investors assumed the accounting treatment would be adverse. The lessees in long lived assets have suffered as alternative structures are more costly. Lessor behavior will change under the proposed rules avoiding lease structures with distorted revenue recognition and the result is increased lease costs for lessees. The current green energy tax credits and 50% bonus MACRS depreciation are tax benefits that serve to foster lease financing, yet the proposed rules will account for these in a way that makes for unattractive revenue patterns for lessors. We support maintaining leveraged lease accounting and revenue recognition so that fixed tax benefits in any investment are included in the earnings on the investment in a rational pattern versus the cash invested.

As the Committee is well aware, tax implications are critically important in commercial equipment acquisition for all sizes of companies. Thank you for the opportunity to provide this statement for the record on the value of leasing and equipment finance, and the additional information in regards to the interaction between tax and accounting standards. We look forward to expanding on the issues raised herein if members of the Committee or staff desire more information relating to these matters in particular, and the lease accounting project, generally.

Fiscal Associates

**WRITTEN STATEMENT SUBMITTED FOR CONSIDERATION BY
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON THE INTERACTION OF
TAX AND FINANCIAL ACCOUNTING ON TAX REFORM**

HEARING DATE: FEBRUARY 8, 2012

**SUBMITTED BY GARY A. ROBBINS
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FEBRUARY 17, 2012

GARY A. ROBBINS
PRESIDENT, FISCAL ASSOCIATES

WRITTEN STATEMENT SUBMITTED FOR CONSIDERATION BY

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

HEARING ON THE INTERACTION OF
TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

Hearing Date: February 8, 2012

I am the president of Fiscal Associates, a consulting firm specializing in the economics of taxation. For 16 years, I was an economist in the Office of Tax Policy and the Office of Economic Policy at the Treasury Department. In total, I have spent more than 45 years building economic models and in analyzing how changes in taxes and other factors affect business capital investment decisions and how those decisions affect overall economic growth.

The Committee has asked for information on "the interaction between tax policy and accounting rules so that we [can] make informed decisions about which policy choices will help employers grow and create jobs." The Hearing Advisory suggests that "comparing a rate cut with expensing requires consideration of the impact of financial accounting considerations on business investment decisions."

The purpose of this submission is to address two questions. First, do companies make investment decisions based on the actual impact the project will have on the company's net worth or on how the project will be presented by accountants on the financial statements? Second, will a tax reduction spread across both old capital investment and new capital investment (such as a cut in the tax rate) yield as much new investment and GDP growth as a tax reduction focused solely on new investment (such as first-year expensing or accelerated depreciation)?

How Is The Investment Decision Made?

The answer to this question is found by looking at how business investment planners actually do their jobs. For years, all business schools have taught some variant of "wealth maximization" as the method that should be used in the analysis of new investments. The reason is simply a matter of mathematics. No other method will yield a more accurate result or better inform the decision to make or forego a capital investment.

Given that wealth maximization is what is taught, what is used in the field in actual practice? A 2001 study by John Graham and Campbell Harvey of Duke University surveyed businesses about how investment decisions are actually made.[1] They state:

> It is a major tenet of modern finance theory that the value of an asset (or an entire company) equals the discounted present value of its expected future cash flows. Hence, companies contemplating investments in capital projects should use the net present value rule: that is, take the project if the NPV is positive (or zero); reject if NPV is negative. But if NPV has been the dominant method taught in business schools, past surveys have suggested that internal rate of return (IRR) was for long the primary corporate criterion for evaluating investment projects. For example, a 1977 survey of 103 large companies reported that fewer than 10% of the firms relied on NPV as their primary method, while over 50% said they relied mainly on IRR. Although the two measures are similar in several respects (and will lead to the same "go-no go" decision if the same hurdle rates are used), the critical difference is that IRR is a ratio while NPV is a dollar measure of value added.
>
> ...most respondents cited net present value and internal rate of return as their most frequently used capital budgeting techniques; 74.9% of CFOs always or almost always used NPV and 75.7% always or almost always used IRR. As noted earlier, however, large companies were significantly more likely to use NPV than were small firms.

It seems clear that potential financial statement presentations by accountants have little influence on capital investment decisions, in either practice or logic. Rather, most firms -- especially large firms -- use discounted cash flow to make such decisions. Similarly, the Committee should be persuaded by how its tax policies affect the net present value of potential capital investments, not by how such policies affect financial statement presentations.

Which Tax Policy Is Best?

This question is addressed by looking at two alternative reductions in business tax burdens. As suggested by the Hearing Advisory, the two options considered are either (1) to reduce the business tax rate or (2) to provide more rapid cost recovery.

The controlling issue is as follows. Will first-year expensing be more helpful to GDP and jobs growth than a rate cut that has the same static revenue cost?

A tax policy change that increases economic activity and maximizes GDP growth is one that decreases the cost of producing output, thereby allowing the price of the output to be lowered and more units to be sold. On the assumption that labor costs and the purchase prices of capital goods are constant, the tax policy change must, therefore, focus on lowering the tax component in the cost of capital investment. Perforce, the preferred tax policy choice is the one that most reduces the cost of capital investment and most increases GDP growth per dollar of revenue cost.

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[1] John Graham and Campbell Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field", *Journal of Financial Economics*, Vol. 60 (2001).

The following Impact Table illustrates that first-year expensing is superior to a rate cut with a comparable revenue cost. As explained in the Technical Analysis, similar results obtain when an acceleration of depreciation is compared to a rate cut.

Impact Table -- Two Tax Cut Alternatives

The Tax Reduction	Capital Cost Reduction	Output Price Reduction	Annual GDP Increase ($B)	Annual Revenue Cost ($B) [2/]	GDP per Revenue Dollar
First-Year Expensing	1.3%	0.5%	121.0	33.7	$ 3.59
Rate Cut	1.0%	0.3%	88.5	33.7	$ 2.63

[2/] Cost in the ten-year budget window.

