UNITED STATES OF AMERICA

\+ + + + +

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

\+ + + + +

THIRD MEETING

\+ + + + +

TUESDAY
MARCH 8, 2005

\+ + + + +

The Panel met at SAGO Networks, 4465 West Gandy Boulevard, Tampa, Florida, at 9:30 a.m., Connie Mack, Chairman, presiding.

PRESENT:

THE HONORABLE CONNIE MACK, Chairman
THE HONORABLE WILLIAM ELDRIDGE FRENZEL, Panel Member
EDWARD LAZEAR, Panel Member - Telephonically
JAMES MICHAEL POTERBA, Panel Member
CHARLES O. ROSSOTTI, Panel Member
LIZ ANN SONDERS, Panel Member

I-N-D-E-X

P-R-O-C-E-E-D-I-N-G-S

9:38 a.m.

CHAIRMAN MACK: Good morning everyone. As I said on my way in, we want to welcome and thank all of you who have come out this morning to listen to and observe in this discussion. This is the panel's first trip outside of Washington, and in my comments in a minute I'm going to run through some of the other areas that we're going to visit. But again, we do appreciate so much your being here.

And I want to say to my panel members. thank you for making this trip down this morning. We have five of the nine panel members. We probably will have four or five panel members at each of our meetings as we travel around the country to continue our work.

So, again, I welcome you to the third meeting of the President's Advisory Panel on Federal Tax Reform. We have anxiously awaited the opportunity to travel around the country to hear from taxpayers, and this is our first in a series of meetings that we will hold outside of Washington, DC. Next week we will be in Chicago, where we will explore the influence of the tax system on important taxpayer decisions. On March 23rd, we will be traveling to New

Orleans for our fifth meeting, where we will explore the perceptions about the fairness of the tax code and the focus of our tax system, and it's effect on families. I will announce the location of our sixth meeting, to be held during the last week of March, soon.

We are grateful that SAGO Networks, one of the millions of small business in this country, has agreed to host today's meeting to examine the impact of the tax system on business and entrepreneurs. At our meeting in Washington last Thursday, we learned that a substantial portion of the compliance burden from our tax laws falls on businesses. Small businesses and self-employed taxpayers in particular are burdened by the complexity of our tax code, and bear a substantial portion of the estimated $125 billion in compliance costs. These costs create a disproportionate burden as studies have found that the smaller the business the higher the cost of complying with the tax code per dollar of tax paid. And as we will learn today, it is these same small businesses that are a powerful engine driving our country. They employ over half of all private-sector employees and generate 60 to 80 percent of new jobs.

We have heard from small business owners from all over America who have told us that the tax code should be reformed and simplified, so that these entrepreneurs can spend less time doing paperwork and more time growing their businesses.

The objective of today's meeting is to obtain a greater understanding of how the existing tax system affects business taxpayers. We will also focus on how our complex business tax rules restrain America's entrepreneurial spirit and hinder economic growth.

We had invited Governor Bush to be with us this morning, and he would have been except today is the opening day of the legislative session in Tallahassee.

I am delighted as well that we have Representative Sam Gibbons. Sam had a distinguished career. He devoted a lifetime of service to this country and to this community as a decorated war hero, a representative of this area of Florida in Congress where he served as Chairman of the tax writing Ways and Means Committee, and as a member of the Florida legislature. And later on this morning Sam will be presenting some of his thoughts as well.

We will also have two discussion panels. Our first discussion will provide an overview of the current business tax system. Jack Levin will explain how the taxation of businesses, like the rest of the tax code, has become increasingly complicated. Professor Douglas Shackelford will put the business tax system in perspective by examining historical trends and recent developments, as well as some thoughts about the continuing viability of our existing system. Professor William Gentry will explain who bears the burden of the corporate income tax, and how the existing tax rules influence a vast number of business decisions.

Our second session will focus on small businesses and entrepreneurs. Roger Harris, who advises small business owners in every part of the United States, will share his insights on the burden faced by small business. Two local entrepreneurs, Todd Flemming of Infrasafe, and David Hurley of Landmark Engineering and Surveying Corporation, will give us first-hand accounts of how the tax system places a needless burden on small businesses. They will also share with us some examples of choices they made that were driven by tax results.

And finally, Professor -- well, that got everybody's attention. Finally, Professor Donald Bruce will discuss how the tax system may affect the level of entrepreneurial activity, including some observations about the impact of taxes on the number of new businesses and the viability of existing businesses.

The United States has the most dynamic and flexible economy in the world. In his testimony last week Chairman Greenspan supported a simpler tax code that would be more economically efficient and that would free up resources currently devoted to complying with the tax laws to be used for more productive purposes. I am optimistic that our tax system can be improved in a way that will significantly reduce the strain that our tax laws currently place on our economy and look forward to working to achieving that goal.

And before I turn to our panel, let me just make a couple of introductory comments with respect to our panelists. I think that the President has in fact put together an excellent panel. I wish that all nine could have been here this morning, but we have five members of the panel.

Liz Ann Sonders, who is seated to my right, is the Chief Investment Strategist for Charles Schwab. She joined US Trust, a division of Charles Schwab, in 1999 as Managing Director and a member of its investment policy committee.

Charles Rossotti, who is on my left, Senior Advisor with the Carsyle Group. Mr. Rossotti served from 1997 to 2002 as Commissioner of the Internal Revenue Service. Mr. Rossotti came before -- if some of you want to come out of your chair at him, let me say he was brought in to try to address some of the serious problems that Congress identified back in the '90s, and did an excellent job at that.

Mr. James Poterba at the Massachusetts Institute of Technology Department of Economics is seated to my left. He serves as Associate Department Head. He has taught at MIT since 1982.

And my colleague, Bill Frenzel, who served in the House until 1990. Former member of the U.S. House of Representatives, served on the Budget Committee and the Ways and Means Committee.

MR. FRENZEL: Mr. Chairman, may I have a word?

CHAIRMAN MACK: Well of course you can.

MR. FRENZEL: You mentioned our former colleague Sam Gibbons. And Sam came to Congress long before I did and stayed long after I had left. But I sort of made my career in the House by following his great leadership in many many ways, and I am just so delighted you have been able to get him to come here to testify for us. I really can't tell you. He's a great American, and I don't know what you're selling today, Sam, and it's too early for us to make decisions, but I'll sure be listening attentively.

CHAIRMAN MACK: Thank you, Bill.

And with that, Jack, why don't now go to you.

MR. LEVIN: Thank you very much, Mr. Chairman.

My name is Jack Levin. I'm a senior partner at the international law firm of Kirkland and Ellis, and I also teach part-time at the University of Chicago Law School and at the Harvard Law School, where I focus on business and entity taxation. I'm co-author of a four volume 3,700 page treatise on mergers and acquisitions, and author of a one volume 1000 page treatise on venture capital and private equity transactions. And I will supply a free set of these books to any panel member who pledges to read at least 10 percent.

As ancient history I served many years ago as Assistant to the Solicitor General for Tax Matters under Solicitors General Archibold Cox and Thurgood Marshall.

I've been asked today to summarize a two-semester course on US taxation of business entities in 20 minutes or less, and I'll try to do so.

So let's look first on page 3, of my slides, at five competing pressures or premises that have shaped the US business tax system. The obvious first premise is that Government seeks to maximize revenue, while the obvious second premise is that taxpayers seek to minimize payments. The third principle is that the system should be and should appear to be fair.

The fourth competing pressure is that inevitably Government amends the tax law to encourage favored conduct such as risk capital investment, increased research and development, more US based production, additional capital equipment purchases. And to discourage disfavored conduct, such as high executive compensation, moving business headquarters offshore, moving employment offshore, and yes, our tax system is replete with such provisions to influence business conduct.

And the fifth competing principle is that the tax law, yes, even the tax law for businesses, should minimize complexity and compliance costs. And that, Mr. Chairman and members of the panel is our worst dismal failure. That's because every special provision to encourage or discourage conduct, creates a special rate, deduction, or credit, and thus creates a little more complexity, a little more compliance cost. And after 1,000 or 5,000 such special provisions creep into the Internal Revenue Code, and after volumes of new regulations and definitions defining each special provision, indeed defining each word in each special provision, bang, we have the current American business tax system. And of course clever taxpayers and their advisors invent clever schemes to squeeze transactions into these special provisions.

And finally, taxpayers, who can't figure out a way to get the benefit of a special provision come to the inescapable conclusion that the special provisions enactment made the tax law unfair, unfair to them.

I will focus on five sources of business tax complexity. First, at least five different types of entities engage in business. C-Corporations, S-Corporations, partnerships, LLCs and proprietorships. And they are subject to three very different tax regimes.

Second. There are two principal sources

of financing for these business enterprises. Debt and equity that is common and preferred stock. And these sources of capital are treated radically different for tax purposes.

Third, there are three completely different mergers and acquisition systems for tax, and a combination of two business enterprises, and these three systems reach very different tax results.

Fourth, the Internal Revenue Code contains a welter of different tax rates, at least nine, for different types of income depending on whether such income is favored or disfavored, and a slew of different tax treatments for favored deductions, and another slew of different tax treatments for disfavored losses and deductions.

This multitude of different rates and treatments generates a vicious recurring pattern. First, the Government adopts a tax incentive. Then taxpayers struggle to squeeze conduct into the favored category in order to use or abuse the tax incentive. Then Government adopts increasingly complex and lengthy rules to define the favored category with more precision. And Government also tends to split the baby by retaining the tax incentive, but using the alternative minimum tax or AMT system to partially penalize those who claim the incentive.

Fifth, each corporation must calculate its tax under both of two very different complex sets of rules. The regular income tax rules with rates up to 35 percent, and the corporate AMT rules at rates up to 20 percent and then pay the larger of the two amounts. The existence of these two radically different tax codes with dozens and dozens of complex differences between them, makes rational tax planning, administration and compliance, geometrically more difficult.

Let's look at a few examples of the undue complexity that I'm speaking about. First, as I said earlier, five different types of business entities are subjected to three different tax regimes in our county. A C-Corporation is subjected to double taxation, that is, corporate tax up to 35 percent on the corporation's annual earnings, and also on gain from sale of the business' assets. Plus a shareholder level tax up to 15 percent on dividend distributions out of the corporation's earnings, and on gain on the sale of the shareholder's stock in the corporation, including undistributed after-tax earnings which make the stock more valuable.

A partnership, LLC, or proprietorship on the other hand, is subject to flow through taxation, which means no entity-level tax, but rather the equity owner is subjected to tax on his or her share of the entity's income, again, at rates up to 35 percent. Because flow through entities? accumulated income increases the equity owner?s basis in the entity, the entity's retained earnings are not taxed again on sale of the entity.

Third, an S-Corporation is subjected to flow through taxation, similar, but unfortunately far from identical, to a partnership, LLC or proprietorship. However, if the S-Corp is a former C-Corporation, gain on an asset sale by the S-Corp is subjected to both entity level tax, and equity owner level tax like a C-Corporation.

Moreover, there are arbitrary and complex limitations on ability to use the S-Corporation rules. No S-Corporation shareholder can be a partnership, LLC, corporation, or a non-resident alien. Only one economic class of S-Corporation stock is allowed, so an S-Corporation cannot have any preferred stock.

An S-Corporation can have only 100 shareholders, and if an S-Corporation violates any of these limitations it automatically turns into a C-Corporation and is subjected involuntarily to double tax.

Finally, under the tax rules you cannot transform a C or S-Corporation into a partnership or LLC, that is a flow through entity, without triggering tax on all the entities appreciation. That is the transformation to a partnership or LLC is treated for tax purposes as if all the C or S-Corporations assets were sold at fair value.

A second example of undue complexity is the radical difference in tax treatment for the two principal sources of business capital. Where a corporation borrows capital, the interest expense is deductible, thus eliminating the corporate level tax on the interest payment and the result is a single tax on the debt holder. But the corporation's interest deduction, about which I just spoke, is subject to six, not four, not five, but six, complex hurdles listed in the Appendix.

Where, however, the corporation obtains equity rather than debt financing, dividends paid on common or preferred stock are not deductible at the corporate level. So there is double tax on the corporation's earnings allocable to equity. That is an entity level tax up to 35 percent, a shareholder level tax on dividends, now at the 15 percent rate, and a 15 percent shareholder level tax on accumulated corporate earnings when the shareholder sells the stock.

Because C-Corporation equity financing is treated less favorably than debt financing for tax purposes, C-Corporations are generally motivated to over leverage. That is, to borrow more and raise less equity. This is one example of a Code provision encouraging undesirable conduct.

The underlying premise for differing tax treatment of debt and equity is a perfectly rational one, because debt is a liability, the interest yield is an expense. But because equity is not a liability, equity yield is not an expense. But the ability for a taxpayer to place either a debt or a equity label on investment capital, offers enormous tax planning opportunities. So the Government has responded with a series of complex rules to treat debt like equity, where the debt too closely resembles equity, and to treat equity like debt where the equity too closely resembles debt.

A third example of undue complexity is mergers and acquisitions. The theoretical underpinnings for tax free organizations and reorganizations is perfectly sound. An exchange of one property for another is normally a taxable event triggering appreciation, but to facilitate business organizations and reorganizations, the Internal Revenue Code permits nonrecognition on a combination of two enterprises or a division of one enterprise, with the old owners receiving stock in the new enterprise. But when taxpayers then seek to extend the tax free rules to circumstances resembling a sale, the Government responds with increasingly complex and lengthy rules.

For example, let's look at the Codes, Section 368, Reorganization rules. These rules are available only to a C or S-Corporation, not to a partnership, LLC, or proprietorship. These corporate reorganization rules contain nine complex and arbitrary pigeon-holes listed in the appendix, which turn on formalities such as whether the transaction is an acquisition of T target?s stock, or an acquisition of target?s assets or a merger. And whether BuyerCo, which is acquiring T, acquires T at the BuyerCo parent level or subsidiary level.

And each of the nine pigeon-holes has a combination of silly distinctions not contained in the other pigeon-holes.

And the rules for a tax free contribution of assets to and a distribution of assets by business entities are also enormously complex, and differ depending on the nature of the assets and the type of business entity.

Turning for a moment from a tax free to a taxable acquisition, the tax result is completely different than where the transaction fits into a tax free acquisition pigeon-hole. As described in the Appendix the tax result varies greatly depending on whether T, the target company, is a C-Corporation, an S-Corporation, a partnership, or an LLC, and whether BuyerCo acquires target's stock or target's assets.

A fourth example of undue complexity is the welter of tax rates and other special treatments in the Code. The normal ordinary income top tax rate is 35 percent for either an individual or a C-Corporation. But the Code contains a welter of different tax rates for different types of income, depending on whether such type of income is more or less favored than normal, ordinary, income.

What are those rates? Zero percent for municipal bond interest income; 14 percent for an individual's gain on small business stock as carefully defined in the Internal Revenue Code; 15 percent for an individual's regular capital gain and qualified dividend income; 32 percent after a several year phase-in for US net production income; 36 percent for an individual's compensation income including a 1.45 percent unlimited Medicare tax, 38 percent for an individual's self-employment income including an unlimited 2.9 percent Medicare tax; an additional 20 points of tax for an individual's disqualified deferred compensation; and additional 20 points of tax for an individual's Golden Parachute compensation as described in the Internal Revenue Code.

One example of a tax break to encourage conduct is the new reduced tax rate enacted in October 2004, phasing the tax rate from 35 percent down to 32 percent over several years. On what? On US net production income. This rate reduction covers net income from activities including sale of tangible personal property, computers, software, or sound recordings, if they are manufactured, produced, grown, or extracted by the taxpayer within the United States. Or, a motion picture film or tape produced by the taxpayer within the United States, so long as there is, quote, "no actual sexually explicit conduct." I'll come back to that concept in a couple of minutes.

This rate reduction for US net production income, while well intended creates tremendous accounting administration and audit complexity. It is now necessary to calculate net income from a covered activity by allocating receipts and expenses between the covered activity, US production on the one hand, and non-covered activity, such as US retail, wholesale, service and transportation income, and foreign production on the other hand.

For example, how many arguments will there be over allocation of executive compensation between the covered and non-covered activities. Headquarters, overhead, between the activities. Research and development between the activities.

Let's turn lastly, as our final topic, to the Government's failures in making tax policy and some possible solutions. First, the failure of Government to make hard decisions, resulting in a multitude of rules, definitions, exceptions, qualifications and subcategories, rather than one or a few rules.