The relatively poor performance of the rate cut alternative in the Impact Table is not surprising, nor is it unique to the analysis here presented. It has long been understood that a dollar of tax reduction spread across both old and new capital investment (as in the case of the rate cut) will boost GDP growth substantially less than a dollar of tax cut concentrated on new capital investment by means either of first-year expensing or accelerating depreciation.

Rate cuts can, however, play an important role. A large benefit to GDP and jobs growth can be obtained by the combination of first-year expensing and reduced tax rates. This is the preferred tax policy from an economic growth perspective.

The least efficacious tax policy is to "pay for" a lower tax rate by reducing presently allowable depreciation deductions. According to our analysis, the GDP growth rate would tend to be reduced, not increased.

The analysis underlying the Impact Table, how it was constructed, various of its implications and other relevant comparisons are explained below.

Technical Analysis and Other Comparisons

We need to create alternative policy changes to determine if it is better to offer a rate cut rather than more rapid cost recovery or other direct incentives for new investment? We will look at a "rate cut" which lowers capital cost by one percent, $33.7 billion. The rate cut applies to both old and new capital.

We will compare two related cost recovery alternatives to the rate cut. Both alternatives will concentrate the revenue cut on investment, new capital, rather than all capital as the rate reduction does. The first alternative will spread the cut evenly across the life of each asset to portray "improved cost recovery allowances". The second will provide the cut immediately to equipment investment in order to portray bonus or "immediate expensing".

All three plans have the same cumulative budget cost. The differences arise in timing and in impact on the firm's decision to invest. The table below shows the pattern of benefits and the budget costs the three alternatives. The "rate cut" will provide a uniform benefit (one-fifth of the total benefit) to capital invested in each of the last five years. The "improved cost recovery" will provide a uniform benefit (one-fifth of the total benefit) to new investment for each of the years of its use. The "immediate expensing" will provide the total benefit at the time of investment.

Three Capital Tax Reduction Plans
Revenue Benefit and Cost by Year

Year Bought	**Benefit Over Life**	**Revenue cost in year:** 0	1	2	3	4	5	…
Rate cut benefitting old machines as well as new. Full cost from year zero.								
-4	6.7	6.7						
-3	13.5	6.7	6.7					
-2	20.2	6.7	6.7	6.7				
-1	27.0	6.7	6.7	6.7	6.7			
0	33.7	6.7	6.7	6.7	6.7	6.7		
1	33.7		6.7	6.7	6.7	6.7	6.7	
2	33.7			6.7	6.7	6.7	6.7	6.7
3	33.7				6.7	6.7	6.7	6.7
4	33.7					6.7	6.7	6.7
5	33.7						6.7	6.7
6	33.7							6.7
	Cost in year	33.7	33.7	33.7	33.7	33.7	33.7	33.7
Cost recovery with uniform savings for new machines year 0 and after.								
-1	0.0				NONE			
0	33.7	6.7	6.7	6.7	6.7	6.7		
1	33.7		6.7	6.7	6.7	6.7	6.7	
2	33.7			6.7	6.7	6.7	6.7	6.7
3	33.7				6.7	6.7	6.7	6.7
4	33.7					6.7	6.7	6.7
5	33.7						6.7	6.7
6	33.7							6.7
	Cost in year	6.7	13.5	20.2	27.0	33.7	33.7	33.7
Immediate bonus for new machines year 0 and after.								
-1	0.0				NONE			
0	33.7	33.7						
1	33.7		33.7					
2	33.7			33.7				
3	33.7				33.7			
4	33.7					33.7		
5	33.7						33.7	
6	33.7							33.7
	Cost in year	33.7	33.7	33.7	33.7	33.7	33.7	33.7

For simplicity we have assumed that all capital has a fixed economic life of 5 years and that replacement is uniform, one-fifth each year. The "Benefit Over Life" column shows the amount of the reductions in the tax burden received by assets purchased in a particular year for each plan. Negative years indicate purchases before enactment of the policy change. The "Cost in Year" row shows the revenue cost of the government by year for each alternative.

We can use the table to look at both permanent and temporary policies. The rate cut expenditures fill the columns. A temporary rate cut just eliminates the columns to the right of the last year of the policy. The cost recovery fills the rows and temporary policies eliminate rows below the last year of the policy. The expensing example fills one cell.

New projects (investments) are the determinants of growth. Benefits to new investments reduce the income an investment must return to be undertaken. Increases in the return to old investments cannot change what has already occurred and therefore do not affect growth.

The first thing we see is that the benefit to the firm for the rate cut and the improved cost recovery are identical for capital put in place in year zero and after. Looking across each row we see that the benefit under each plan is the same for each year of purchase and year of use. We can conclude that the incentive to investment will be identical in the case of a permanent change in either. The cumulative revenue costs of the two plans are identical but the improved cost recovery costs less in the early years. This is because the rate cut provides a benefit to investment put in place before the policy change. The improved cost recovery costs $67.4 less in the first four years.

Over a fixed budget window, the cost recovery plan will deliver a greater investment incentive per dollar of revenue cost. The average cost over a 10 year budget window for the cost recovery plan is $27 billion versus $33.7 for the rate cut.

The third alternative demonstrates the incentive effect of an expensing approach. The cumulative benefit going to new projects for expensing is identical to the other two alternatives and the 10 year budget window cost is equal to $33.7. The expensing plan, however, provides all the benefits at once instead of spreading it over a number of years. This means that expensing will reduce capital costs by more than the others and thereby reduce the price of output by more.

Temporary policies would also favor the expensing plan. For a temporary one-year cut the expensing plan will deliver about five times as much incentive per dollar as the rate cut. The rate cut delivers only $6.7 in benefit to the year zero projects while the expensing delivers $33.7. The rate cut delivers 20% as much benefit to new projects as the expensing plan in the first year. This percentage rises by 10% per year until year 5 where the rate cut provides 60% of the benefit of the expensing plan. The efficiency of the rate cut continues to rise as the temporary period is expanded. A temporary, 10-year rate cut yields 80% of the benefit of the expensing plan, 90% by year 20, and 95% by year 40.

Using the two different types of investment approaches allows us to observe that cuts which are stretched out over time have a lower incentive effect than those given earlier. This is the rationale for the just-expired bonus depreciation. In general, more rapid cost recovery schedules lead to higher growth as they reduce the return necessary to undertake a project. Proposals that call for the lengthening of tax lives or limiting the amount of write-offs in the early years of depreciable assets lead to lower investment and growth. Finally, proposals that call for rate reductions to be paid for through reductions in the rate of cost recovery will lead to lower investment and growth for the reasons given above.

We should also point out that accounting reports would show that the permanent rate cut and cost recovery changes would have the same impact on the firm's balance sheet after year 4. The total revenue benefit would be the same. Accounting reports of a temporary policy change might somewhat blur the advantage of the superior cost recovery relative to the rate cut. Because they generally do not deal at the new project level, accounting reports might not recognize any difference between a temporary expensing and temporary rate cut. Their general intent is to give the potential investor a bird's eye view of a firm's long- run operation and growth.

To estimate the economic impact of the proposals, we set out an approximate breakdown of the components of U.S. business output in 2008. This provides a method to directly compare the impact of the reductions in the tax burden on prices. The table below shows factor costs and private business output for 2008.

Structure of US Private Business Output (2008)
Baseline Factor Payment

Factor	Cost ($Billions)	Percent
Labor	6,431	65.6%
Capital	3,370	34.4%
Equipment	1,424	14.5%
Other Capital	1,946	19.9%
Total	9,800	100.0%

One can lower the tax on all capital income through a rate reduction. The rate reduction applies to production using both old and new capital. We will look at a rate reduction which lowers the capital cost for each category by one percent. The table below shows the revised cost structure.

Permanent Rate Reduction Equal to 1% of Capital Cost

Factor	Reduction	New Cost ($Billions)	Percent Reduction
Labor	0	6,431	0.0%
Capital	34	3,336	1.0%
Total	34	9,767	0.3%

Total capital costs have fallen by 1% but more importantly the cost of using new capital has fallen by 1%. The marginal cost of production is determined by the cost of using the last unit of each factor of production. The marginal cost of using new capital drives the marginal cost of production just as does the marginal cost of labor. As is seen in the table, the marginal cost of output has fallen by 0.3% because of the 1% reduction in the marginal capital cost.

We will adjust this example to make it more comparable to the cost recovery alternatives. We will limit the rate cut to the income on equipment. We accomplish this by reducing the tax base by a percentage of the return on equipment. All we have done is apply the entire rate cut to the equipment category, leaving the impact on the cost of capital and the price reduction unchanged. We will use this as the rate cut example.

As we saw in the prior analysis the cost recovery example provides the same amount of price reduction as the rate cut. The patterns of reductions in the tax burden are the same for both plans. This means that we can use this economic analysis for both examples.

Will producers pass the cost reduction on to buyers? It seems highly likely that they will. Some producers will see the opportunity to expand market share and cash in on the higher profit rate. In essence the profit margin has jumped by 1% of the return to capital which is a large percentage change on a normal margin of something like 5%. As soon as one of the existing producers or even a new entrant begins the price reduction, the rest will have to follow or lose their position in the market.

If we assume that households and investors spend the same amount of money as they would have before the change, the quantity of goods and services will increase by as much as the price has gone down. Output initially expands without any additional income because prices have fallen.

Finally, we need to provide an estimate of the impact of the expensing plan to the rate cut and cost recovery plans. Using Commerce Department estimates of the stock of and investment in business equipment, we estimate a reduction of 3.2% in the factor cost of new business investment versus a 2.4% reduction under a rate cut plan.

Expensing Plan for New Equipment

Factor	New Cost ($Billions)	Percent Reduction
Labor	6,431	0.0%
Capital	3,197	1.3%
Equipment	1,379	3.2%
Other Capital	1,946	0.0%
Total	9,755	0.5%

The 3.2% reduction in the cost of using new equipment lowers the marginal cost of production by 0.5%. As before, we can expect the price reduction to be shared with purchasers of output through normal competitive forces. The lower price will result in a larger quantity of output which will increase income and again expand output and income.

If we expect purchasers to spend in the same proportions as they did before the change and businesses to employ factors of production under the same technology, we can estimate the long-run economic effects of the two plans.

Long-Run Estimates of Effects of Plans
($Billions)

Factor	Rate Cut	Investment Expensing
Labor	6,474	6,488
Capital	3,381	3,400
Equipment	1,429	1,437
Other Capital	1,952	1,963
Total	9,855	9,888
Percent Change	0.6%	0.9%

The table shows that the change in output under the investment expensing case is 60% greater than under the rate cut and expanded cost recovery. The change in Investment is more than 2.2 times larger in the expensing case. Labor compensation is 0.9% higher in the expensing case relative to the baseline. As for employment, the expensing case would create 446,000 jobs versus 377,000 jobs for the rate cut and cost recovery plans. It should be remembered, however, that the cost recovery alternative is less expensive than either of the other two plans.

Focusing the policy change on new investment through a speedup of capital cost recovery will yield a larger change in marginal cost and price per dollar of revenue reduction. This is because the cost of investment along with labor costs set the marginal cost of production. Investment typically replaces 20% of the stock of equipment which means that concentrating revenue cuts on new investment is more efficient than a rate cut that goes to all capital.

Institute for Research on the Economics of Taxation

Institute for Research on the Economics of Taxation
(IRET)

Statement of
Stephen J. Entin

Submitted to the House Committee on Ways and Means
for the Record of the Hearing of February 8, 2012:
"Interaction of Tax and Financial Accounting on Tax Reform"

I am currently President and Executive Director of the Institute for Research on the Economics of Taxation. I served as Deputy Assistant Secretary for Economic Policy in the Treasury Department for eight years during the Reagan Administration.

The Committee is seeking to determine how financial accounting practices might affect its efforts to reform the income tax, encourage investment, and promote economic growth and job creation.