For example, the AMT rules laid on top the regular tax rules. Listen here. To the extent the AMT rules are sensible, incorporate them into the regular tax. To the extent the AMT rules are not sensible, discard them. To have two different tax systems is semi-lunatic.

CHAIRMAN MACK: I'm not sure everyone heard that last statement.

MR. LEVIN: Sorry, Mr. Chairman.

A second example is C-Corporation interest deductibility punctuated by six complex exceptions as described in the Appendix. Let's at least rationalize the six exceptions.

Our third example is the nine complex pigeon-holes defining tax free reorganizations. Let's at least rationalize the nine pigeon-holes. In addition I believe we should consider whether the rate reduction for US net production income, and the other special rates, deductions, and so forth, are worth the significant increase in accounting, administration, and dispute resolution costs which they inevitably entail. Or whether on the other hand a broader tax base with lower rates and no capital gain ordinary income distinction, as in the Reagan 1986 tax legislation, might better serve the nation.

We should also consider whether given the availability of the LLC format, the separate S-Corporation tax regime is still worth the added complexity. In addition we should consider whether all business entities should be governed by a unified single tax regime.

Second, let's talk about the failure of Government to stick with decisions once made, resulting in hundreds of tax law changes each year, many of which are not really essential. That is the constant churning of the tax law that has gone on for the last 10 to 15 years. For example, the sunsets for each of the Bush tax reductions, and on and off again R&D credits and bonus depreciation.

Third, let's look at Government efforts to make social policy through complex tax distinctions. For example, the complex golden parachute tax penalties for executive compensation related to a change in corporate ownership, generally an extra 20 points of tax. Or the Code provision limiting to $1 million per year, a public company's deduction for compensation to each of it's five top executives, with no similar arbitrary limitation on deductible compensation to an athlete or an actor. No nondeductible expenditures for advertising or travel. What I'm saying is, these are interesting social experiments, but do they really belong in the tax law audited by the IRS and covered by hundreds of pages of regulations?

Or the October 2004 enactment of tax penalties for an executive receiving deferred compensation not within a statutory pigeon-hole. Again, generally, an extra 20 points of tax.

Let's talk about my favorite. As I mentioned earlier, in granting a reduced tax rate for US net production income, the Code denies this reduced tax rate for making a movie which is sexually explicit. Thus making IRS auditors the arbiters of what is sexually explicit. This is one example of assigning to IRS issues its auditors are neither trained nor suited to resolve.

CHAIRMAN MACK: We all appreciate you putting this in here, this highlighted part.

MR. LEVIN: It's an example, Mr. Chairman.

Fourth, let me be clear. Complexity, unfairness, and tax law churning, all breed contempt for the tax law. A taxpayer disadvantaged by a tax law change, questions why the change is necessary and he or she feels aggrieved. Hundreds of changes each year mean millions of taxpayers feel aggrieved each year.

Fifth. When a tax principle is submerged in a flood of constantly changing legislative and regulatory rhetoric, hundreds of pages of code and regulations, artificial tax shelters grow by seizing on a few choice words out of that verbal flood. So if you don't like tax shelters, make the tax law simpler and more stable.

Sixth. While tax complexity is inevitable, because taxes are inherently a complex matter, much more Government attention and effort is necessary to minimize rather than geometrically multiply the complexity.

I thank you for your patience.

CHAIRMAN MACK: We thank you for your presentation.

Our next panelist is Douglas Shackelford. he is the Meade H. Willis Distinguished Professor of Taxation and Senior Associate Dean for Academic Affairs at the University of North Carolina's Kenan-Flagler Business School. He's also a CPA and previously was a Senior Tax Consultant with Arthur Andersen and Company.

So, glad that you're with us. It's your turn.

MR. SHACKELFORD: Thank you.

I appreciate this opportunity to discuss business taxes. I applaud your efforts to assist the President in reforming our tax system.

Let me outline my comments. First I want to look back and show that corporate income tax has been in a long decline. Next I want to explore a few reasons why that might be. Namely, international competition, alternative organizations forms, and more effective tax planning focusing on tax shelters and the increased mobility of income. Then, I want to look ahead and ask whether the corporate income tax is feasible for the future given the difficulties of measuring income in an information economy.

This graph shows corporate income tax as a percentage of total federal revenue, the pink, and GDP, the blue. With both scalers the story is the same. Corporate taxes declined steadily from the 1950's to the 1980's with some stabilization over the last 20 years. The stabilization, however, may be misleading. Despite a decade of record profits in the 1990s, the corporate income tax never recovered to the level of the less prosperous 1970s.

Why have corporate taxes declined in importance? I think there are at least three key reasons. First, nations compete for business, and most business is very mobile in today's economy. This competition has constrained all countries? ability to extract corporate tax dollars.

Second, the legal benefits to the corporate form are attainable without facing corporate income taxes. Especially with the S and LLC. In fact I view the corporate tax as a special levy on companies that have to access capital through the public equity markets. This special levy has driven many businesses toward organizational forms that provide corporate protection without the corporate income tax. In addition, firms have also adopted other techniques to eliminate double taxation.

Third. Tax planners may have become more effective.

First, on the decline in the corporate income tax rates. According to a recent study by Jane Gravelle, marginal effective tax rates were at an all time low -- that's the pink. Statutory rates, the blue, are only 1 percentage point above their historical low. These patterns are not unique to the United States. Around the world corporate income tax rates have been falling.

Another legislative change that has eroded the corporate income tax is the S-Corporation. The business profits of an S-Corporation are only taxed on the individual shareholder's tax return. The S organizational form is restricted to privately-held businesses, thus, businesses that do not need to access the public equity markets, and some of these businesses are very, very large, enjoy the legal protection of the corporation forum without incurring the corporate income tax. As you can see from this chart, the IRS anticipates the popularity of the S-Corporation to continue to rise.

It's important to note that the erosion of the corporate income tax does not necessarily mean that business income is going untaxed. Instead, most of the taxation of business profits is now showing up on the individual tax return of shareholders in S-Corporation and other flow-through entities.

This point is nicely made with a slide that Fred Goldberg recently showed this panel. I have reprinted it here. It shows that total business net income from flow-through entities, principally the S-Corporation, recently exceeded total business net income from firms filing corporate tax returns. I'm not sure that this pattern will hold with post-recession returns, but it does indicate the growing importance of flow-through entities.

The problem with the C-Corporation of course, is two levels of taxation on business profits. One at the entity, the other at the shareholder level. S-Corporations and other flow-through entities are only taxed once, and are a mechanism for eliminating one level of taxation. Privately held C-Corporations can pay bonuses at year end to the employee shareholders and eliminate the corporate income tax. Larger, publicly traded firms, often resort to leverage. Since interest payments are deductible, the returns to debt are only taxed on the lender's tax return. Similar tax reducing payments can be achieved by locating intangible assets in low tax jurisdictions.

Employee stock options can also eliminate double taxation. The company borrows from their employees and repays them with stock. My research with John Graham and Mark Lang shows that the deductions from employee stock options can wipe out large portions of the corporate tax base. For example, we estimate that in 2000, total deductions from stock option exercises were 10 percent of the total pre-tax income of the largest 100 US-Corporations. However, for the Nasdaq 100, the total deductions exceeded total pre-tax income. In other words, the business profits from the high tech industry were largely taxed on the returns of the employee shareholders who exercised options.

In short, the corporate income tax base is under attack from many directions. Nonetheless some studies suggest that these explanations cannot fully explain the shrinkage of the corporate tax base. They report that even after adjusting for legislative changes to the tax base, stock option compensation, differences in accounting for foreign profits and other items, the gap between the accounting earnings reported to shareholders and the corporate taxable income reported on the tax return has been spreading.

Assuming accounting earnings are not overstated, which they may very well be, this book tax gap has led many to speculate about the importance of corporate tax shelters.

Before we look at corporate tax shelters, I would like to address one change that some, with the best of intentions, contend would improve both book and tax reporting. Book-tax conformity. Their argument goes as follows: If companies are overstating book profits and understating taxable income, then require them to report the same figures to shareholders and the taxing authority and you fix two problems at once.

I don't agree. It's fine if tax and gap naturally reach the same accounting procedure. In fact, it simplifies overall accounting costs. However, to blindly tax a firm's net income, or alternatively stated it to constrain the information that it provides to its shareholders to its taxable income figure, ignores the critically important role that accounting information plays in the markets. It's important that this information not be subject to tax minimization pressure.

Now, onto corporate tax shelters. Until recently a loose collection of tax plans known as corporate tax shelters were substantially reducing, and in some cases, eliminating the tax liability of some US companies. These shelters met the letter but not the spirit of the law. I would term them, legal non-compliance. The best of them reduced taxable income without effecting book income. It is nearly impossible to estimate the magnitude of these tax shelters using publicly available data. Nevertheless, all indications are that shelters were non-trivial. For example, the Joint Committee estimated the elimination of just one shelter, leasing transactions, generated $4 billion of tax revenue in a single year.

Today corporate tax shelters have fallen out of favor. The recession blunted demand, no profits, no tax planning, and companies and firms have been tarred with bad publicity from shelters. The IRS has also become more aggressive. In addition, one of the primary suppliers, the big four accounting firms, have withdrawn from the market in part because of penalties and negative publicity, but because shelters threatened to undermine the highly profitable audit work that they are currently enjoying with Sarbanes-Oxley.

The shelter market could revive if the economy and thus income taxes began to boom again, if recent IRS setbacks in the courts embolden taxpayers, and perhaps if the big four spin-off their tax practices thus freeing tax planners from the conservatism brought about by Sarbanes-Oxley.

Now I would like to address why I believe that tax planning has become more effective in the last couple of decades. The issue is the mobility of income. All financial information in a firm flows from the same source, the historical cost accounting system on which the tax system is overlaid. Accountants are struggling to define and measure income in an economy dominated by intangible assets. These measurement problems provide opportunities for tax planners, and raise doubts about the long term viability of any tax system built on income.

For example, derivatives enable firms to hedge and diversify without selling assets and triggering taxable events. Income mobility becomes increasingly problematic for globalization. With firm assets across the globe, within firm transfer pricing can now shift income to low tax jurisdictions. Now, surprisingly a disproportionate amount of income is now recognized in tax havens and other low tax jurisdictions.

To understand this problem, let's look back in time. For much of the 20th Century the key factors in production for the large US Corporations, primarily manufactures, were largely immobile. Large production facilities, heavy equipment, large labor forces producing goods for shipment. Gross income was straightforward. Sales less the cost of manufacturing the goods. The thorniest accounting problems involved determining the cost included in inventory and depreciation of the plant equipment. Taxable transactions mostly involved the movement of goods through the production and sales cycles.

Today the key factors of production are highly mobile. They're intangible assets, brains, information, that most likely never appear on a balance sheet. The quality of a highly skilled labor force is often the most important economic asset. The thorniest accounting problems involve intangibles.

For example, what's the value of a brand name or a customer list. When do we recognize the value enhancement from a firm's R&D, from its investment in human capital. How do you measure profits when the key profit center is in people's heads.

Many transactions are unobservable and impossible to locate in a specific jurisdiction. For a simple example, where does the telephone call occur; when the caller dials the number, when the phone is answered? Who can tax it? The country from which the call originates, is received, or travels through?

Accountants are struggling to answer these problems for financial reporting purposes, so it should be no surprise that these measurement problems are undermining the foundation of the income tax system.

The key question is whether a tax system built on such a difficult to measure unit as income will be feasible in the future. A tax system depends on market frictions that impede attempts to undo the tax. In old days you could not easily dismantle the plant. Today you can move profits around the globe with transfer prices or a plane ticket.

Let me close with a challenge. An indication that tax reform succeeds will be a reduction in the need for tax planners. The key to reducing the need for tax accountants and lawyers is the elimination of the differences in tax rates. Whenever you tax the same income differently, you provide an opportunity for a planner to reduce taxes.

Here are some current examples of policies that create a demand for tax planners. We will repeat some that we heard from Mr. Levin. Tax the same income differently at different times. A recent example is the tax holiday for repatriated foreign profits. Tax the same income differently in different places. An example is the sourcing rules in the international area. Tax the same income differently in different organizational forms. We've already discussed this issue with S-Corporations, but untaxed parties such as tax exempt organizations and pensions are playing an increasingly important role in tax avoidance.

Tax the same income differently depending upon the savings vehicle. For example, stock returns are taxed differently depending on whether the stock is held in a 401(k), a mutual fund, or a personal account. Finally, tax similar income differently. A recent example is the lower tax rates for domestic manufacturing.

These types of rate differences provide tax planners with endless opportunities to shift wealth from the Treasury to taxpayers for a fee. What's the best way to narrow rate differences? It's an old answer. Lower the rates, broaden the base.

Thank you very much. I look forward to your questions.

CHAIRMAN MACK: Thank you, Doug. We appreciate that.

Our next presenter is Mr. William Gentry, an Associate Professor of Economics at Williams College. Professor Gentry taught economics at the Columbia Business School and Duke University before accepting his current position. He is on the Editorial Advisory Board of the National Tax Journal, and we appreciate your being here and look forward to your testimony.

MR. GENTRY: Thank you very much. I appreciate this chance to discuss with you how economists view the corporate tax. I believe that my two predecessors have convinced us all now that it's a challenging part of the tax system when considering tax reform.

I want to focus on two areas today. First, I want to talk about what economists call tax incidence. That is the process of determining who ultimately bears the cost of a particular tax.

Second, I'm going to outline several important ways in which the corporate tax system distorts economic decisions, and I'll focus on three specific areas; organization form choices, investment decisions, and financing decisions.

Before delving into my two broad topics I want to highlight two views of the corporate income tax. In one sense the corporate income tax is tax on capital and used for corporations. Income is measured as the return to the shareholder, so income captures the return the shareholders anticipate by investing in corporations.

Now, one key thing to note there is that it's just the return that goes to the shareholders and not the creditors. So it's not all capital used by the corporation, it's just the capital that's financed by equity. Alternatively, if you had a business property tax, that would not draw this distinction between debt and equity.

But there's another sense in which the tax is a tax on pure profits of corporations. By this economists mean the returns that are above to ordinary risk adjusted return, or the returns that people would expect to get out of an investment. One of the tricky issues here is that these views are not mutually exclusive. In practice the corporate income tax base includes both types of returns, both the ordinary and the extraordinary, and it's very hard for an income tax to separate the two.

Now, what's important for tax incidence is those two different views are going to matter for how we think about it. But first I want to talk a little bit about why economists talk about tax incidence. It's the part of economics where we take a tax burden and we allocate it across people. And it's critical for evaluating the fairness of the tax system, so policy analysts create distribution tables that summarize how taxes affect different groups of people. Often grouped by income.

Every distribution table that's produced by academics or government agencies, has to rely on a series of incidence assumptions. Thus, understanding tax incidence is critical for understanding tax fairness.

The first key rule, when economists talk about tax incidence, is that it's insufficient to know who writes the check. A simple example will illustrate this. Suppose you were thinking about a gasoline tax, and the person who writes the check might be the owner of the gas station. But we don't really think that the owner of the gas station bears that tax, we kind of think that if the tax is increased the price at the pump is going to go up, and the consumers are going to bear that tax.

Well, when we take that analogy to the corporate income tax there becomes a complicated web of responses for who ultimately bears the burden of the corporate tax. And I'm going to talk briefly about what some of those responses are, what are the avenues for shifting the corporate tax. So if you view the tax, the tax on capital used by corporations, well one thing that the corporations could try to do is raise their output prices, and that's going to shift the tax to consumers.

Another is that they reduce their output because they have higher prices. That's going to affect labor demand. At the same time they're going to be substituting away from capital the highly taxed factor, and potentially towards labor. You might say, well, that's good for workers, but then you go on to realize that there's less capital for every worker, and that's going to reduce the productivity of the workers.

And lastly, another way of thinking about this problem is, if you have investors and they're thinking about whether to put their money into corporations or put their money into other business organization forms, or other types of capital, such as housing, they're going to be equating the rate of return after tax if they get across these types of capital. And at the end of the day the tax can be shifted across different types of capital so that it does not just rest at the corporate level, but it affects all different capital.

On the other hand, if you think about the tax being a tax on pure profit, that's going to be much harder to shift, and so that would tend to reside with the person who comes with the great idea, for example.

Now, what do economists think when they say, well, what's our best estimate of corporate income tax incidence. The empirical evidence surprisingly is relatively scarce. It's proved to be a very difficult problem in economics to solve.