The short answer is that the effect of tax policy changes on business balance sheets and income statements should not be the determining factor in the design of a sound, pro-growth tax reform. Accounting concepts can distort the impact of proposed tax changes. Annual and quarterly reports based on GAAP can misrepresent gains as losses. They can confuse business executives and policy makers as to which policy changes are most effective at encouraging investment and hiring.

It is best to think of the financial accounting presentation as a public relations communication between the business and the public, including its shareholders. This has, or should have, nothing to do with policy formulation, because it is of no relevance to economic growth and job creation.

Instead, policy work should be based on the actual effect of tax policy on a business's after-tax cash flow from new investment. This is the approach taken by businesses to make their investment decisions, and is the real driver of investment, productivity, and wages. If you want businesses to expand their investment and hiring, that is the button you must push. That should be your concern as you develop a pro-growth tax reform.

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How businesses make investment plans

Business schools throughout the world teach students the optimal means of determining if a proposed investment will add value to the business (and to the economy) or subtract from it. The most common method requires the student to determine the net present value of the investment. The calculation compares the present value of the revenue expected each year from an investment, after taxes, with the present value of the costs incurred each year in association with the investment, using a discount rate appropriate for the riskiness of the investment and the alternative investment opportunities of the business. If the present value is equal to or greater than zero, the investment is viable. If several investments are viable, they may be ranked from the highest to the lowest in present value to determine which should be done first.

A related approach is to determine the internal rate of return that equates projected revenues and costs. If this expected rate of return matches or exceeds the minimum "hurdle rate" that the business expects to be able to earn on other projects, also known as its "cost of capital" or "service price," then the project is viable. If the two methods – present discounted value and internal rate of return – employ the same discount rate, and the rate is unvarying over the time span, they yield equal results. If the discount rate is apt to vary over the time frame, the present value approach is more accurate.

Finance texts stress that, in both methods, costs are to be expensed in the year they happen. They are not to be treated as if they were spread over the life of the asset, as with depreciation. Depreciation rules are used only to calculate each year's tax liability, not to value the cost of the investment. Thus, neither method has anything to do with accounting presentations, which pretend that only a portion of an investment expense is current, and the rest is spread over future years. Business students and executives in the real world understand the time value of money, while the tax system and the accounting rules that employ depreciation ignore it.

Surveys show that businesses generally employ these present value or internal rate of return valuation methods to formulate their investment plans. That is, businesses are being run by people with business school training in the right way to measure such things.[1] Consequently, a tax change that raises the discounted present value of a new investment, at the margin, will expand investment and the amount of capital the firm creates and employs. By contrast, a tax change that has no impact on the calculated value of additional investment will not spur added capital formation. Tax rebates or retroactive tax cuts on investment already in place would raise a business's cash, and be gratefully accepted, but they would not cause the firm to increase future investment.

The same business finance courses instruct budding stock analysts and fund managers in how to evaluate the worth of a company or its stock. The value of a company is the present value of its projected cash flow, using the same discounting method as when valuing an investment project. That includes ignoring depreciation and expensing costs in the year they occur.

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1 See John Graham and Campbell Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field", *Journal of Financial Economics*, Vol. 60 (2001).

Expensing and corporate tax rate reduction

The tax system is biased against capital intensive industries, distorting the methods of production and the mix of output. Depreciating assets over time for tax purposes understates costs. The capital consumption allowances lose value due to the time value of money and inflation. (See Table 1.) The understatement of costs is larger for long lived assets, and is made worse by inflation. The understatement of costs is matched by an overstatement of business income, and a higher effective tax rate on such industries. This depresses the present value of a proposed investment as calculated by business school methods and investors throughout the business community.

Table 1
Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 Yrs	7 Yrs	10 Yrs	15 Yrs	20 Yrs	27.5 Yrs	39 Yrs
Present value of first-year write-off of $1 of investment:		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.96	$0.94	$0.91	$0.88	$0.80	$0.74	$0.65	$0.55
	3%	$0.94	$0.89	$0.85	$0.79	$0.67	$0.59	$0.47	$0.37
	5%	$0.92	$0.86	$0.81	$0.74	$0.60	$0.52	$0.39	$0.30

Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.

One of the goals of tax reform should be to move toward immediate expensing of capital outlays, at least for equipment. For structures, the Committee should consider a "neutral cost recovery system" in which the delayed portion of the write-off is augmented annually by a real increase of about 3 percent plus inflation, to create the same present value as expensing but without any major near-term cost to the federal budget. These changes would encourage a more efficient use of resources and more efficient mix of output. The artificially beaten-down manufacturing sector and other capital intensive sectors would gradually recover and expand relative to the service sector. The policy would also be an efficient way to encourage investment from the point of view of the federal budget. It would concentrate the tax reduction on new investment, and lower the cost of investment more per dollar of static revenue loss than other types of tax relief, such as a corporate tax rate cut.

Some businesses would prefer a cut in the corporate tax rate, if a choice must be made. They are generally firms that earn their returns on non-depreciable assets, or short-lived assets, or intangible assets. Lowering the corporate tax rate would be good for growth for such industries, and for capital intensive sectors too, but would not redress the bias against the capital intensive industries. The corporate tax rate should be reduced in addition to, not instead of, expansion and extension of expensing.

Consider a business producing a standard sort of product through the use of machinery in a highly competitive industry in which extraordinary profits have been competed away. The present value of the earnings on its capital is just equal to or a very small bit higher than the cost of the capital it employs. In that situation, immediate expensing of its investment will roughly equal its earnings, and its net profit and net tax payment over time will be roughly zero, which is the correct result. If, instead, we retain depreciation, then matching the appropriate tax collection by means of reducing the tax rate would require a zero tax rate on the overstated income.