There's a wide agreement that the corporate income tax is not just a tax on pure profit, there's also a wide agreement that there is shifting of the burden from shareholders to all capital. What that means is that it's just not the corporate shareholders, but it's all capital. It means that the returns throughout the economy on investing, whether it be inside corporations or S-Corporations or proprietorships or small businesses, or even investing in housing, these returns are all affected by the corporate income tax.

There's less agreement on whether any of the taxes shifted to workers or consumers but it's certainly possible that some portion of the tax is shifted onto the workers or consumers, so that it constructing one's distribution totals you need to consider that.

How do the distribution tables in Washington actually work? Well, sometimes they ignore the corporate income tax and sometimes they tend to allocate it to all capital owners, which is the standard point that we have agreement on.

Now I want to turn to what some of the distortions are. It's a broad overview of distortions from the corporate income tax. I would say that there are five areas to think about. Organizational form, investment, financing decisions. Those are the three I'm going to focus on today. There are two other areas I am not going to talk about. One would be the multinational effects, so having multinational corporations and the sort of distortions you get across countries are in the second output in the category of tax shelters. And I understand that there will be future hearings that are dedicated to each of those.

So now I want to turn to the three distortions I'm going to talk about. We heard quite a bit about organizational form and that the corporate tax applies to what is known as C-Corporations. Alternative business forms avoid the corporation income tax, and as Doug Shackelford's slide showed, the alternative forms have grown recently.

What that leaves you with is the corporate tax applying to one set of firms, often the set of firms that is public and it's increasingly becoming a tax on being public. That becomes a distortion that taxes may be discouraging the organization of C-Corps, which it then says the tax system discourages the firms from missing out on the benefits of being public and some of the benefits of the large scale or public corporations. Those views, in some sense it might be hard to quantify that notion, but there certainly are economic models that suggest that these types of distortions are large. It's also true that the distortions would go across industries because some industries are more likely to organize as large public firms because of the needs of the industry. So the automobile industry, where it's almost all corporate.

The second type of distortion is investment. And taxes can affect investment through several ways. One is the tax rate. The other is a set of tax rules. For example, depreciation rules. Whether business investment is depreciated over time, or whether it's expenses. Typically either higher tax rates or less generous depreciation rules increase the cost of capital for firms.

These differences can effect both the level of investment and the type of investment. So the level of investment is how much capital we have, but the type of investment is whether you invest in structures or equipment or intangible capital, such as advertising or research and development. The bottom line on this distortion is, I believe the consensus is that there are substantial effects on the amount and type of investment undertaken by corporations.

Financing. Another distortion is the question -- there's two financing distortions. One of is the question of debt versus equity. The general wisdom is that the double taxation of corporate equity favors debt over equity. There's a bit of an offset in the sense that interest is taxed more heavily at the investor level than dividends and capital gains at this point. So in some sense it's a question of where are we going to collect the tax on corporations. Is it going to be at the corporate level or the investor level.

That offset is incomplete. In general the evidence on taxes and over-leverage suggests that because of the corporate tax we have a corporate sector that has more debt than it would otherwise have. For example, there are estimates by Roger Gordon and Young Lee who find that if you cut the corporate tax rate from 35 percent to 15 percent corporations would have about 8 percentage points more of their assets financed by debt.

Now, these affects may not be huge, but there are other things that happen when you try to distinguish debt versus equity. First, you have some industries or firms that have more access to debt, either because they're large or they have lots of tangible assets which makes it easier for them to borrow. Therefore the tax system, though the financing rules affects the investments of these industries or firms. The second collateral affect is that it becomes a fault line for tax planning and tax sheltering, the difference between an instrument is debt or equity.

The second financing distortion is in how firms decide whether to pay dividends. So firms have to decide whether to distribute their earnings as dividends or retain them and potentially reinvest them in the firm. They also have to decide if they're going to pay money out to shareholders, whether they should do it in the form of dividends or share repurchases. And the tax system can affect both of these margins in particular because shareholders face different types of tax rates on dividends and capital gains. Even when the statutory rate is the same between dividends and capital gains, with the capital gains you get to decide when and you get to defer the tax.

There's recent evidence on the 2003 tax cut which cut the personal level taxes on dividends, but these tax cuts increase corporate dividends after the tax cut. The distortion here by distorting dividend policy is the taxes can alter which firms have capital. So the tax system encourages Firm A to keep its capital and keep its retained earnings. That means it doesn't get paid out to the financial market and reinvested in newer and more innovative firms it might have been projects. So that's the sense in which the distorting the dividend choice can affect capital allocation efficiency. The capital, how it's allocated across firms.

So in summary there's a wide range of economic distortions, both how firms organize, how much they invest, what types of assets they have, and how they finance these assets. And these can have large effects across different types of corporations.

So in conclusion I think what I would leave you with is that while economists tend to think that most of the burden of corporate taxation falls on all owners of capital, there's some disagreement. It could fall some on consumers and some on workers. What I want to key in on that point is, is that it's not just the shareholders. It is spread out through the economy by affecting the rate of return on all sorts of investments, whether those be in large businesses or small businesses. And because we have the corporate income tax, all capital ends up with a lower rate of return.

Second, I want to point out that there are economic costs in terms of distortions from the corporate income tax, and these are wide ranging and likely to be substantial. And you might want to say, well, of course all taxes are going to distort behavior to some degree, so it's not enough to just say, oh there are distortions here so we should close down the corporate income tax. But I think what one has to think about is how these distortions compare to other distortions and also compare that to the amount of revenue that we're raising, which is becoming increasingly small as the tax planners have become better. So we're incurring many many distortions without raising very much revenue, which calls into question whether we should continue with the corporate income tax or whether it should be a prime target in tax reform discussions. Thank you.

CHAIRMAN MACK: Thank you all for your presentations. I'm sitting here thinking about the complexity that you've laid out for us, and I think we probably should have talked to them before we accepted this position.

One of the things that struck me was the -- again, the enormous complexity, but one of you said, and I think it was Doug, I'm not sure, made the comment that the way to get at this complexity is, in essence, the same solution for the corporate business side as it is for the individual side, and that is to lower rates and broaden the base. It seems like though that's a so much more difficult thing to do in this particular area we've been talking about this morning.

And the other, I guess, message that I heard was that the different rates on income create the tax planners, and I suspect Jack, as well, probably created these five entities that you mentioned. I mean which came first, the entities and then the tax rate? I suspect it was the tax rate created the entities. So is the answer to reduce the number of entities that a business can choose from?

MR. LEVIN: No.

CHAIRMAN MACK: I guess let me get to what I think is the question I want to pose, and that is for each of you, think about it for a moment. In the three areas that we have been given direction by the President, simplicity, fairness, and growth, if you had to pick one or two areas would it effect simplicity, what would you do, to effect fairness, what would you do, and to effect growth, what would you do.

And anybody can go first. Whoever is so inclined.

MR. LEVIN: Well, I certainly would

comment that simplicity and fairness are hooked together in the sense that complexity makes everyone feel that they're being treated unfairly. Summarily the constant changing of the tax code makes those who are disadvantaged by the change, and generally about half of the people are disadvantaged by change, makes them feel that there's unfairness in the system. So I say that simplicity and fairness are often hooked together.

Now, several of the business tax issues that I talked about earlier, that I think are affected by the simplicity and fairness issues, are the three different tax systems for taxing business enterprises. The C-Corp, the S-Corp, and then the flow-through system for partnerships, LLCs, and proprietorships. Having those three different systems adds a great deal to the complexity of the business tax world. It also seems unfair.

You see, the concept of LLCs, which is now generally the most popular approach for a small business, was not even invented, was not adapted by all the states, until less than 10 years ago, about 10 years ago. So most businesses formed before 1997 are corporations. So they're either in that C-Corporation or S-Corporation set of rules. Many of them wish that they were in the LLC set of rules, but they can't get into it, because to switch to an LLC would cause them to be taxed on all the inherent appreciation in their assets and business.

Secondly, not every lawyer and every accountant keeps up on every change in the law. And so even since 1997, when a change in tax law and a change in state laws, made LLCs so dramatically the best way to go with respect to most non-public business entities. Lawyers and accountants have continued to form C-Corps and S-Corps, often oblivious of the existence of the advantages from a tax point of LLC, and therefore owners of businesses have woken up a year or five or ten years later and said, my god, how did I get into this C or S regime when I would have preferred to be in the LLC regime. So there is unfairness as well as complexity.

Now, I am not here testifying on the transitional problems of moving from one regime to another. We have to decide what we want as the future regime before we talk about the complexity of transition. What I am saying is that one of the ways to move toward both fairness and less complexity, is to focus on the three tax systems; C-Corps, S-Corps, and flow-through for partnerships, LLCs, and proprietorships, and to try to rationalize those into a simpler system.

Now, that leads you then to another thing I talked about, which is mergers and acquisitions. Now that may sound like a small topic, but there are mergers and acquisitions going on, hundreds and hundreds of them every month in this country. There's a great deal of acquiring and selling and dividing businesses going on. And when you have these three tax systems, the double tax system for C-Corps, the single tax system for partnerships, LLCs, and proprietorships, and the hybrid system for S-Corps, every merger or acquisition has tremendous complexity, because it depends on whether you are acquiring a partnership, an LLC, an S-Corp, a C-Corp, all different tax systems. And our merger and acquisition system also is complicated by having taxable and tax free. The tax frees have the nine pigeon-holes, that are really senseless in their distinctions, and there's the distinction between acquiring stock and acquiring assets.

So once you start to simplify the number of business entity tax systems, you can also start to simplify the merger and acquisition system. And I also talked about getting rid of the AMT, which causes every business tremendous headaches by having two Internal Revenue Codes with senseless differences.

CHAIRMAN MACK: Thank you.

Doug, you want to give a shot at that?

MR. SHACKELFORD: Sure. In my mind the system is like a very elderly person who has gotten sick and they're going to die. And we need to begin to make plans for how you sort of transition to the next stage.

With that mind-set that it's not a matter of really making some adjustments. I don't think income is a system that exists much longer, and that's in my statements. And I'm an accountant so I come from that perspective. So I think now you have to start talking to moving to some sort of second best solutions in some scenarios. But these, I think, the time is such that they are necessary.

So an example would be integration. We need to move to an integrated corporate shareholder system. The President proposed what ended up in the 2003 Bill where we wouldn't tax shareholders. That might be a good direction to go.

What we are observing now is that basically companies are doing what I would call home grown integration. And so that may be used in organizational form, it may be taking more debt on the books, it may be -- I used the example of stock options. There's lots of things. But effectively integration is going on. We might as well recognize that and go ahead and put it into the system, and that would be I think a movement toward both simplification was well as growth.

A similar type thing I think goes on in the international area. The current system that we have with deferral of profits until they're brought back into the US. That system, again, in kind of an ideal world, maybe in the 1950's when it sort of was given birth, it was exactly the right thing to do. I think in the current day we either need to decide to go to a territorial system and so we're just going to tax activity in the US, or we need to go to the other extreme which is to say we're going to tax all profits worldwide as they're earned. Being somewhere in the middle I don't think makes a lot of sense. And I think either of those two would lead towards simplification.

And growth might be a little more difficult for me to speak to. But clearly we're in a position with our current system which is not putting us in a terribly competitive position with our other trading partners. So we need a system that goes to one or the other.

And then I guess I can give a negative example. What we don't need, in my mind, is the current tax bill that was just passed. It's essentially industrial policy. It goes against concepts of simplification, fairness, or growth. So when we decide -- and I think Mr. Levin did a great job of talking about the manufacturing. When we decide we're going to tax manufacturing at a rate different from the rest, that's a ludicrous concept, and will lead to all sorts of problems which go against all three of these things.

When we decide that if you bring back profits from foreign countries during some one year period we'll tax you at a different rate, that's a ludicrous policy.

So we're doing some current things, I think, which are going in the wrong direction. And it may be again because we're trying to take an aging ailing patient and try to sustain it for another six months or another year in a tax system maybe 10 years, 20 years, but I think what your group is called to do, and I'm pleased what the President is trying to do, is back up and say, we need to be planning something for the next generation. And the next generation isn't going to look a lot like what we have here. And so minor modifications aren't going to get us there. We need to make some big decisions and move there.

And the last thing I would think of, and this is only once you get sort of the situation cleaned up, is somehow we could reduce the number of changes to the tax law. Every time Congress goes in, tremendous effects on anti-simplification, tremendous burden placed on the IRS, tremendous burden placed on tax compliance and the taxpayers. And there's a tax bill in play or substantial changes going on, it seems continually. And I think that's a tremendous cost.

CHAIRMAN MACK: Good, good. Bill.

MR. GENTRY: I think I can sing the third verse to this song. On simplicity I think Jack Levin's comment on the AMT is exactly right. The AMT was put in as targeted fairness and a notion that there's a few either corporations or individuals that are taking advantage too much of particular things. We're going to fix it up with the AMT.

I believe that the tax provision makes sense, you keep it in the Code, if it doesn't, then don't have it in the Code. But the benefits of the AMT seem pretty small relative to the complexity cost that it's creating. So I think on simplicity that's certainly one I would think of.

Another element of simplicity I would focus on, having relatively few brackets without too much dispersion across the tax rates in the different brackets. That does raise issues of fairness. I think I would focus the fairness debate on how to relieve the tax burdens on relatively low and modest income households, and if that means -- you know, you could have a tax structure that there might be a few people in the top half of percent that don't seem to have a really high average tax rate. But when you start trying to go after them, sometimes you create things like the AMT or really high tax brackets, that just create a lot of complexity and tax planning opportunities.

On growth I'll echo Doug's comment on having some form of integration between corporate and personal taxes. This is a tax policy that's been tried in many countries. Some of our competitors have these systems, it can be done in a number of different ways. What it's going to buy you in terms of the corporate side and business taxation is, it's going to reduce or eliminate distinctions between organizational forms and debt and equity. And so you're not going to have the same size of distortions that I was talking about. And I think I would echo his comment on taking a look at how we tax multinational corporations as a place where you could improve growth and also probably simplicity.

CHAIRMAN MACK: All right. Thank you for your responses.

I do remember, I think 10,000 amendments have been made to the tax code since the tax reform of 1986. Imagine that, 10,000 changes in the tax code.

Liz Ann, we'll turn to you next.

MS. SONDERS: Thank you very much.

Gentlemen, can you talk about the cash flow tax as a total reform option, and in particular the transition rules, the impact that they would have on revenues and also administrative and compliance costs.

MR. LEVIN: Be a little more specific on the type of system you're alluding to.

MS. SONDERS: Well, there's been a lot of proposals to just scrap the current income tax and go fully to a cash flow. So this question, more total reform as opposed to, to use your analogy, of attempt to heal an ailing patient here, and whether -- that given one of our goals is revenue neutrality, whether that's something even possible to consider in terms of the impact to revenues, at least in the short term.

MR. LEVIN: Well, you're probably alluding to something more like a consumption tax?

MS. SONDERS: As close as you can get on the corporate side.

MR. LEVIN: Well, one set of rules are that -- or one approach to that is a VAT, or national sales tax. If that's what you're alluding to. A VAT or national sales tax, like is prevalent throughout Europe at rates ranging from 15 to 25 percent. That kind of tax is in the end paid by consumers, whoever buys goods or services. Typically that kind of tax will apply to the purchase of either the good or services. So medical expenses, food, clothing, cars, legal and accounting services. That kind of a tax is, at least at first blush, easier to administer.

However, the problem with that kind of a tax is that you quickly have, because of the size of the tax, 15 to 25 percent, you quickly have a push for lower rates for certain kinds of things. The low income person is buying food and clothing and medicine and, well, we need a lower rate for that. But you just can't say food because food includes fancy dinners at a restaurant, food includes caviar. You just can't say clothing, because clothing includes fancy ski garb and fur coats. And so now you start with what kind of food and what kind of clothing, and you start with variable rates. That brings complexity, so you have to think that through.

There is another approach to a consumption tax, and that is to have a uniform rate on everything. No variable rates, no exemptions. But then to have low income people entitled to a rebate, and so now you're back to a bit of an income tax system, they have to demonstrate what their income is and file papers to get a rebate.