In contrast, a business which relies mainly on intellectual capital or intangibles, with little depreciable capital, might prefer a corporate tax rate reduction. Its income is correctly measured, and all it cares about is the tax rate. Also, businesses with extraordinary profits (economic profits or quasi-rents) have returns in excess of costs even with expensing of capital outlays. Such profits ought to be yielding taxes to the government. They arise from patents, superior R&D, brand loyalty, better service or management, etc. The costs incurred in earning such extra income are generally expensed as wages and salaries of researchers, managers, and people with the human capital to make the business unusually successful, and the returns should be taxable. Such businesses might prefer a reduction in the corporate tax rate to expensing. There is nothing wrong with lowering the corporate tax rate to make such firms more globally competitive, but that should be done in addition to correcting the bias against capital intensive businesses.

Trading expensing for rate cuts: bad for GDP and jobs

Several tax reform proposals have urged the lengthening of asset lives to pay in static terms for a reduction in the corporate tax rate. Do not trade away longer asset lives for a lower corporate tax rate. That would exacerbate the tax bias against capital intensive industries, especially those with long-lived assets. It would probably result in a higher cost of capital (higher "service price" or hurdle rate), a smaller capital stock, lower wages, and less employment.

Adopting longer asset lives would depress the economy and fail to yield any of the estimated "static" revenue to pay for the rate reduction. Indeed, it would reduce revenue. Such a trade is both unnecessary and unworkable. Making expensing permanent and lowering the corporate tax rate have little near term cost and, longer term, recover their cost by raising revenue from other taxes as they expand the economy. Both are good for the federal budget over time. However, expensing has less initial cost and a more powerful revenue reflow under current tax rates and the mix of assets that make up the capital stock.

Table 2 displays the effect of altering expensing and the corporate tax rate.

Table 2
EFFECT OF EXPENSING FOR EQUIPMENT AND CUTTING THE CORPORATE TAX RATE ON GDP, CAPITAL STOCK, LABOR INCOME, SERVICE PRICE, AND FEDERAL REVENUE
(Effects and revenue estimates are modeled at 2008 income levels.)

Tax options	1*	2*	3*
GDP	2.71%	2.33%	2.26%
Private sector GDP	2.81%	2.41%	2.34%
Capital stock	7.64%	6.54%	6.34%
Wages	2.29%	1.97%	1.91%
Hours worked	0.51%	0.44%	0.42%
Million jobs	0.71	0.61	0.59
Service price			
Corporate	-5.56%	-5.58%	-5.58%
Non-corporate	-1.94%	0.17%	0.17%
Total	-4.49%	-3.87%	-3.87%
Static revenue ($ billions)	-34.2	-20.2	-51.6
Dynamic revenue ($ billions) **	48.7	51.3	19.1
% revenue regained from economic change **	243%	353%	137%

* Tax options:
1: 100% expensing of equipment for all businesses
2: 100% expensing of equipment for corporate sector only
3: cut corporate tax rate to 25%
** Tax rate decrease raises GDP to the point of gaining revenue.

- Case 1: The current provision for 100% expensing of equipment would raise GDP by 2.71% over time, if made permanent. Its static revenue cost of $34 billion would be converted to a dynamic revenue gain of $49 billion, a 243% reflow of revenue (at 2008 income levels). It focuses the tax reduction on newly acquired capital equipment, and is of particular interest to new or rapidly growing businesses. Eventually, all capital is replaced, so even established businesses gain as their stock of equipment rolls over.

- Case 2: The corporate sector's share of the expensing provision would boost GDP by 2.33%, or about 86% of the total expensing provision. Its static cost is $20 billion. Growth returns about $71 billion, or 353% of the static cost, for a net revenue gain of $51 billion.

- Case 3: A reduction in the corporate tax rate to 25% would generate a 2.26% rise in GDP, about the same as the corporate expensing provision. It would have a higher static cost, about $52 billion, generate a similar $71 billion dollar reflow, or 137% of the static cost, and net the government a gain of $19 billion. The higher static cost is due to the application of the lower corporate tax rate to returns on existing capital as well as new capital. This approach favors established or slow growing businesses, or those with more investment in structures than equipment.

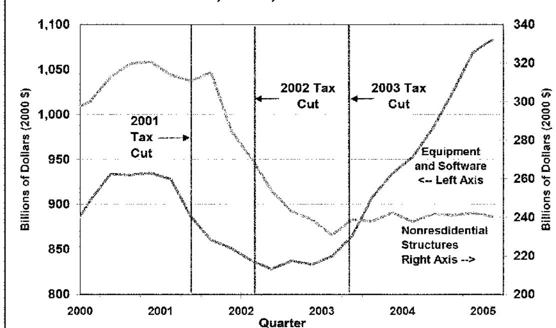
Giving up corporate expensing in exchange for a lower corporate tax rate in the range shown would yield roughly offsetting GDP effects, but cost more revenue on both a static and dynamic basis. It might please established businesses in the short run, but would not be as focused on rapid growth. The trade should not be necessary, because neither provision costs revenue after growth effects are considered. If Congress insists on relying solely on static revenue estimates, a lower short term revenue impact might be had by phasing in the corporate rate cut. If expensing must be altered, it could be replaced by a "neutral cost recovery system" in which the deferred portions of the depreciation write-off are augmented each year by an appropriate interest rate, such as inflation plus the long term real return on capital of about 3%. The present value of the deductible business cost for the investment would be preserved at 100 cents on the dollar.

Historical evidence of the need to cut the cost of capital

Accelerated depreciation, corporate tax rate reductions, investment tax credits, and lower tax rates on capital gains and dividends act to reduce the cost of capital at the margin and spur growth. By contrast, taxes that are not at the margin, or not much at the margin, such as the 1975 Ford tax rebate, the 2001 rebate-like refund reflecting the 10% tax bracket, and the more recent stimulus rebates, make little difference to production and employment.

The last recession and the Bush tax cuts. Chart 1 tracks the effect of the 2001 and 2003 tax cuts on GDP. There was a very slow "jobless recovery" from the 2000-2001 recession in the first two years after the 2001 tax reduction. The individual marginal rate cuts were phased in so slowly that there was little initial incentive effect. It was not until the 2003 tax cut that there were significant incentives for saving and investment. In that year, the capital gains and dividend tax rates were reduced to 15%, lowering the double taxation of corporate income; expensing, introduced in 2002 at 30% of equipment spending, was boosted to 50% of equipment outlays for corporate and non-corporate businesses; and the rest of the individual marginal tax rate cuts were brought forward. Estate tax relief helped too. After 2003, investment in equipment rose rapidly, and job growth accelerated. More recently, the expensing provision was increased to 100% for equipment as a counter-cyclical tool. It would be more effective if made permanent, which is also good tax policy.

Chart 1 Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

The Tax Reform Act of 1986 (TRA86). TRA86 raised the net tax at the margin on capital and reduced it for labor. We estimate that, on balance, it slightly reduced potential output by about 0.6 percent. The business provisions alone would have reduced GDP by 2.3 percent, while the lower individual tax rates would have increased GDP by 1.5 percent.[2] The bill would have been a modest positive for the economy if Congress had followed the Treasury reform plan as submitted, but it did not. Treasury had recommended indexation of depreciation allowances for inflation. That would have helped to reduce slightly the required service price or "hurdle rate of return" that capital must earn in order to be a feasible investment, in spite of the longer assets lives and repeal of the investment tax credit that were part of the bill. Congress dropped the indexing provision, and the hurdle rate went up, discouraging investment.

TRA86 cut the corporate rate 12 points from 46% to 34%, but offset about half that reduction by eliminating provisions that were already mitigating some of the corporate tax at the margin (loophole and preference closings). TRA86 cut the top individual tax rates from 50% to 28%, with a 33% rate bubble to recapture the benefits of rates below 28%. These cuts lowered the top tax rate on dividends to 28% or 33%. However, TRA86 also raised the top tax rates on capital gains from 20% to 28% or 33%. TRA86 raised taxes on capital in other ways. It eliminated the investment tax credit. It switched from ACRS (accelerated cost recovery system) to MACRS (modified ACRS), with longer asset lives, especially for long lived structures, which went from 31.5 years to 39 years. Passive loss rules were tightened on real estate, and upper income taxpayers were limited in their access to IRAs. TRA86 is not a good model for a pro-growth fundamental tax reform. It moved away from a neutral tax base toward a more-inclusive and more anti-investment version of the broad-based income tax.

The 1981 Reagan tax cuts and the 1962 and 1964 Kennedy cuts. President Reagan's Economic Recovery Tax Act of 1981 cut asset lives, increased the ITC, and lowered tax rates on capital gains and dividends along with individual marginal income tax rates. It was enacted too late, and phased in too gradually, to avert the 1981-82 recession, but produced an unusually strong recovery in 1982-1986. Had it remained in full effect, we estimate that it would have increase long term GDP and labor income by over 12 percent. Subsequent tax increases in 1982, 1983, and 1984 would have held the GDP gains to about 10 percent. Taken together, the Acts reduced the service price of capital by nearly 13 percent.[3]

President Kennedy cut asset lives by switching from Bulletin F lives to Guidelines and implemented an investment tax credit (ITC) of up to 7 percent in 1962. In 1964 and 1965, his income tax plan reduced the corporate tax rate from 52 percent to 48 percent, and cut marginal individual income tax rates across the board. About two-thirds of the reduction in the service price of capital and about 55 percent of the economic gains came from the investment incentives and corporate rate cut. Growth was strong following the Kennedy cuts. They reduced the

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[2] Stephen J. Entin, "The Reagan Era Tax Policies," *IRET Policy Bulletin*, No. 102, November 11, 2011, available at http://iret.org/pub/BLTN-102.PDF.

[3] *Ibid.*

service price of capital by nearly 11 percent. We estimate that they would have raised long term GDP by nearly 8 percent had they not been interrupted by the Johnson surtax.[4]

Proposals to avoid

Wyden-Coats and Bowles-Simpson. The Wyden-Coats bill (formerly Wyden-Gregg) and the Bowles-Simpson Commission emulate TRA86. They would cut tax rates on businesses in exchange for higher tax rates on capital gains and dividends, and much slower tax depreciation of plant, equipment, and structures. They cut taxes on labor income where the growth benefits are small, and on balance raise taxes at the margin on capital income where the adverse effects are large. They are heavier on the penalties and lighter on the rate reductions than TRA86, and would do even more damage to GDP and employment. For example, we estimate that Wyden-Coats would reduce GDP by 4.32%. A small estimated revenue increase of $33 billion would turn into a revenue loss of $105 billion.[5]

Wyden-Coats would revert to asset lives of the old Guidelines system from 1962, but make them even worse with straight line depreciation instead of double declining balance. The bill would raise the tax on capital gains and dividends from a maximum of 15% to 22.75%. Expensing would end for large firms doing most of the nation's investment. Businesses would not be allowed a deduction for the inflation portion of their interest costs, but lenders would be taxed on the full amount of interest received. The bill would increase the standard deduction to 2.5 times its current level. The top individual rate would remain at 35%. The graduated corporate tax rates with a top rate of 35% would be replace by a flat 24% rate. The depreciation changes and the higher tax rates on capital gains and dividends would make the bill a strong negative for the economy, in spite of the rate cuts and enlarged standard deduction.

How accounting rules can distort appearances.

Consider a business that is carrying unused tax credits on its books. Perhaps these credits are investment tax credits that have remained unused because he business was not profitable at the time the investment was made. The unused credits are an asset on its balance sheet, according to the accounting rules, because they will lower future tax liabilities when the company becomes profitable. Suppose Congress were to eliminate the corporate income tax going forward, without making such unused credits refundable. The accountant would report the loss of an asset, marking down the company's value on the balance sheet. In reality, the company's future income tax liability is reduced more by the permanent elimination of the tax than it would have been by the credits. The company's value, the discounted after-tax profit stream, is higher, not lower, in spite of the loss of the credits. The accounting convention turns a genuine gain into an apparent loss. However, the amount of future taxes saved by the elimination of the tax is not counted under accounting rules, because the future profits and taxes that would have been owed are uncertain. Trained stock analysts, mutual fund and pension managers, and thoughtful investors are not fooled by the accounting misdirection.