Now, that kind of tax will generally, unless the rate is very high, not raise enough revenue to completely supplant the income tax system. And so you have to think, are we going to have a dual system, as most european countries do, both a VAT/national sales tax, and an income tax, with both raising revenues. And then you might lower the rate on one or raise the rate on the other. That of course -- while you're starting towards simplicity by adopting the VAT or national sales tax, you're ending with complexity because you now have both taxes. So you're now back to all the Subchapter C versus Subchapter K versus flow-through entities I had talked about.

Finally, my last point would be that that whole consumption tax is imposed in the end on the buyer of the goods and services. The ultimate buyer of goods and services. And so it doesn't necessarily supplant the corporate income tax. You could have a consumption tax in lieu of or as a reduction of personal income tax, but now you still have to grapple with the issue of whether you're going to have a tax on business, a tax on the closely held corporation or the publicly held corporation, because the consumption tax doesn't really apply there.

The consumption tax is collected in stages. So Company A produces a wheel and sells it to Company B, which incorporates it into a chassis which sells it to Company C, which incorporates it into a truck and then sells it to the consumer. In the end, although each pays a small piece of the VAT or national sales tax in most systems, the final buyer of the truck is the one that then reimburses all the others for the tax so businesses don't bear that tax.

So you have to grapple with the philosophical issue of a consumption tax being paid by the ultimate buyer of the goods and services and not by the business. And so most european counties, at least, have stayed with a business tax, and all the issues that entails, as well as having that VAT or consumption tax.

CHAIRMAN MACK: Bill?

Excuse me. Go ahead.

MR. GENTRY: Actually the cash flow tax would actually be one form of integrating the tax system. It's one way of getting rid of the distinctions between different organizational forms if done properly.

So in the first Bush administration there was a green book put out by Treasury that talked about various integration schemes. And the comprehensive business income tax was one of those, and it was a cash flow tax at the business level.

When you think back to my comments I drew a distinction on the corporate tax being a tax on capital used by corporations and a tax on pure profits. But one of the things that happens in a cash flow tax, is that instead of having depreciation allowances, firms get to expense and give an immediate write off on expenditure on equipment or structures, because that's the nature of the tax flow tax. The cash went out so they get a deduction.

So the tax then becomes much less a tax on capital and much more a tax on true profit, over and above the extraordinary rate of return. And that's the part that was hard to shift, and it's hard to shift onto consumers.

You mentioned transaction, and that is one of the costs of moving to a cash flow tax because you have a set of firms right now that are locked into a system where they're expecting depreciation allowances in the future, and then you're going to go to a system where, well, when you buy anything new you're going to get to expense it and you don't have depreciation allowances. So what do you do with all those depreciation allowances that people were expecting to get that you then threw out the depreciation table.

Well, you know, as with almost any tax transition issue, if you want to throw some money at it you can fix the problem. But transition is always an expensive problem to fix.

MR. LEVIN: Now, we just talked about two completely different types of systems. I'm not sure what you had in mind with cash flow, I was talking about --

MS. SONDERS: Well, I'm happy to hear your answers on consumption. That is more specifically the question that I was asking. But your answers were really helpful too.

MR. LEVIN: What I think Bill has just talked about is a system that is still an income tax, but it redefines how you measure income to be more cash flow oriented than it is now.

CHAIRMAN MACK: Bill?

MR. FRENZEL: Gentlemen, thank you very much. It's been most helpful. You've told us all the awful things that we face and you've given us a very slight hint of how to move forward.

If we assume the animal or the person is very sick, as Doug suggests, and if by some miracle we're able to pharmaceutically heal the beast, how much longer will it be before he is reinfected?

If we have the 10,000 changes between '86 and 2004, are we wasting our time or do we just consider ourselves one in an endless line of future Tax Reform Commissions having to operate at closer intervals over a long period of time?

MR. SHACKELFORD: Well, I've heard someone say that if you go back in history, in '39, '54, '69, '86, all of those were major changes. If you kind of look, there's about a 20 year interval. We're at about a 20 year interval. But I would say if you could do something that would make things better for the next 20 years, that takes us all a long ways out to the future.

Are you permanently going to fix things? No. But, part of that is just because the world is going to change so radically. So 20 years from now the problems we're going to face can be radically different. If you go back 20 years ago, intangible assets were a problem, but they weren't anything like what they are now. Twenty years ago globalization existed, but it wasn't anything like it is now.

In my mind very many of the problems you're facing are problems that have been brought on by technology. And technology is a great thing, it just undermines a system that was built with bricks and mortar. Nonsense. If you could build a system that works with the current technology we have, I know in 20 years we're going to have a different technology, it will undermine that system. But 20 years is a pretty good way out to the future to improve the system.

MR. FRENZEL: Jack, do you think we can build a system that will last a couple years?

MR. LEVIN: I think that you will never build a system that will be perfect forever. I think that what happens is, you've got to go into the factory where people have dumped some garbage here and spilled some waste there, and you've got to periodically clean up that factory.

Now, two years or ten years from now there will be more waste and more garbage. But you've got to every once in a while take a look or pretty soon that garbage chokes off your ability to operate the factory. And as I alluded to in my testimony, in 1986 there was a major tax reform. We broadened the base, we did away with a bunch of special rates and special provisions. We made the tax law much simpler with lower rates.

Now, that only lasted a few years before Congress got real enthused about starting to enact encouragements. Put in a lower rate for this and a higher rate for that and a penalty for this and a special deduction for that. And that, to me, is like starting to spill the garbage and dump things around the plant. And what we've gotten now is a geometric increase in that.

Forty years ago when I first started to practice law and to teach and to write in this area, you would have three or four tax changes a year. And it has accelerated over the years. In the last 10 to 15 years it has accelerated to the point where there were hundreds, sometimes thousands of tax law changes every year. Many of them really needless. They're there to try to make a social point, and now we have the Code filled with this social legislation. Encouraged items and discouraged items and nine different rates, as I talked about. And if we keep the present income tax system, it's time for some group, and this looks like a wonderful group to me, to help to clean it up, and to convince Congress to do the clean up, and then lay off for a while. Stop changing it, so that we don't have a thousand pages of regulations every six months coming out interpreting all these new provisions and building little monuments here and there filled with complexity. It's time to do that.

There's a second alternative, which is to abandon the system and to go to something more like a consumption tax, a VAT tax, or something very different. I was told by the staff not to come here and propose the final solution, but to explain what we have, explain the problems, and explain some of the ways we might start to fix the system.

And I agree with you, or I think the inference of your question. That is, we now need to clean up the mess that we've made, and we have to hope that that clean up lasts for a decade or more, and then some other group will have to do it again.

MR. FRENZEL: I suppose that when Hercules cleaned out the Augean stables, he knew that horses were going to do again what horses have always done, and he knew that somebody else was going to have to come along a few years later.

MR. LEVIN: Nothing is forever.

CHAIRMAN MACK: I've never heard a better job description of what we're engaged in.

Well, there was a thought that I had which I have now forgotten, so I will turn to Charles and let you go with it.

MR. ROSSOTTI: Well, all I was going to say, Mr. Levin, is that I guess left the IRS just in time because at least I didn't -- I had to look at all these rules that Congress was passing, but I didn't have to watch any sexually explicit movies. I'll guess they'll have to put a special screening room in Mark Everson's anteroom or something like that.

I just wanted to follow up on one thing. I know it may sound like an arcane area, but it is actually one of the things that is really maddening about is, could you talk a little bit more on this issue of business combinations. You made the point very well how out of control it is. But it is an inherently complex area.

Did you have -- and you can even follow-up for the record if you don't want to elaborate on it here. You sort of alluded that there were at least some things that could be done, you know, that would rationalize that and make it more simple and still accomplish its objectives.

Do you have any thoughts along those lines?

MR. LEVIN: Yes. It's a very complicated area and I'll give some generalized thoughts. First of all, on tax free reorganizations, that is the putting together of two companies with the principal consideration being stock of the resulting company, but often with some boot, some extra cash.

There are now nine different pigeon-holes. And if you haven't read about them, you would be surprised how complex each is. Each has four or five or six requirements. And strangely they often have nothing to do with each other. If you fit in one pigeon-hole if you meet five -- if you do it on a Tuesday, south of the Mason-Dixon line, on a cloudy day.

MR. ROSSOTTI: Yes.

MR. LEVIN: And then another one has yet

another completely different set of requirements. When you look at these nine you say, these are crazy. The very first and simplest at the margin, you clean that up, you turn that into a comprehensive set of tax free reorganization rules that are one set, that don't turn on fitting into these different pigeon-holes.

The second thing is that in taxable acquisitions, where you're not within the tax free acquisition rules, taxable acquisitions. Again, there's a whole series of distinctions. They turn on what is the type of entity you're acquiring; a C-Corp, an S-Corp, partnership or LLC. How are you making the acquisition; stock versus assets. And it's, again, a whole coterie of different rules. From time to time I'll give a speech to tax experts on mergers and acquisitions. I can speak for four hours on the issues that are arising in mergers and acquisitions, the tax issues, without even denting the topic. This 3700 page treatise that I'm a co-author of, it gets updated and republished every six months. Tremendous, hundreds of changes every six months. It's a system that is so complicated and is now being changed and is so out of control every time it gets changed, that it's overly complicated.

So therefore, what I am suggesting is,

that in a merger and acquisition area, first of all, you clean up the tax free reorganization rules to make them uniform. And it's Congress that's made them different. These nine are all in the Internal Revenue Code, so the IRS comes along and generates nine different sets of regulations.

And then to change also the system for business taxation, so we have a more uniform system.

MR. FRENZEL: If you have any papers or anything that lay out your ideas in that area, it would be interesting if you could send them to us.

MR. LEVIN: Yes, sir.

MR. POTERBA: Thank you all for extremely set of presentations. Let me ask one general question and one specific to Jack on some of the Code provisions you mentioned.

General question is, all of you have spoken about the corporate income tax in some sense as an isolated tax. Yet, one of the things that we often hear about the corporate income tax is that in a world where we have an income tax -- personal income tax, the corporate income tax provides an important backstop and essentially keeps a variety of activities that could easily move off the tax books into the individual tax side within the net of the tax system.

And that therefore even if the corporate tax doesn't collect a lot of revenue in its own right, it is providing this backstopping function.

I'm wondering if any of you would jump in and address that.

And the question about the complexity, and this is more to Jack. As you list out the nine different structures and pigeon-holes that one can go through, is the complexity burden sufficiently great on the taxpaying corporations and all the other entities that are there, that even those that would lose because they currently fall into some of the pigeon-holes that have been created by their lobbyists and their executives in working with the political process over -- in years, would there be anyone who might lose because their pigeon-hole was taken away who might nonetheless say at the end of all of this, well, you know, they've really done such a streamlining that we don't have to think about this anymore, we can get rid of our tax department.

And to be honest, you know, even though it may cost us a little bit more on net it probably is worth it. Or is that an idealistic hope, and in fact is this a situation where as soon as you try to close one of the nine pigeon-holes the pigeon in it is going to scream and not recognize any value to doing this.

MR. LEVIN: Addressing your second question first. There's no question that the way the world works, whenever you're going to make a change in the tax law someone is going to be hurt and someone's going to be helped, and those that are hurt are going to scream and lobby.

However, I think that in the end the businesses of American understand that the paperwork, the regulations, the tax departments, have become so complicated that they would in the end, welcome rational simplification. You wouldn't get rid of a tax department, but a corporation or a business that had 50 people in its tax compliance department, perhaps could cut it to 20. One that had 20 maybe could cut it to 10. A tremendous amount of America's resources are going to tax compliance and tax planning. Those that find a way through the tax planning maze to get a benefit, like it, but they also recognize that they're wasting tremendous resources doing it.

So I think in the end, grudgingly you would be applauded if you really brought simplification.

MR. SHACKELFORD: To the first question.

I agree wholeheartedly it's a backstop. It's a false dichotomy to say there is a corporate income tax. It's part of a whole way we tax business. And part of that's on the individual side, a part's on the corporate side. For that matter part of it's on the estate tax side.

So it's all integrated, you can't look at one piece alone. The way I look at flow-through entities, is flow-through entities is part of the individual income tax, and it's just a way we accumulate and collect business taxes, and eventually drop them onto the individual's tax return.

The C-Corporation has this bizarre entity tax matrix so that we actually tax it, but where we sort of drop it on the individual return. I think some form of integration would turn a C-Corporation into much to what we have within the flow-through entities where it's a place where we accumulate the business profits and move them to the individual return.

So I agree wholeheartedly, it's a backstop. You could not come along and drop out the taxation of corporations or C-Corporations if we have them, and not have a profound effect on the individual tax because we'd all in this room suddenly become corporations. And we can all look back to the '50s and '60s when we had professional service corporations, which were doing similar things, because being a corporation was a better tax advantage position than being taxed as sole proprietor.

MR. GENTRY: I concur with Doug that it's not a discussion of making the corporate income tax rate zero and saying we're done with it. Boy, look at all those pages of the Code that would go away. It does serve as a backstop. I think that should guide the sense of how to think about integration, and to watch integration as being either something you do at the investor level or something you do as the cash flows from the corporate sector to the investor level.

CHAIRMAN MACK: Very good. One of our panel members, Ed Lazear, is listening in on this conversation and has emailed a question, which I will attempt to pose. And this is what his email says:

Following on Senator Mack's question, much of your discussion has been about distortions in form of business and type of financing. But some business tax retards investment. Which feature of the business tax system is the primary culprit in reducing rather than distorting the nature of business investment.

Hello?

MR. LEVIN: One of the methods for simplifying corporate taxation is to eliminate the distinction between debt and equity financing. And as I said during my presentation, that's because you can frequently obtain capital from someone and slap a debt label or an equity label on it. And so there's a lot of gerrymandering that goes on. So the IRS has come out with, and Congress has come out with, hundreds of pages of rules about what's debt and what's equity. There are, as I said, six hurdles to obtaining an interest deduction listed in the Appendix to my presentation.

This creates tremendous complexity. It also creates the tendency toward over leveraging because debt is treated better for tax purposes than equity.

Now, one way of achieving simplification is to move to a single system where debt and equity are treated the same. In the end I don't think that's going to discourage capital equipment and capital investment, but it does require a number of adjustments and it results in a simplification. You wipe away the six. A simple change is to try to integrate the six into a comprehensive system rather than having six different tests.

As I say, a more complex approach to this problem is to treat debt and equity the same. Now that requires you to look at a number of issues. If you're treating debt and equity the same, what do you do with tax exempt organizations, that is pension plans and university endowment funds that hold debt instruments that will now be treated as equity, they're tax exempt and they may lose their tax exemption.

There are issues that arise, but in the end you would achieve a great deal of simplification if you grappled with those issues and did away with the two forms of financing as having two completely different systems, each with their six exceptions and six rules.

CHAIRMAN MACK: Bill.

MR. GENTRY: It appears that Professor Lazear's put forward a multiple choice question, and I'm hoping one of the possible answers is all of the above. Is it tax rates or is it, say, the depreciation rules that affect investment. And when economists think about that we think about constructing effective tax rates that depend on both.

But in some sense you could think about it, well, a big part of it must be that the corporate income tax, and so it matters what depreciation rules you have. If you have a low corporate tax rate then the effective tax rate's going to be low. But as soon as I say that I run afoul of Jim Poterba's previous question, if we make the corporate tax rate really low, then having the corporate tax as a backstop, we're making sure the income gets taxed somewhere, is a problem.

CHAIRMAN MACK: Very good. Any other questions -- excuse me, yes.

MR. SHACKELFORD: I'll be real quick. I think, if I understand the question, is just reduce the corporate rates. Now obviously how you reduce the corporate rates and keep the same amount of money where you had to broaden the base. So here's a question I would just throw out. I don't have the answer to this.

Suppose that we did away with deferral. How far could we drop the corporate rates if we did away with deferral. And if we could drop the rates 5 percentage points -- and I'm just pulling that out of the air, I don't have any evidence to suggest that. There's tremendous gain from dropping the corporate tax rate 5 percentage points. So there's an example of broaden the base, lower the rates. I think you would increase investment, and it's not a distortion issue per se.

CHAIRMAN MACK: Tell me what you mean by "do away with deferral".

MR. SHACKELFORD: The devil's always in the details. But just in some concept that if money's earned worldwide it's taxed worldwide.

MR. FRENZEL: No deferral of foreign income is what you're alluding to.

MR. SHACKELFORD: Exactly.

CHAIRMAN MACK: Very good.