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[4] Stephen J. Entin, "Economic Consequences Of The Tax Policies Of The Kennedy And Johnson Administrations," *IRET Policy Bulletin*, No. 99, September 6, 2011, available at http://iret.org/pub/BLTN-99.PDF.

[5] Stephen J. Entin and Michael Schuyler, "Economic Consequences Of The Wyden-Coats Tax," *IRET Policy Bulletin*, No. 100, October 28, 2011, available at http://iret.org/pub/BLTN-100.PDF.

Suppose the credits in the example are unused foreign tax credits. Suppose the United States were to reduce the U.S. corporate tax rate below that of nearly all other nations or were to move to a territorial tax system to enhance the competitiveness of U.S.-based companies producing here or abroad. In either case, the existing foreign tax credits would be of no use (unless the legislation made them refundable in the transition), because there would be no future U.S. tax owed on the foreign income. The accounting rules would declare that the business had suffered a loss of an asset. In reality, its future after-tax income stream would have been increased, as would the present value of the business, neither of which is reported on the balance sheet by the accountants. The balance sheet is not telling the whole story. Knowledgeable observers are not fooled.

Could a business care more about accounting than real profits?

Would business executives ever wish to give up a permanent improvement in after-tax income and the value of the company to protect a rosy picture being painted by the current accounting rules? Perhaps, if they are trying to hide something from their shareholders, and if they assume that the shareholders are not capable of seeing through the ruse. I recall a real world example.

The late 1970s was a time of high inflation. Depreciation allowances are not adjusted for inflation, and the cost of plant, equipment, and buildings allowed for tax purposes greatly understated the true cost of these investments in that period. The result was an overstatement of business income, sometimes even turning real losses into apparent accounting profits and taxable income. The consequence was a rise in the effective tax rate on the real earnings of businesses. The effect of the inflation was greatest for capital intensive industries with long-lived assets, such as steel mills, power plants, dams, and transmission lines, commercial and residential rental structures, etc. The lower real after-tax returns on investment were discouraging investment and depressing productivity and real wages.

Dr. Charles Schultze was the Chairman of President Carter's Council of Economic Advisors. He was on a panel with several business leaders, including CEOs of a steel firm and an electric utility. The topic of the discussion was the state of the economy and policies to fight stagflation. I was on the staff of the Joint Economic Committee at the time, and was in the audience. During the question and answer period, I asked Dr. Schultze if indexing depreciation allowances for inflation might more nearly reflect the replacement cost of the capital, offset some of the disincentive to invest caused by the inflation, and help restore real growth and wage gains. He replied that the idea was sound economics, but that the Administration would be concerned about the near term effect on the federal deficit, and not support the policy at that time.

The utility executive interjected that he did not want replacement cost accounting for depreciation in any event. The steel executive asked, "Why ever not?" The utility executive said, "Because if my shareholders ever found out that we are actually losing money instead of making money, they would have my head!" The steel executive retorted, "Really? What has happened to your share price in the last two years?" [It had dropped sharply as the inflation took hold.] The utility executive turned red in the face and the audience laughed.

The point is that shareholders, especially professional stock analysts and mutual fund and pension managers, are not fooled by false pictures painted by narrow accounting rules. Professional analysts are also trained in business school to ignore artificial concepts like depreciation and to count costs when incurred, not when they are allowed for tax purposes. They are taught to value a whole company according to the discounted present value of its expected cash flow (in much the same way as they are taught to evaluate the merits of a particular investment project within a company).

Nothing is to be gained by giving up a real improvement in the production climate to keep a fictitious asset or income number in the annual reports to the shareholders. Similarly, the economic benefits or costs of a tax policy change cannot be judged by the effect on the accounting statements. The policy changes can only be judged by their effect on the cost of creating and employing capital. If one wishes to encourage capital formation, higher labor productivity, wages, and employment, look to the cost of capital. That is what business decision makers do when they practice what they are taught in business school. That is what business leaders ought to be telling you when they testify. If they do not do so, they are playing games with numbers instead of growing their businesses.

Conclusion

Expensing is a more efficient way to spur investment than a corporate rate reduction, but both are worth doing.

Static scoring aside, doing both is affordable because both increase GDP and bring in revenue from other taxes.

A truly pro-growth policy change with little or no adverse impact on the federal budget should include all of the following features:

- Make permanent the 100% expensing of equipment.
- Make permanent the 15% tax rate on long term capital gains and dividends.
- Gradually lower the corporate tax rate by ten points or more while phasing out the manufacturers credit.
- Introduce neutral cost recovery for structures (raising outyear write-offs by an appropriate interest rate, perhaps 3 percent plus inflation).

Accounting issues, and complaints by firms with little or no depreciable capital that expensing is of no concern, should be ignored in developing a pro-growth tax reform plan.

United States Steel Corporation

Transmittal Supplement

TO: The Committee on Ways and Means
U. S. House of Representatives

FROM: Scott Salmon
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SUBJECT: Hearing on the Interaction of Tax and Financial Accounting on Tax Reform

Attached please find a written statement to be included in the official record of the full committee hearing held on February 8, 2012 on the Interaction of Tax and Financial Accounting on Tax Reform. Please direct questions concerning this statement to the name and address listed above.

WRITTEN STATEMENT SUBMITTED FOR CONSIDERATION TO:
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE INTERACTION OF
TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

HEARING DATE: FEBRUARY 8, 2012

SUBMITTED BY GREGORY A. ZOVKO
VICE PRESIDENT & CONTROLLER
ON BEHALF OF
UNITED STATES STEEL CORPORATION

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Pittsburgh, PA 15219

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FEBRUARY 22, 2012

GREGORY A. ZOVKO
UNITED STATES STEEL CORPORATION

WRITTEN STATEMENT SUBMITTED FOR CONSIDERATION TO:
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE INTERACTION OF
TAX AND FINANCIAL ACCOUNTING ON TAX REFORM

Hearing Date: February 8, 2012

United States Steel Corporation ("U. S. Steel") is an integrated steel producer of flat-rolled and tubular products with major production operations in North America and Europe. An integrated producer uses iron ore and coke as primary raw materials for steel production. According to World Steel Association's latest published statistics, we were the eighth largest steel producer in the world in 2010. U. S. Steel is also engaged in other business activities consisting primarily of railroad transportation services and real estate operations.