MR. POTERBA: Just let me put a point on Eddie's question from the west coast. One could think about changing corporate rates, wholesale as you've just described. One could also think about investment subsidies of some sort, and I think this is a great place where it highlights issues that -- Jack, your comments in particular went after.

If one thought about two ways of trying to be more growth friendly, or more investment friendly, one of which was to put in place more investment incentives for new investment that was being done, while holding constant the current corporate rate. And the other being basically to cut the corporate rate.

Could I just hear quick reactions to the three of you from which of those you would do.

MR. LEVIN: Investment incentives are yet one more of those different rates, different treatments for things that you favor. When you favor investment incentives, is it for all capital equipment or are we going to say, no, if it's the cigarette industry or the liquor industry or the beer industry, we're not going to give the incentive but we will give it to the airline or the manufacturer. Not if it's sexually explicit. And we start with all these rules.

Now, what you're talking about is two kinds -- there may be many others. But one is the old investment tax credit. We'll give you a credit on your tax return for 5 percent or 7 percent or 10 percent of your expenditure on good equipment. And now you start defining what's good and what's sexually explicit and what is used in making movies and is that okay, and many things like that.

And then the second is faster depreciation. And we've just had that. During the recession the tax law was changed to give bonus depreciation. You could take faster, more depreciation, extra 30 percent, an extra 50 percent. Now, each of those then is accompanied by lots and lots of rules and lots and lots of regulations and more complexity.

And as I say, if you do it once it's not that complex. But when you do it 50 times, a hundred times, the Code is now filled with all these different rates and different things. I would say to you, you have to choose between incenting or disincenting conduct; sexually explicit, US production, less executive compensation, more this more that. Choose between this welter of different rates and benefits that are so complicated, and say, look, let's not influence conduct, let's just have a uniform set of rates and let the economic system run itself.

We have been, for the last 20 years, headed down the path of more and more special rates, special treatment, special credits, to incent certain kinds of conduct, and that in part is what has gotten us into this massive tax system with 10,000 changes in the system because everybody's tinkering with it all the time and thousands and thousands of pages of Code and regulations, and thus the appearance of unfairness because it is so complicated and so churned every year or two.

So my answer to you, as sort of a tax technician is, be careful when you go down that road to incenting this and disincenting that, you end up with social policy, you end up with rules and regulations, you end up with shelters to try to get the benefits.

MR. SHACKELFORD: I agree.

MR. GENTRY: I think I'll make it third.

CHAIRMAN MACK: All right. Well, again, gentlemen, thank you very much. It's been very informative, and as I say, it has indicated the tough road that we have in front of us. Thank you very much.

We're going to take a five minute break.

(At 11:23 a.m., off the record.)

(At 11:34 a.m., back on the record.)

CHAIRMAN MACK: All right. We'll go ahead and reconvene. And I've already, in essence, introduced Congressman Gibbons. But again, Sam, I'm just delighted that you're here. Again great service to our nation. Enjoyed working with you in the Congress, and again, delighted that you're here.

CONGRESSMAN GIBBONS: Thank you, Senator Mack, and to my former colleague Bill Frenzel, and to all my friends on the panel I want to say, nobody enjoyed that last presentation more than I did. You know, it vindicated all the things I've been thinking for years and finally got the nerve enough to say and the last time I said it they threw me off the conference because I told them they didn't know what the heck they were doing, and I think they vindicated all of that.

I'm here today to talk about a solution to the problem that you face. And it's not a brand new solution, it's not something that's not foreign to the rest of the world, but it is foreign to the United States of America.

CHAIRMAN MACK: Sam, if I could -- and I apologize for interrupting, but I want to put this into context.

The panel has pretty much established a process in which the public hearings that we were going to do through the end of this month were designed to understand the problems of the present Code. And then in the following meetings in June, May, June and July, we would begin to address specific issues, or specific alternatives to the present Code.

And you may have heard the comment about -- one of the gentlemen said that the staff had asked him not to come here and lay out solutions to the problem but just to lay out the problems.

But the reason we've asked Sam to present his proposal is he has spent an enormous amount of time developing these ideas over the years. And secondly, it wouldn't really be possible for Sam to travel to these other places we were going to do it. So I wanted you to kind of understand the context in which this was being presented.

CONGRESSMAN GIBBONS: I plan to be out of the United States part of the time.

I appreciate you letting me do this. And you know, I don't mind criticism on my ideas. In fact, if you go back into my writings that I did about ten years ago and put in the Congressional Record and tax hearings and everything else, I pleaded for people to come forward and start criticizing the ideas that I had put forward. So I would welcome criticism. I know that nothing is ever perfect. I know that change is constantly going on.

But what I'm trying to do is get America in step with the rest of the world, and to recognize that the system we've got now it's just broke and you can't fix it.

Let me tell you a little story. I went on the Ways and Means Committee, I was on there for 27 years, I can't really tell you how long ago that was. It goes way back. I came on as a tax reformer, all full of vim and vigor, all full of great bright ideas. After 27 years I figured there wasn't a damn thing you can do with this mess, it's beyond repair.

That's because various people have various interests and the things that are in there, and the Congress tends to heap more and more and more on it. That's the political process. And you can't go back and fix something that's got as much defect in it as this current Code has.

I have contributed to those defects. I won't accuse you or Bill Frenzel having done any of that.

CHAIRMAN MACK: Sure we have.

CONGRESSMAN GIBBONS: But I will admit that I have contributed to a lot of the defects that are in the Code. I probably have not quite made my share, but a lot of them, and they are important. And if you want to interrupt while I'm talking here, and ask a question or challenge me, it doesn't bother me a bit. I'd rather have a dialogue with you than me to try to sit here and lecture to you.

But I am proposing that we do some things that are very important. I am proposing that we abolish the personal income tax, the corporate income tax, and substitute in lieu thereof a value added tax.

And then outside of the tax code we've got to have some kind of tax burden adjustor. Because a consumption tax, which I proposed as a replacement, a flat rate consumption tax, subtraction method consumption tax, very much like the rest of the world is using. Everybody in the world uses it except us and Australia, but they use it to varying degrees. In some places they have melded it with a consumption tax with the remains of an income tax, and left their economy in complete turmoil.

I think we could do much for the American economy by just going from the income tax, from an antiquated idea into a consumption tax, because it is much easier to measure in tax consumption than it is to measure and tax income.

I do not advocate at this time the abolishment of the estate tax and all of the competitions that are in that. That's another whole time. And then I do not touch like all of the excises taxes, like the gasoline tax and the cigarette tax and the wine tax. You know, that's complicated enough in itself. I attempted that while I was in Congress and brought some order to the excise tax system but not a whole lot.

But for the income tax system, it's

busted, it can't be fixed. Maybe some technician can figure it out, but then you got to sell it to Congress and by the time they get through messing with it, and I don't mean it in any derogatory word but that's the best way to describe it, it is a mess, and it will be a mess again if you try to reform it. You just got to ditch it, get rid of it, say it's a bad idea, it's gone, but let's go on with the future. A value added consumption tax based on the simple subtraction method is the way most of the rest of the world is going to tax now, and we've got to get in step with the rest of the world or they're going to eat our lunch and all of our jobs.

I think the best way to refer to what I've tried to do is to call your attention to page 7 -- you've got it under your tab there, and if all is going well, or my testimony, you're going to see a proposed form in there for taxation.

Have you all got that?

CHAIRMAN MACK: Yes.

CONGRESSMAN GIBBONS: Well, I know the audience doesn't have all this, so I'll try to do it.

I say, A Revenue System For America's Future. And you notice I presented this on June the 6th, 1996, so it's been around a while, in a public hearing and I also put all of this in Congressional Record about a year later. So it's been around, it's been in the public domain a long time. Some people have picked it up and criticized it, some people have ignored it. But this is what I want to talk to you about.

Essentially since we've abandoned the personal income tax and we've abandoned the corporate income tax, we've got to collect a tax some way or chaos would result in the United States. So I propose that we'd adopt a subtraction method, simple value added tax that is very common in the world, and that we set one uniform rate for that tax. And the real job that Congress would have in the future is not changing the structure of the tax, but changing the rate as it needed to be changed to meet the demands. And politically I think that would be a much more responsible way of fulfilling your political responsibility than all these convoluted changes that I have participated in on the Ways and Means Committee. And nobody really understands what we do. And I must say, sometimes we don't understand what we do either.

But just changing the simple rate from say 20 percent to a 19 percent or 20 percent to 21-1/2 percent or any other thing, and people would understand, and they would hold us politically responsible for what we were doing, and which is the American system.

So this is a system that will make us more politically responsible. Our conduct could be measured better, and America would profit because there would be less tax code influence in sound economic decisions in the marketplace. This allows the marketplace to make those -- if Congress feels the urge to get into social engineering or economic engineering, it ought to do it some place other than in the tax code. The tax code should be used simply to collect the amount of revenue that the Government has to have and that's all that should be done. It should not go into tax engineering in the tax code. And that's the thesis in which I'm entering this conversation today.

It is not a thesis that I enter into lightly. I have sat through 27 years of these types of hearings and discussions that you all are having here today, and I have come to the conclusion that the current Code is unfixable. So let's talk about the future.

We've got to collect the tax someplace, so we collect it from business. But let's not kid ourselves. It's the consumer that pays the tax. The consumer is the one that pays the current tax system in a very convoluted system. And so we're coming right back to the consumer to pay this tax.

It appeared that Congress defines each business would have to file consumption tax return. And you see it's any business name, anybody, whether it's a private individual or a General Motors or a Metropolitan Life Insurance or Chase Bank or whatever it is, they'd all have to file the same tax return.

What they do during the taxing period is, they add up all their sales, everything they sold during that time and they put it on line number 1. And then they add up all their sales that they made from exports, and put it on line number 2. And then on line number 3 they subtract line number 2 from line number 1, and they get their gross receipts from sales.

Notice in there that I subtracted the gross receipts from export sales. That's in accordance with the general agreement on tariff and trade, that's in accordance with the World Trade Organization rules, that's in accordance with the rules of the United States, imposed on the rest of the world in 1947 in Washington where we met with all the bankrupt nations of the world that we had defeated in World War II, and we said we're going to do it like this. You cannot adjust a income tax at the international border, but you can adjust a consumption tax at the international border.

Now, that just happens to be the same way we treat our sales tax in the United States. Those of you who are familiar with the techniques of sales tax knows that they can be adjusted at the border. In fact they're adjusted every day at the border, because that's just the way we do it.

So far we're right on target. Then we add up all our purchases that we made in the business, and we subtract from those purchases the imports that we bought from overseas. That brings in the border adjustment at the border that we can do other than make international trade rules. We can do under the GATT rules, we can do under the same thing that we imposed upon the world in 1947 when we ran the world in effect after World War II.

Well, then you get down to make your calculations. You have to set some rate, the rate should be sufficient to meet the needs of Government, and only Congress and the President acting together can do that, set that rate. I picked out 20 percent because it seemed to be about right for the time, and you multiply that times the Line 7 above, which is the result of subtracting your purchases from your receipts.

Every business on earth keeps that basic same kind of information or they really don't know what the heck they're doing. They have to do that in order to make a profit. If they don't do that you end up in Chapter 7 or Chapter 11 of the Bankruptcy Code in the United States, or Chapter 13 or wherever it is in the Bankruptcy Code. But it's all in there, and if you don't make a profit you don't keep on doing business.

So then you remit the tax. And then the surprise comes if your purchases exceed your receipts, you get a rebate from the Federal Government. Let me repeat that. If during the same taxpaying period your purchases exceed your sales, you get a rebate from the United States Government. Now, that's got to shock a lot of people. But that's the way most of the other countries on earth treat their value added tax. I don't know of any that have a value added tax. I don't know of any that have a value added tax that don't treat their value added tax the same way.

So that would produce enough money to replace the personal income tax, the income tax on corporations, and all of the so-called FICA taxes; the Social Security tax, and the Medicare tax. That's 90 percent -- at least 90 percent of all the revenue of the United States Government. And that's what I suggest must be done in order for us to go forward and maintain our standard of living, maintain our leadership in the world, and maintain our position in the world.

Those are big changes. I do not depreciate them at all, but they can be done and they must be done. It's going to take a lot of political courage to do it. It will not take any real complicated transition rules, which have driven all of us who have ever written tax law around here, crazy about how you transition from tax bill to the current tax law. It just does away with that. You don't need to do it. On the first of some year you can just do this, put it all in operation, give businesses enough warning as to what to do, and they'll know how to work with it. And you don't need transition rules.

CHAIRMAN MACK: Sam, can I pose a question to you?

CONGRESSMAN GIBBONS: Yes, I would welcome it.

CHAIRMAN MACK: With respect to what the other countries in the world do with the value added tax.

CONGRESSMAN GIBBONS: Yes.

CHAIRMAN MACK: Most of them though also have several other taxes, don't they? I mean you're proposing -- and I think it would probably be more acceptable to the American public if your idea, with respect to the value added tax, the elimination of the other -- the corporate tax, the income tax, so forth--

CONGRESSMAN GIBBONS: Senator, you're wise. You're wise.

CHAIRMAN MACK: I knew I liked you, Sam.

But that's what you're saying.

CONGRESSMAN GIBBONS: Yes. You got to do away with the devil or you know you can't go ahead in this thing, and the devil is in the personal income tax and the corporate income tax and the FICA tax too.

CHAIRMAN MACK: I guess the point though that I want to get to is, the concern that many people raise by adding a new tax form is, it wouldn't be long before somebody would propose -- and we talked about the tinkering of the tax code. I can imagine it wouldn't be long before somebody suggested an income tax --

CONGRESSMAN GIBBONS: Well, you've got to create a political environment that says to the Congress, don't take away the thing, let it work as it should.

We in the private sector, out there in the public sector, we'll do the tinkering, we'll go ahead and work it out. We'll solve the economic problems as they come up. We know how to make a promise. Leave us alone. Don't keep coming in here year after year, day after day, hour after hour, changing these rules on us. It's driving us nuts. And that's what businesses say. That's what this panel was saying that preceded me; that nobody can make any sense out of this system we've got now.

CHAIRMAN MACK: One other question and then I'll turn to the other panel members. You mentioned burden adjustment.

CONGRESSMAN GIBBONS: Yes.

CHAIRMAN MACK: And I assume that's to get at the issue of progressivity?

CONGRESSMAN GIBBONS: No. If you look at -- this last panel touched upon this. I'll try to elaborate a little on it and maybe you ought to call some experts to find out what the burden is now. Let me tell you when you do call the experts to find out what the tax burden is now you're going to get a bunch of different answers from them, because all of them figure different ways.

I tried to figure it out. I tried to get the Joint Tax Committee, I tried to get the Congressional Budget Office, I tried to get the IRS to tell me what the tax burden was, and everybody came up with a different answer. It's because they all see the mess we've got with different glasses, and they can't really determine what is the tax burden. The economists look at it one way, tax lawyers look at it another way, tax collectors look at it another way.

If you stop and think about all of this, the consumer ultimately pays all the taxes. Low income consumers spend all their income. Upper income consumers are able to spend a part of their income, so 20 percent tax burden as a for instance, would not be the same for all of them. If you take -- and the best figures, and I've got them attached to one of my statements around here but I've had so little time really to prepare for this I didn't attach it to yours. I'm trying to get those figures updated. They're 1995 figures, showing the tax burden.

But if you go back 30 years, Senator,

prior to 1995, you'll see that the tax burden between say the lowest fifth of the country, the second lowest fifth, the middle fifth -- divide people up into five quintiles of revenue, of wealth, that there hadn't been a whole lot of change with all the tinkering we did in Congress between those five levels of wealth.

In fact, it wasn't until the earned income credit came in that the lower income people taxes actually ever really went down. That's because the FICA tax, the way it scored, it was so important of all that thing.

So you all can pick out the experts you want to listen to. Get them to tell you what the current tax burden is. I'll be surprised if you had a panel of 100, that all of them wouldn't have a different figure of that.

CHAIRMAN MACK: Sure.

CONGRESSMAN GIBBONS: But you all can figure it out. You've got to be arbitrary and pick out what the burden is. Use the best evidence you can find and then try to come up with a burden adjustor. But do not do it in the value added tax. You got to do it outside of the tax system. You don't want to do engineering in the tax system.

CHAIRMAN MACK: Gotchya.

CONGRESSMAN GIBBONS: If you'll do that people will understand this tax system. If you'll just stay out of engineering in the tax system, try to do all these social things and economic things in the tax system, but just use it as a way to collect revenue, a fair way to collect revenue, people will respect and not be suspicious of what we, as lawmakers, did, and what you all as tax technicians are doing. They'll learn to accept it and they'll believe it, and say, you know, it's fair. But you're going to have to adjust the burden or you're going to really push it off on the lower people with a flat single rate tax system that I propose. Some people operate at that level get some great benefits out of it. So you've got to have a burden adjustor.

I've got it. Believe me, Senator. I went all through this thing. This is H.R. 4050. This is the new tax code that I introduced it in Congress on September the 11th, 1996. It's only 53 pages long. But I'm sure that by the time Congress got through changing this thing it would be a little longer, and by the time history went on for a number of year it would be a little longer. But it can work.

CHAIRMAN MACK: Sam, let me just interrupt you and go to the other panel members.

CONGRESSMAN GIBBONS: That's all right.

CHAIRMAN MACK: Charles.

MR. ROSSOTTI: Thank you very much, Congressman Gibbons. It must be quite a turn of events after so many years chairing committees to now be testifying before sort of a committee.

CONGRESSMAN GIBBONS: I love being on this side.

MR. ROSSOTTI: Yes, sir. You said that you didn't think there would be transition issues, but from what I read could I just give you one example and see how you think this would play out.

CONGRESSMAN GIBBONS: Sure.

MR. ROSSOTTI: Which is, that if you say that this VAT is now effective on a certain date and all the other taxes are eliminated.

Some business that has just built, let's say, a gigantic factory in the anticipation that they were going to get a tax deduction over the period of the life of that factory, now will suddenly be paying 20 percent tax, and that --

CONGRESSMAN GIBBONS: No, they won't be paying 20 percent tax. They'll be collecting 20 percent in their product that they sell to the consumer. The consumer will be paying the tax.

MR. ROSSOTTI: But if I've got two factories, one factory was built the day before this tax went into effect, he now pays tax on 100 percent of the value added, getting no deduction for the factory. His competitor next door built the factory the next day. He gets 100 percent deduction for the cost of his factory.

CONGRESSMAN GIBBONS: If you build a factory in a day it won't be much of a factory.

MR. ROSSOTTI: Well, if it goes into effect next year.

CONGRESSMAN GIBBONS: You know, it does take time.

MR. ROSSOTTI: Yes.

CONGRESSMAN GIBBONS: I would say, Charles, that may happen. It's got to be so unusual that whoever did that invested money will not make that mistake.

But, you know, you can't go back -- having no corporate income tax beats a deduction any day. Every businessman understands that if you don't have a corporate income tax to have to screw around with, just like the last panel described, plain having no tax beats that deduction any day. Any businessman I've ever talked said, I'd much rather have no tax than have all these stored up deductions I've got.

MR. ROSSOTTI: Could I, just one other question. I notice that you indicated that you would apply the value added tax to financial institutions --

CONGRESSMAN GIBBONS: Yes.

MR. ROSSOTTI: -- and non-profits. So in other words the non-profit hospital that provides services, most of their services are labor -- most of their cost is labor and so forth, they were value added. So they would get 20 percent tax applied to their patients.

CONGRESSMAN GIBBONS: Those hospitals don't make any money that I've ever dealt with. They don't have any income.

MR. ROSSOTTI: They don't have income, but they do have value added.

CONGRESSMAN GIBBONS: Most of the hospitals around here in my own community, have never had profits.

MR. ROSSOTTI: But they do have value added because they have labor that's part of their services. So if you just took their charge for their patient, as you put it on your form, minus their outside purchases, which is just their supplies, they would have to charge 20 percent, pay 20 percent tax and charge that to the patients. Would they not?

CONGRESSMAN GIBBONS: Consumers pay all taxes. All taxes today. You know, we're not doing anything new to these people.

MR. ROSSOTTI: Sure.

CONGRESSMAN GIBBONS: We are abolishing the difference between a 501 (c) (3) business and a profit making business, and if you look at them it's hard to tell the difference between now anyway in actual product sales or anything else, yes. You know, everybody ought to be included in it, including Government.

And I can rationalize that for you and tell you why Government needs to pay taxes on its sales and its products. You wouldn't argue with that, would you?

CHAIRMAN MACK: Now, Sam, I'm not going to allow you to draw me into that argument.

CONGRESSMAN GIBBONS: All right. You better stay out of that.

CHAIRMAN MACK: All right. Bill, any questions?

MR. FRENZEL: Sam, looking at page 6 on your Steps to Tax Reform, you say you'd repeal most payroll taxes. I assume what you would not repeal would be unemployment compensation --

CONGRESSMAN GIBBONS: Correct, those kinds of things. Bill, you're very perceptive. I did not repeal unemployment compensation and all those things. They're not big items in the thing and they're horribly complicated. And I left that for somebody else to repeal.

MR. FRENZEL: With respect to the adjustor, in your 4050 did you have some kind of a super income tax on high income?

CONGRESSMAN GIBBONS: Yes, I do.

MR. FRENZEL: How did you adjust the burden tables?

CONGRESSMAN GIBBONS: Bill, it's all in here. You can pick it up and read it and you know, you're smart enough to understand it.

There has to be some burden adjustor or you're going to have a social problem, but don't do it in the value added tax. The europeans tried to do it in the value added tax. They came up with something that was so complicated they couldn't administer it. They've all told me, as I've gone around and talked to them, don't do it within the tax. If you've got to do it, do it in some other social legislation, but don't do it within the tax system, the mechanism of collecting the tax.

MR. FRENZEL: Thank you, very much. Thank you, Mr. Chairman.

CHAIRMAN MACK: Liz Ann.

MS. SONDERS: One quick question.

CONGRESSMAN GIBBONS: Yes, ma'am.

MS. SONDERS: Aside from the goals that you've listed here in the beginning, that we are under, which is fairness, simplicity, and growth, is also the desire to maintain the biases toward home ownership and charitable giving. What does a structure like that do to those goals?

CONGRESSMAN GIBBONS: Home ownership is not a business, so it's not taxed when you sell it. You've got a home and you've lived in it long enough to call it your home. You can't just move in one day and move out the next. There have got to some simple rules, like I think it's two years now under the current tax code you have to live in it two years before you can get a long term gain versus ordinary income gain. And you would have to have some rules like, lived in it one year, two years, three years, whatever it is, and then you could sell it without having to pay the value added tax. That's not a business. Only business collects the tax and pays it.

CHAIRMAN MACK: Jim.

MR. POTERBA: Congressman, thank you very much for sharing your wisdom on this plan with us.

When you've talked to other countries about the operation of their value added tax --

CONGRESSMAN GIBBONS: Yes.

MR. POTERBA: -- the export credit that in some sense you get, seems like it's a place where you would get some pressure for either evasion, with an attempt to categorize as exports, products that were actually sold at home, or the kind of issues that Mr. Levin talked about earlier. If I sell fuel to an American Airlines jet that's bound for London, was that an export sale because it was consumed over the Atlantic, or was it a domestic sale.

Do these kinds of issues surrounding what are exports and what are not, prove to be complicated administered of problems and practice?

CONGRESSMAN GIBBONS: I have tried to define it in H.R. 4050. I cannot thoroughly describe it to you now because I did this ten years ago. But that is a problem and it can be done, and I describe it all in 4050 as to how it's done.

I often use this illustration. Let me just take this bottle of water now. If you produce this in the United States and you send it overseas, when it goes overseas, when it passes the United States border and goes over to some foreigner for consumption, it carries with it the full cost to the United States Government. When it gets to that border under their tax regime, they impose their value added tax on this bottle of water. So when it goes to the consumer overseas it's got two tax systems on top of this bottle of water. It's got the US system and it's got the foreign system in there when it goes to the consumer.

But, if you produce this bottle of water almost anyplace in the world except Australia, when it gets to their international border they do what I describe in here, they shave off their value added tax. That's the problem that Congress has been struggling with the income tax as recently as this year. We went through it all the time I was there. How do you comply with that international rule that you can't adjust an income tax at the border, but you can adjust a consumption tax at the border.

So when they ship this bottle of water out of their country to America, they shave off their cost of Government, they take it off, legally, they can do it, at their border. And just like I do on Line 2 of this tax form. And then they go to the United States, and our system because the rules are so screwy, we're able to levy very little additional tax on it when it is sold to the American consumer.

So where do you go to produce water? You don't produce it in the United States and try to sell it in the international market. You produce it someplace else. The same with glasses, the same with airplanes, the same with automobiles, the same with everything else. We are exporting our jobs like we're insane because of our inability to adjust at the border the tax system that we have. Those are the rules that we imposed upon the world, and they've trapped us.

CHAIRMAN MACK: Sam, the issue that you've raised is an important one, and I assume you that as we move forward in future panel discussions the issue of border adjustability will be something that we will pursue.

CONGRESSMAN GIBBONS: And the only one that you can legally do, Senator, is a consumption tax. You cannot legally adjust an income tax at the border.

CHAIRMAN MACK: I understand that.

CONGRESSMAN GIBBONS: The WTO has held so many cases against us and Congress has been weaving and dodging trying to get around that, it has come up with a lot of crazy solutions. None of which will work, or have worked.

MR. FRENZEL: Each one is bigger and more complicated.

CONGRESSMAN GIBBONS: And more complicated and causes more confusion.

CHAIRMAN MACK: Sam, I want to thank you for your presentation this morning. I know the amount of involvement and commitment that you have had to this idea. You have just, in a sense, kind of kicked off the various alternatives that we will be looking at over these next number of months. And again, thank you so much for being part of what we're doing here today.

CONGRESSMAN GIBBONS: Well Senator, like everybody in this audience, I love my country, I want to do what is right. Believe me, 27 years of sitting up there and having my brain fried in those Ways and Means Committee hearings has brought a lot of something to me as to, we need solutions. We don't need anymore brain frying as happened there.

Bill Frenzel and I both lost our hair over it. You seem to have done real well.

CHAIRMAN MACK: Well, again Sam, thank you. Thank you.

CONGRESSMAN GIBBONS: If I can help you, let me know.

CHAIRMAN MACK: We are planning to take a little lunch break here. Is that right? And we'll start again at 12:45.

(At 12:10 p.m., off the record.)

(At 12:53 p.m., back on the record.)

(Panel Member Liz Ann Sonders not present.)

CHAIRMAN MACK: I think we'll go ahead and start. One of our members of the Tax Panel had to catch a flight. The flights back into the northeast today are apparently being disrupted by snow, wind, up I guess in the Boston/New York/Washington area. So in any event we've lost one of our members, we'll persevere.

Delighted to have you four gentlemen with us today. I'll just give a brief introduction for each.

Roger Harris is President and COO of Padgett Business Systems. Padgett has over 400 offices in the United States and Canada that provide tax accounting and financial guidance to service retail businesses. He also served on the Internal Revenue Service Advisory Council.

Todd Flemming is the Chief Executive Officer of Infrasafe, Incorporated. Prior to co-founding Infrasafe, he served as President and CEO of -- Advantor?

MR. FLEMMING: Advantor.

CHAIRMAN MACK: Advantor Corporation in Orlando.

David Hurley is the Owner and Principal of Landmark Engineering and Surveying Corporation. He is a professional surveyor with nearly 40 years of experience in the field of surveying and also civil engineering.

And Donald Bruce is an Assistant Professor in the Center for Business and Economic Research at the Department of Economics at the University of Tennessee, Knoxville. He has published numerous articles in academic journals. His paper on Tax Policy and Entrepreneurial Endurance -- and I love that phrase, entrepreneurial endurance because -- I mean it clearly takes endurance to make it. But was awarded the National Tax Association's Richard Musgrave prize for the most outstanding article published in the National Tax Journal in 2002.

And again, we're delighted that you all would take the time and participate with us today. And I understand that we will hear some experiences from you all as well as to some of the decisions that were made because you had to take into consideration the tax aspects of it.

So, Roger, if we could, why don't we go ahead and start with you.

MR. HARRIS: Thank you, Senator Mack. And I would be remiss without thanking each of you on behalf of all the small businesses and individuals for taking on this task. This is a task that was long overdue and we all look forward to your final report.

Because the only thing I would differ from this morning's panel on, is the comment that this is a dying patient. I think the patient has already died and it's time we bury it and move forward with something better.

I think it might be helpful to put some of my comments in perspective to give you a little idea about our company, and hopefully I can get this slide to go forward.

CHAIRMAN MACK: Have we got an expert here that could...

MR. HARRIS: Okay. Good. You can tell

technology is not my strong point.

To give you a perspective on my comments, I think it's important to see what our typical customer looks like, because I think it's reflective of small business as a whole. We do have offices in the US and Canada, so we do have experiences with two tax systems. We have over 100,000 customers. And the key points here is, they go from zero to 250 employees, but they average six-and-a-half and they have annual sales of $10,000 to $10 million. They are not rich by any stretch of the imagination. The average net income of our client base is $47,500.

And to go along with some of the comments that were made earlier today. Three-fourths of their customers report their business income by filing through their personal return, so they operate in one of the structures, either a sole-proprietorship, S-Corporation, LLC, or whatever.

When you compare this to the small business as a whole you see that our customer base is pretty similar to the general small business population. I think the interesting point here is that over 89 percent of the employers have fewer than 20 employees, so it's clearly a huge marketplace.

When I was asked to be here, the Committee asked me to kind of take you through the life of a small business owner and try to talk to you about the different decisions they have to make and where they interact in a positive or negative way with the tax code.

And I think one of the best ways to start with that, something someone once said to me, and I think you could substitute starting and operating in this, to say that starting a small business means doing the one thing that I love and the 99 that I hate. Unfortunately, the rest of this session is going to figure on the 99 that they hate more than the one that they love, in the hopes that we can get them back to that.

I think that the beginning of their complexity starts before they even open the doors. And again, some of these things have been talked about earlier this morning. They have to make a decision about the entity that they elect. We even had this discussion over lunch. It's a very complicated decision and yet it's an extremely important decision about how they go forward in their business career. The difficulty here is how do they even know that these choices are available to them, where do they turn. What are the factors at the moment that they have to make that decision, how those factors change as they go through their lifestyle.

The impact of this decision is great. In fact it has a direct impact on the next two areas that are mentioned here. I think we have to recognize that most small business owners got into business, and the first time they got into business their experience with the tax code up to that point was as an employee, meaning that they received a W-2, they had taxes withheld, they filed a tax return once a year.

Now suddenly they're in business, and all of that changes. And the things that they knew before don't mean anything to them today. They have to determine how to even pay themselves. That's a question we get asked time and time again. Now that I'm in business how do I pay myself. And of course the second part of that is, then how do I pay my taxes; do I withhold them, do I pay them through a business return, do I pay estimated tax. Unfortunately the answer in many of those cases is, all of the above. And it's a terribly complicated issue for someone who's never been in this place before.

The last two choices are things that sometimes are made subconsciously. They don't know that they've made these decisions, they don't know that these decisions were made for them. But their method of accounting and their tax year can be very important critical decisions. And again, these are all things that they face from Day One. And how does someone who has never been in business before, recognize and find ways to make these decisions, and shouldn't starting a business be a little simpler than this.

The next hurdle, and this could be in conjunction with their opening of the business or it could be later down the road. Is that they have become or will become an agent of the tax system and that they now will be responsible for withholding taxes for their employees and remitting those taxes to the appropriate Government agency. Again, this is something where they have always been on the other side of the table. They have always been the recipient.

And as I'm sure Mr. Rossotti can tell you, there are a lot of problems in the IRS with this part of the tax system. And while this is not necessarily what you're charged with looking at, I think you have to realize that it's a big part of what these people face. They have multi-levels of complexity they deal with. They deal with their business and trying to take the income from a gross to a net, and then at the same time they're responsible for collecting the taxes that their employees will ultimately need to file their tax return. And it comes at many levels; federal, state, local. Again, the timing of this can be monthly, it can be quarterly, it can be annually, it can be all of the above. And again, making a mistake here can be terribly expensive.

So, again, a great amount of the time that they spend, when they could be managing their business, is spent in looking at these.

There are huge additional complexities that every person that's ever owned a business recognizes. One of the big ones is recordkeeping and record retention. I think one thing that would be interesting as we hear from people in business is to talk about the records they keep because they need to keep them to run their business, versus the records they keep because they need it to file their taxes. And I would believe that you would find they keep a lot more for filing their taxes than are necessary just to manage and run their business.