U. S. Steel appreciates the opportunity to add to the discussion on tax reform that occurred during the February 8, 2012 Hearing on the Interaction of Tax and Financial Accounting on Tax Reform. My written testimony is based on my experience as the Vice President and Controller for U. S. Steel. Among my current responsibilities, I am responsible for both the preparation of our financial statements and for the financial evaluation of capital projects.

Congress has the goal of making the United States a more attractive venue for investment, promoting economic growth and job creation, and simultaneously reducing the deficit. We are encouraged by proposals for a reduction in the corporate tax rate to induce new capital investment. Reducing the corporate tax rate to 25 percent would provide a substantial incentive for the expansion of business in the U.S. and help make our company more competitive internationally.

Furthermore, the retention or enhancement of accelerated depreciation when combined with a reduction in the corporate tax rate would be a powerful tool to promote investment in the U. S., something that the country sorely needs. While current tax deductions and credits will have to be carefully examined to determine if any should be changed or eliminated in order to achieve a lower tax rate, we believe that a reduction in the corporate tax rate should also be accompanied by the retention of accelerated depreciation to best encourage new capital investment, fostering economic growth and employment in the U.S.

While we would generally expect a tax rate reduction to increase net income and earnings per share in our financial statement, that impact will not necessarily translate into increased cash flows for capital intensive industries if accelerated depreciation is not retained. Cash flow is the lifeblood of a business and investors are very focused on cash flow generation and liquidity in addition to net income and earnings per share. Cash flow and liquidity considerations are major components of investment decisions and provide businesses with the confidence to continue to invest in projects that will grow America's manufacturing base. Corporations cannot focus solely on book earnings; cash flow is a critical measure of a company's financial viability and accelerated depreciation obviously increases cash flow in the early years of an investment.

U. S. Steel requires significant capital investments for its steel manufacturing and mining facilities in the United States. The net present value of future cash flows is the most important criterion in determining if a discretionary capital investment should be made. We evaluate the present value of future income taxes on earnings from the investment, as well as the present value of future income tax savings from depreciation on the investment. While a lower federal income tax rate will reduce the present value of tax on future earnings, that benefit may be more than offset by the reduced present value tax savings from future depreciation deductions. Accelerated depreciation has a substantial impact on all of U. S. Steel's investment decisions and is built into our models for evaluating the success of capital projects.

The availability of cash also determines how much we can invest and when we can invest it. Many job-creating, domestic investments may be delayed if cash flow is limited. Non-discretionary projects mandated by statute or regulation would by definition occur regardless of the cash flow analysis, but discretionary value added projects require an extensive analysis of the net present value cash flow. We are currently pursuing a promising large capital investment program with spending in 2011 and 2012 approaching $1 billion for each year. We are currently building new coking facilities in Pennsylvania and Indiana, and pipe mill facilities and a continuous annealing line in Ohio. We have also received all the permits required to expand and modernize an iron ore mine and pelletizing plant in Minnesota and have several dozen other projects under consideration for facilities in Michigan, Alabama and elsewhere. These planned investments will create thousands of construction jobs and hundreds of permanent jobs. These projects will result in billions in goods and services being bought from local and national suppliers. Some of these and future projects may not be as viable if accelerated depreciation is changed or eliminated. Some may view accelerated depreciation of less importance in the current low interest rate environment, but current interest rates may not be appropriate for judging long-term projects, especially for cyclical industries such as the steel manufacturing industry. Instead, we look at an "all-in" cost of capital that reflects both long-term interest rates and the cost of equity capital.

Making accelerated depreciation a constant tool for capital investment would enable companies to take this benefit into consideration when deciding what capital projects to undertake and when to undertake them. One reason some companies have responded to accelerated depreciation less enthusiastically than anticipated is due to the fact that recent proposals to further accelerate depreciation (the so-called "bonus depreciation" provisions) have been sporadic and enacted or extended very late in the year and thus have only provided an incentive for short term projects. Most large scale projects are planned for years ahead, where the one year at a time extension of bonus depreciation provides very little incentive due to its uncertainty.

Other countries with lower tax rates than the U.S. still encourage capital investment to fuel growth. For example, Canada has made investment more attractive by reducing the corporate tax rate and providing for accelerated depreciation. Canada has a lower federal corporate tax rate than the U.S. (the Canadian corporate rate in 2012 is 15%, which, when combined with provincial rates is approximately 25%), and they allow accelerated depreciation. For example, most machinery and equipment has a 30% depreciation rate applied against the unrecovered capital cost. At this rate, over 83% of the cost can be written off over 5 years. Even if the U.S. corporate income tax rate is reduced to be closer to the Canadian rate, if accelerated depreciation is eliminated in the

U.S., manufacturers with operations in both countries will still have a tax incentive to invest in Canada rather than in the U.S. Continuing or enhancing accelerated depreciation would help make the U.S. a more desired location for new capital investment.

A lower overall tax rate would benefit both old and new investment equally. However, accelerated depreciation provides a strong incentive to undertake new capital expenditures by providing a faster return on capital investment. Thus, to the extent that accelerated depreciation is repealed to reduce the tax rate, new investment is actually penalized since it bears the full burden of that cost while the corresponding "benefit" is split between new and existing investment.

A lower tax rate combined with accelerated depreciation provides a strong incentive for businesses like U. S. Steel to invest heavily in domestic capital projects, thus creating new jobs and expanding the U.S. economy.

As the Committee further analyzes the best way to structure corporate tax reform, I encourage you to consider the benefits of maintaining and further enhancing accelerated depreciation. Accelerated depreciation directly results in new capital investment, an essential part of economic recovery and job creation. We welcome the ability to further contribute to the tax reform discussion. Thank you for the opportunity to address the Committee.