And again, this is a huge -- we've outlined some different categories where recordkeeping is required. Again, a very common question is, how long, and when you get into our current tax system there may be a need to keep records for years and years and years, beyond there's any other reason for keeping those records other than that.

And then for all the talk of what we try to do in our tax system, how we try to give people incentives for doing things that we think are good and positive. When a small business is faced with trying to do that in the air of retirement planning, medical insurance, medical benefits, they find that they just walked into a very complicated area, a maze that they sometimes are taken away from because of the complexity.

While they're well intended and would love to provide these benefits, trying to pick the right plan, what is the contribution based on. What type of income, what rules are set. I mean you almost discourage the activity you wish to encourage by making these areas of the law so complex and so difficult that I think that we have to find an easier and better way to make retirement and benefits for employees available through small business.

Special concerns. And I can put these in a couple of categories. I would be remiss if I didn't jump on everybody else's comments about the AMT, alternative minimum tax. There may be nothing more frustrating to a small business owner than to do everything they know how to do to plan all year to try to minimize their taxes, only to find out at the end of the year that this second system, that they knew nothing about, has taken away all their planning activities. And I think it borders on almost being a dishonest tax, that it's there. And we either need to get rid of it or make it something that at least people understand. I'm not sure anyone can properly explain it to anyone, much less plan for it.

Depreciation and basis. Again, this is a recordkeeping nightmare where we must track and keep track of assets. And we're talking about -- this is maybe a more general area. We're talking about complexity because of timing. If a small business owner buys an asset for $50,000, there's no question that over some period of time they are entitled to deduct $50,000. The question is, how much complexity do we want to put in the tax code to adjust the timing of that deduction. Because every time we shift it from one period to the next, or for any extended period of time, you are asking that small business owner to keep the records accurate for that length of time. So I think the depreciation in basis really could be talked more about as a timing issue.

These others are things that absolutely drive tax preparers, small business owners, and individuals, crazy. Phase-in, phase-out, transition rules, income threshold, effective dates. It's almost impossible to know if you qualify for a deduction.

Simple questions like, can I deduct my medical expenses cannot be answered yes or no. Yes, but depending on your income, when you buy something, what's the effective date of it, what's the income threshold it must exceed, what's the phase-in date. There's so many of these in our current tax code that if we could just eliminate those, it would go in large measure to greatly simplifying the tax code.

Again, I think you heard that in some of your earlier -- I think even former Commissioner Goldberg mentioned that this is probably one of the most recent problems with the tax code is this introduction of all of these types of things. And they are all well intended, but they had tremendous complexity.

And then fear of making a mistake, I think, really takes a lot away from the productivity of a small business owner. I am someone who is a big sports fan, and I enjoy nothing more than watching a athlete naturally perform without thinking. I think business needs to be able to operate that way as well. They need to be able to perform naturally without thinking. Unfortunately, their actions are not able to do that. They have to stop and make decisions before they act, and sometimes, as we'll talk later, the tax code even comes in conflict with what would seem to be a normal business decision.

What is the cost of all this on small business? Obviously the amount of time that they spend on it can be spent in so many better ways, and I'm sure you will hear on this panel, that echoed. The loss of productivity that they have in terms of having to worry about something other than that one thing that they love, which is running their business.

Companies like us. Our fees are much higher because we are constantly faced with having to talk to our clients and deal with them on a complexity basis that's ever-changing. It's like you never catch up. And as soon as you think you have a handle on something, something changes and you start over. And everything you just did yesterday is no longer applicable today.

And then there's the cost of penalties and interest. Because how hard we try, mistakes are going to happen. And there's going to be intentional and unintentional errors that cause penalties and interest. So it's a huge cost, and again, that's money that could be better spent doing other things.

I think any new tax system needs to, again, as I said earlier, make decisions seem normal. There are so many opportunities where we have to make decisions first about taxes and then about our business. And I can't think of anything other than a tax system that would tell someone who's doing really well this year, that as the year draws to a close you should stop earning money. Or that if you're having a bad year, maybe you should stop paying your bills.

Or tell someone, I know you need a new vehicle, go buy a big one, a heavy one that doesn't get good gas mileage.

We need to get common sense back in the tax code and make it such that a normal business decision is always the right decision, and that you shouldn't have to call me before you do things in your business. And I could tell you story after story of where people doing things that were just perfectly natural and seemed like the right thing to do for their business, turned out to be, in the tax world, the opposite of what they thought it was.

And then last, borrowing money is difficult for any small business owner. And in an attempt to simplify the world we came up with different interest rules. And small business has a difficult time finding money, and when they do, they have a very difficult time of deciding exactly how it can be paid back and what's the deductibility of interest. We find in many instances they are forced to tie up their house, because it's the one asset that they understand the interest is deductible on, and the rules of tracing interest and things like that. There needs to be a simpler and better way for business to get the capital they so richly need.

In wrapping up I would say that what we all hope that you can do in your hearings is to come up with a simpler and fairer and more growth oriented code that will allow these people who have risked their lives to start a business, to focus not so much on their tax return, but on their business.

And to wrap up I would say, to get back to doing that one thing that they got in business to do that they love. And with that, I again thank you for your efforts in this, and look forward to your report and your questions later. Thank you.

CHAIRMAN MACK: Thank you. Just a quick comment. The comment about the sports figure acting without thinking. You know, at first people might react and say, well, everybody ought to think about what it is that they're going to do. But the point that you're making is that the sports figure is so well trained and so focused on the activity that they're engaged in, it's, in a sense, already a learned response. And wouldn't it be great if all business was able to be that agile, that they didn't have to spend the kind of time consumed with what are the alternatives that I face, what are the consequences to those alternatives. It was a good message and I appreciate that.

Todd, we'll move onto you.

MR. FLEMMING: Thank you very much. To reiterate Roger's words, I would like to thank you all very much. This is very important for us as small business owners to have somebody listen to us about what we face as far as taxes are.

First of all, you know, the time coming over here, by the way, has already been well spent. I found myself at lunch surrounded by people who know a lot more about tax than I do. And I certainly, by no means, am a tax expert.

But what I've been asked to do is just sort of give you our perspective on what it means to be a small business and a taxpayer, and sort of what we have to go through and how it impacts our business day to day.

Infrasafe, we're a relatively new company. We were founded in 2002. We have 52 employees, and in 2004, this past year, we had about $16 million in revenue. We provide electronic security products and services primarily to the Federal Government, it's about 95 percent of our business, so we do have a lot of experience dealing with the Government, which is interesting in its own right.

As far as taxes I guess the first area really to address is sort of our compliance costs. First of all we're well past the point where we can prepare our taxes ourselves, and even very small businesses need the help of someone. The tax code is entirely too complex for us to comprehend and then still keep our eyes on the complexities day to day of running a business. You know, you have a new challenge every day, and in a small business you've got to wear a lot of hats, and you've got to rely on a lot of different people to help you make good decisions about your business. So of course one of the selections you make is who is going to help you out with your taxes, and hopefully you've made a good decision there. Sometimes you have and sometimes you haven't. I think we had made a good decision.

But in 2003 we had this prepared for us. This is our 2003 tax return, and for 52 employees that seems like a lot of paper, but in addition to federal we've got all these -- it says state, state, state, state. We do a number of filings in a lot of individual states because we have employees managing projects for United States Air Force bases and military bases throughout the United States and throughout the world. So we have a fairly complex return.

I read through it in some detail a couple of times, and I can't say it's what I enjoy doing very much. It really -- in retrospect I have a business background and it really doesn't have a whole lot of bearing -- it doesn't look a lot like my management reports. Let's put it that way. And there is some necessity to keep certain records that have to be attached, and of course certain records to manage your business with on a day to day business because those numbers are often more meaningful. And there are also currently I think some discrepancies between GAAP accounting and the tax code, which force you in some cases to keep two sets of records. And for a small business, that's quite a burden.

In addition to that of course we have payroll service fees. We don't do our payroll ourselves either because, again, there's a lot of wonderful firms that have grabbed the opportunity of being able to help you with these things, so we use ADP and they help us manage our filing. But again, we incur a lot of fees that way.

And of course, as Roger alluded, we have to keep a lot of records. And I'm very fortunate we have a good staff and I've got a good Chief Operating Officer who can make sure that we're keeping the right records. But we probably spend, I would guess, anywhere from 40 to 60 man hours per week just keeping records on an ongoing basis for tax. We spend, I totaled up the numbers, between $15 and $16,000 last year to prepare the tax return, and then we spend another few thousand dollars to handle the payroll tax processing through ADP and the others.

This we discussed briefly, and I'm hoping I didn't make some of the wrong decisions when we formed the business, because I was in the lunch room and I got Jack's card here, since we have some of these people to help us out. But we initially incorporated as a C-Corp because we felt that what we were going to need to do is go raise outside capital, and most of the capital sources at that time, and currently, really want you to have two classes of stock. Have a preferred stock so they can basically help protect themselves. And typically they tend to want to invest more favorably in C-Corps as opposed to S-Corps and LLCs. You sort of pigeon-hole yourself as sort of being a ma and pa business.

And as of last week our accountants said, you know, you haven't had to raise equity, which is good. We went and did most of our financing through some local banks. And we really didn't end up -- we were able to become profitable without having to go out and raise outside equity. And they said, well, now we're looking at things, you probably ought to since you are making money, change your corporate form from a C-Corp to an S-Corp because if you were to try to sell the business or someone to offer you money for the business today, you'd have all these built-in C-Corp gains which -- and we tried to go through and understand that, and we had a very small Board and tried to help them understand that. And of course we couldn't at that point go to an LLC, it would cause a whole bunch of other consequences. So last week we elected to undertake the S-Corp form. Now Jack's telling me there's no going back. So I could be in trouble, I don't know. But he said there's probably some interesting ways that you could move around that, so maybe if you guys make things simple, hopefully we won't have to explore some of those.

There is some transition costs. We have to go back and have our business appraised now because of course there's these built-in C-Corp gains that not until after 10 years, is my understanding, that those go away. So we want to make sure we've got a good sort of foundation in time so that say, in year six the business is sold and we're asked to substantiate those built-in C-Corp gains we can, as accurately as possible, do that.

Of course all this time we're consulting our tax advisors, and talking to them about these things. And of course I went and picked up the 2005 edition of the Small Business Tax Guide, which is about 600 pages of just really fascinating reading for a small business guy. But Your Complete Guide To A Better Bottom Line is really what caught my eye, and that's why I picked it up. And lo and behold I go through there and I find a couple little areas there to quiz our accountants about because we do some business in Puerto Rico, and there's a Puerto Rico Economic Activity Credit, and I said, I don't know if that's available to us or not, but could you just find out for us, and few other things. So I got a little bit of education there.

That goes back. Roger mentioned a couple times, there's a lot of decisions that from a business standpoint don't make a whole heck of a lot of sense, but because the money's out there, from a tax standpoint you tend to want to do those things because you do tend to want to do what's best for the bottom line in your business. And some of it doesn't make a lot of sense, but the way the tax code is put together you do that.

There are some beneficial provisions. I will say that. We do audit our finances because we feel it's important, so we have an audited financial done which is somewhat unique for a business our size, and we looked at our capital expenditures and we spent $102,700, which this year's capital expenditure that you can expense is $102,000. I didn't make that decision, but it sort of ended up that way.

And then I think there's some opportunity to make some changes that can lead us to be more productive and maybe make better or simpler choices as far as our entity structure is concerned.

Efficiency of scale issues. We paid far more as a small business than a large business per employee for tax preparation cost. There's no doubt about it. We probably pay, from the numbers I've seen, three to five times as much as a large business in tax preparation costs. So it's higher to do that. Our cost of capital is already high, because if somebody goes to either lend us money or provide us equity, small business inherently has more risk. That's how they basically determine your cost to capital, and then that's going to be adjusted by tax. And of course you heard the other panel talk about the disparity between debt and equity and the differences in the tax treatment, and that also results in difference in the cost of capital. So equity capital becomes substantially higher because you do have to weigh in the taxes on the return.

Exit and succession are difficult. If you guys want to talk about estate taxes. My father passed away in 2003. I'm managing that estate. It's a nightmare and it's very complex. And if you can, if nothing else, do something with the estate tax as far as the tax code itself. I think he put together -- he thought he put together a very good plan, but he never knew when he was going to die. So that makes it difficult.

And then I think it also makes -- you know, if you do exit the business I'm not sure you make the best decisions about reinvesting your money back into the economy and growing the economy. And I think there's a lot of evidence to probably support that.

From a small business perspective what I'd like to see, and I belong to a small CEO group, there's about 10 or 12 of us over in Orlando, and we'd like to see just a certain, clear Code. We'd really just like to know what to expect so we can plan for our business. Our business is on a day to day or month to month or a year to year basis, so reasonably uncertain to begin with, and we'd really like to take this element of uncertainty out of the business.

Of course the AMT is just basically, it's two tax systems, and this has AMT calculations in it. And I couldn't begin to tell you how that all works. You know I think it's really time for us as a country to eliminate the tax on capital. I mean we tax capital, we tax employment, we tax sales. And we may want to weight that tax and either eliminate or further reduce the tax on the returns of capital and savings and capital investment. I think that would stimulate growth of small businesses.

Please, keep the tax cuts that you gave us, if nothing else. Don't take those away. I walk out of here I'd be lynched by other small businesses if I said anything like that. And in retrospect, just simpler and flatter if you can. You know, either some type of a flat tax or a national sales tax. Unfortunately I'm high skeptical of things like a value added tax because it gives us the opportunity to hide things, and we need that transparency and we need to be able to see what's being taxed and what isn't. And europeans have been very good about burying their taxes through various stages of the production process. And for us I don't think that's a good idea.

So those are my thoughts. I think that's where I end.

CHAIRMAN MACK: Todd, thank you very much. Maybe just a couple of thoughts that you triggered.

With respect to keep the tax cuts that have been passed in place. We have been instructed, as a result of our Executive Order, that we work from a budget base, if you will, that assumes that the tax cuts of the President's first term are permanent. So we will not get engaged in saying that we think that one tax cut ought to become permanent and another one shouldn't. So we will start our deliberations by assuming that those tax cuts are permanent.

The second issue, just again, for clarification to others that might be listening. Is that our directive basically takes the inheritance tax issue off the table. We are focusing on income tax. So that's an issue that we won't get into.

But thank you for mentioning both of those and giving me a chance to clarify that.

MR. FLEMMING: Okay.

CHAIRMAN MACK: David.

MR. HURLEY: First of all I'd like to thank you guys for coming here. I thank you, Senator, for spending your time in this worthy thing. The small businessman. I'm really glad that President Bush has taken on this issue. It's not a simple issue. It's never been an easy issue, and most people have found it real easy to duck it. So I'm real pleased with that.

Now, I'm going to talk about the tax code burden on small business. I am a small businessman. We have -- started this business 20 years ago, 21 years ago. We have 80 employees. We do civil engineering and land surveying. Last year our revenues were up about $5 million.

Now, labor costs represents 60 percent of our total revenues, so we don't have manufacturing costs and things of that nature, we have people costs. And people costs add up, of course, through taxes and payroll taxes.

And NFIB, National Federation of Independent Business, did a study in 2001 about coping with business regulations. The survey of small business members, the greatest complexity and difficulty they ran into, and as you know NFIB has 600,000 members in the United States, so they had a pretty good broad spectrum, and I don't think you'll find anything here that disagrees with what the first two panelists said. I was waiting for them to say something I could disagree with but neither one of them did. So whatever they said, I amen to it and we'll keep on going.

The survey results said the tax rules create the greatest difficulty for responding to small business. These people looked at all the different things that they touched, and all of those things are important. OSHA talks to us about health and safety, employment issues. We get to deal with those.

Environmental issues we can't avoid, occupational issues, and all those other things.

But tax, and 36 percent -- that was the biggest piece of the pie, was the tax issues. I'm very aware of it. When I moved here from Indiana, almost 30 years ago, I was in a partnership us there and I sold my share of the partnership and was all happy because the amount of money I got took one check and moved to Florida and thought I was fat and happy. And the next year IRS said I wasn't as fat and happy as I thought I was. And that was the beginning of my learning to do tax planning. And I spent a goodly amount of my life since that time trying to figure out how to avoid taxes. I know I can't evade them, but I think it's my duty to try to avoid them. Sometimes with more success than others.

Where you have the most problematic tax regulations, in an NFIB study coping with regulations in 2001, the survey of small business members was about the greatest compliance difficulty. There were five categories that they supplied, the questionnaire, A, B, C, D, or E, and then there was a place to write-in. And they found that the write-in got the most votes. And thought that was interesting because they talked about depreciation, capital gains. Those are difficult things that we have to take care. And then sales and use tax was the top thing of the first five, and inventory and independent contractor stuff.

But then we went into the issues that people wrote in, which by far out stepped the others. And we had withholding, the reporting issues, income tax -- by the way, the reporting issues, and I don't know how far your Committee goes on this, but I provide duplicate information to the governments and the state governments and sometimes more than one agency in the Federal Government and more than one agency in the state government.

So if there would be some way, and I know they've had Paperwork Reduction Act, and I've heard the name but I haven't seen much result. Like when we file our UCT-6 with the state, we're going to give the Federal Government the same information at the end of the year. If there was there way we could just copy that thing and send it over, sign it again, or let the state forward it. It doesn't bother me, but I think there's an awful lot of work that we're doing or paying someone else to do that duplicative.

And one of the things in a business, it's one of the things I'm continually working on in my business, is trying to keep people from duplicating effort, because I pay for that duplicative effort. It slows down production and it costs money. And so if we could at least be efficient with the way they take the paper from us I think that would be a great help. And you'll see that all the businesses throughout the United States pretty much agree with me.

CHAIRMAN MACK: Excuse me for a second. The dividing line between --

MR. HURLEY: The ones on the bottom, the ones that have parentheses around them, withholding on down, those were write-ins.

CHAIRMAN MACK: Okay.

MR. HURLEY: From withholding on down, those are write-ins. And I think the interesting thing to me about the write-ins, that's passion coming out. You know, when you check off a checkbox, yeah, probably that one. But when, I'm going to write this in so they know. And to me that has a whole lot more of the story if they'd just left the whole thing blank and said, write it in for us, it might have been even a better survey.

CHAIRMAN MACK: Gotchya.

MR. HURLEY: The paperwork burden and recordkeeping. NFIB study again in 2003 asked business owners about their paperwork and recordkeeping burden. The survey of small business members, they asked who prepared their taxes and who kept the records. The first slide will show you that it shows a significant number of small businesses use an outside person to compile records, and the second slide talks about the per hour costs, which is I believe Mr. Harris brought some information on.

Who does your tax records. Well, if you think anybody in there is doing it themselves, it's a very small amount and they're probably making big mistakes when they do it because it's very complex.

I have another small corporation that I'll get to later, that should be the simplest thing in the world, I should be able to do it on one eight-and-a-half by eleven piece of paper, but that's not the way it works. The tax code, the complexities of this -- and we're not talking about people that are just walking out of a door and suddenly have the light shine in their eyes. We're talking about people who worked their way through to starting a business. Many times they're in a profession and have accomplished some things but they cannot get to that spot where they do their own taxes because it's outrageous.

The per hour costs for business recordkeeping by record type. You see the tax there on the end is the highest number. That's because most of the time the owner is involved in it, and partly out of what Roger was talking about, fear, if it's messed up I know who goes to jail and I don't want anything to do with that. I can drive by a jail on the street, but I don't want to look out. It's a street from the inside.

And the tax and financial. I'm not sure if there's a lot of difference between tax and financial because they're so intertwined. So if you can see what the cost is to a small businessman, because he's working on the tax information when he could be driving his business, making more things happen, paying attention to the business part of the business. I think that that's one of the things that a lot of people who start that small business, that Roger was alluding to, they don't understand that the business of the business is what they have to do. It's not that 1 percent thing that they like, it's that 99 percent thing.

Can I use that thing again? Give you credit.

But we have tax driven business decisions. I guarantee you that I make more decisions in my business based on tax issues than based on anything else, any other single factor. Capital acquisitions, expenditures. We look at buy versus lease. Now, last year we had the Section 179 expensing, which is a wonderful thing, because I needed some new equipment and I took advantage of that. Unfortunately was set to expire in 2006, now they extend it to 2008. Well, there's some unintended consequences in that, which means that between now and through 2008 I'm going to plan on replacing as much of my equipment as I can, and getting it up current and modern. But guess what I'm going to buy in 2009. A cup of water. That means that everybody that's selling equipment is going to be in a depression when 2009 hits.

I've heard a recession is when your neighbor's out of work, and a depression is when you're out of work. So the vendors are going to have some depression come 2009. And it hurts when you're in business because these rules just keep changing. You know, the volatility that we face day to day, what's happening, the rules keep changing, we have uncertainty for buyers or sellers. I mean I buy things and I sell things, and that's how business works.

And if I knew it was going to be the same way in three years or four years or five years, I could do some long term planning. But I have a five year plan, but I'm really only looking two years, and I hope that things don't change before the end of that, but I really have to make some big jumps.

It really makes planning difficult. Planning is something that's very important in business. A big vehicle example I think is one they call arbitrary, it's only subjective. I don't know if there's argument between what's subjective and what's arbitrary.

The 6,000 pound SUV you can write off. And I have almost 20 pick-up trucks in my company and they're all half ton pick-up trucks and none of them weigh 6,000 pounds. And guess what, every one of them is out there working. They have a sign on the side, they have dirt on 'em, dirt in 'em, and a crew in there working, but I couldn't write them off. But if I had gotten me a HUMMER to drive over here today, I could have written it off. And I think there needs to be some sense to that.

Compliance costs related taxes for small businesses are significantly higher --

CHAIRMAN MACK: Let me just ask you to pause for a second.

MR. HURLEY: Okay.

CHAIRMAN MACK: Because Jim is going to have to catch a flight and leave early, and I think he has a question.

MR. POTERBA: I think we have enough time for him to finish.

CHAIRMAN MACK: Okay.

MR. HURLEY: Well, the compliance costs are really really big for small business. The Federal tax compliance is just one piece of the layer. We've got state and local, everybody else lining up. I have an S-Corp, as I said, I have about $20,000 in revenue. I paid $630 for the taxes to be done, and that's about 3 percent. That seems pretty high to me just for the ability for taxes.

I think in conclusion, the important role of small business in the economy has to be a recognized fact that the number of jobs are created by small business. That's where the jobs are being created. The high compliance costs. We're tying the money up one place or another, there's only a certain amount of money to go around. I love to tell people that I don't pay any taxes in my business because my business doesn't make any money. I just hired somebody else for something. The money come in and I give it to the Government.

So the people that are buying the end product are paying the taxes. So that's where it starts. So I don't want you to forget that important role of small business, and remember that we are the unpaid servant of all those governments, because the Government doesn't collect taxes from people, businesses have to collect the taxes and route them to the government. So we're an unpaid employee of the Federal, state, and local governments.

And I really thank you for coming here, and I hope that we can see this go through, and I hope you're very successful in your travels and bring some good stuff to the table.

CHAIRMAN MACK: Okay. Thank you very much. I appreciate that.

Again, we'll pause for just a second.

Jim, I want to give you an opportunity. You've got a question you wanted to raise.

MR. POTERBA: Yes. Thank you all for coming, and I just want to apologize to Don, whose comments I'm unfortunately going to miss. But we'll catch up offline on your handouts.

I think one of the very interesting things that emerges, at least for me, from listening to all three of your comments, is that some of the things that we take for granted about the corporate income tax may be based on the experience of large firms, that they might be somewhat different than the experience that small firms face. And I think that highlighting that and trying to draw that out is one thing that's very useful in the kind of comments you've given us.

Roger, you said something in particular that I think stood in contrast to what we heard earlier today, and I just wanted to follow up.

Most of the discussions about the corporate income tax recognize that debt is deductible, equity is not, and therefore think of us as having a bias toward debt, and consequently more leverage in the system as a result of the current corporate tax rules than we would have had otherwise.

Yet, your discussion about the borrowing opportunities for a small business suggests that in fact it's very difficult to get debt onto the books, and that we see people using mortgage interest deduction in some sense as a device to finance the accumulation of business equity in some sense for the small business side.

I was hoping that maybe you, or any of you could sort of elaborate on the challenges, whether they are regulatory, induced by the tax system and the tax code, or whether this is a financial sector where you just can't borrow because of small business, that makes it very different as we think about the debt/equity choice for the small business versus the large business.

MR. HARRIS: I'll take the first stab at that, and I think they're bogus. And probably each of these gentlemen have started a business can speak to this as well. But when you first start your business the ability to raise capital is extremely difficult. I mean I can tell you hundreds of stories where people have started their business off of credit card debt, you know, where they've had to go and maximize credit cards, because the financial institutions are just not ready to lend money to the small business owner on a risk, as they see it.

Now, what is fortunate for them is that some day they pass a line and they wake up and the next day they became great credit risks and banks are now calling on them, but unfortunately that doesn't work for every business.

What further complicates it in the tax code is there ability to borrow that money, how it's paid back, what the collateral is, what the purpose of the use of that money was, as to whether or not they can deduct that interest at all on their individual return, through their business, and it has great impact on the taxes it may or may not save.

So I think there's two levels. But I will say this: Small business will borrow money from wherever they can first, and worry about the tax consequences in that case, second.

MR. FLEMMING: Typically what a bank is going to do is, a small business, they're going to look at it and they're going to say, well, we want a personal guarantee from you, which, my understanding is the reason a corporation was set up to allow people to take risk and separate their personal assets somewhat, at least that's the original idea. And so if you're willing to put forth a personal guarantee or pledge some other assets some way, a bank is more likely to give you some money.

Now, that in contrast to bringing in equity partners, especially some professional private equity guys who, frankly, have most small business owners pretty much out-foxed, if they'll lend to them at all. And they're basically looking for very very high rates of return. So if you can get debt it's a lot cheaper for a business because you don't have to give up -- you know, initially it's 20 percent of your business, then it's most all of your business, especially if you make it big time.

So if you're able to raise sufficient debt it is quite a bit cheaper, plus then again you throw on top of that the tax implications, it's cheaper yet still.

MR. HURLEY: I don't want to simply echo what they said, but it is very difficult when you're beginning, because it is you that they want when you're borrowing money at the beginning, and the banks show up when you don't need to borrow money, that's when they come and talk to you. Until then they don't want anything to do with you.

MR. FLEMMING: That's when you raise your line.

MR. HURLEY: That's when you raise your line, right.

But I know when I was borrowing money when I started my business, I asked if they wanted a pint of blood and my first born, and they said, no, your first born eats and hasn't finished college yet.

But it is difficult to raise that capital as a small business. And I think the larger business, you know, if you go to General Motors and General

Motors wants to borrow $1 billion on what their revenues are this year, that's probably not an outrageous thing for them. If I wanted to borrow the same percentage of my revenues this year, they would look on that as a serious risk and you'd see the bankers high-tailing it down the hall, or throwing rocks at me to keep me away, because they would not be involved in that at all. It's all about risk, and unfortunately in small businesses many of them do fail. But I think a lot of the failures are because of what Roger said, the complexity. When you begin it up, it is tough.

I had a guy that just left me recently to start a little business on his own and he's all excited and he's worked for me for almost 20 years, a little over 20 years actually, and I stared asking him about, you're aware of the self-employment tax. He said, well, it's Social Security. I said, well, you're paying both sides now. And I started mentioning some of the other things and he had this quizzical look on his face and I really wish him well, but he's going to be -- I'm sure he knows more now -- or he'll know more in a couple months than he knew a month ago. I'm sure of that.

MR. POTERBA: Thank you all very much, and thank you, Mr. Chairman, for twisting our schedule to accommodate our frenzy of air traffic controllers.

CHAIRMAN MACK: Absolutely.

(Panel Member James Poterba exited the meeting.)

CHAIRMAN MACK: Donald, why don't we go ahead with your presentation.

MR. BRUCE: Well, let me add my thanks to you, Senator, and to the panel for this opportunity to come before you and represent what I think is a growing and exciting area of economics literature.

My name is Don Bruce. I'm at the University of Tennessee. And this is why I do what I do. The importance of the research for me is to be policy relevant, so the opportunity is very much appreciated.

So let me start by reiterating some points that have come out today about just the general importance of small businesses to the economy, and these are very well known facts published by the SBA. I want to highlight the last two on the slide.

Small businesses or according to the SBA, those with less than 500 employees, generate 60 to 80 percent of new jobs on average and virtually all job growth during a recessionary periods. That's an important point to make very early in this.

They also create more than half of non-farm private gross domestic product. So clearly small businesses are extremely vital to the American economy.

CHAIRMAN MACK: And just again, I want to clarify. First that the 99.7 percent of all employers employ 500 employees or less. Is that what that --

MR. BRUCE: That's absolutely correct, yes.

So how are these small businesses taxed. I think we've learned a lot about this today, so I won't belabor these points. The key I will make here is that most small businesses, the vast majority of all businesses, are taxed under the individual income tax. Fully 16 percent of individual income tax returns include a Schedule C with sole proprietorship income, and 5 percent have income on a Schedule E from a partnership or an S-Corporation. So up to 80 percent and even higher by other measures of all businesses pay their tax through the individual income tax. And the point that I'll reiterate is that individual income tax reform is in fact small business tax reform. So you have to keep that in mind.

CHAIRMAN MACK: If you will indulge me.

Every now and then my mind wanders. I don't know whether that happens to you all or not, and something you said triggered me off.

Would you mind running through that again, the sole proprietors?

MR. BRUCE: Most small businesses pay their tax through the individual income tax, not through the corporate income tax. Virtually all sole proprietors, partnerships, and S-Corporations. So individual income tax reform is indeed small business tax reform.

CHAIRMAN MACK: Thank you.

MR. BRUCE: This chart shows some figures from IRS data of the number of Schedule C income tax returns and the individual income tax every five years since 1980, with estimates for the year 2005. The blue bar is simply the number in millions of those Schedule Cs attached to 1040s and 1040-EZs and so on.

The red line shows the percentage of all income tax returns that include a Schedule C, and you see that number up to about 16 percent, as I mentioned on the previous slide. So one wonders, when looking at these trends, if there has been an impact of tax cuts on these trends. And that's the purpose of the research that I'll present to you today.

Going beyond issues of complexity, which are very important, into issues more of in terms of the raw burden, in terms of a tax rate. Have tax rates influenced this trend?

Well, the overarching question here in the first place is, should folks like these gentlemen on my right be tax favored. They seem like perfectly good folks to me, but the question still remains, do they deserve preferential tax treatment, not just neutral tax treatment, but some sort of preferential tax treatment. I think the answer to that question really follows from answers to the questions on the slide. Do these small businesses create positive spill-over benefits in terms of job growth, contributions to economic growth and vitality and so on. We have some evidence that, yes, in fact they do.

Do liquidity constraints result in too little entrepreneurial activity? In other words, scarce capital resources, financial resources. And there's very strong evidence that capital constraints are particularly binding for potential entrepreneurs.

Does the inherent riskiness in entrepreneurship detes entrepreneurial activity? Is the tax code relatively more complex for entrepreneurs? I think we've heard firsthand that, yes, in fact it is. And we have some good evidence on these things. But even if we believe these entrepreneurs deserve preferential tax treatment or tax favored status, the answer really hinges on the fundamental question, do taxes distort small business activity? Do they matter? That's why I'm here.

New taxes matter. As an economist I'm obliged to at least give you a very small dose of theory with two hands fully employed. So if you'll allow me this indulgence. On one hand if we tax entrepreneurial returns we reduce the value of going into business and we potentially reduce entrepreneurial activity. At the same time, on the proverbial other hand, a higher tax rate with a loss offset compresses the distribution of after tax returns. In other words, the more I make the more tax I pay so my after tax distribution's a lot lower. The more I lose the less tax I pay. I can use my loss to offset other sources of income. So it's an ambiguous combination. We're not quite sure whether a tax is going to incentivize entrepreneurial activity or not, in theory.

You add incentives to evade or avoid taxes, which are very clear and obvious, and you just contribute to the overall theoretical ambiguity of the tax. And so this is inherently an empirical question. In other words we need to go to the data and look for the actual evidence, and that's what I do.

One more preliminary. Who are we talking about? What makes an entrepreneur. And to be sure, entrepreneurial spirit is simply unmeasurable. Everyone of us has some element of entrepreneurial spirit. And there's no agreement on which measure is best. So we in the literature have to resort to measurable proxies, and most of the research has simply looked at survey responses to the question, are you self employed. And I've done some work myself where I used just that question.

The work that I'll talk about today, which I think is better, looks at tax returns to actually see what you have in terms of income. Do you have entrepreneurial income. On a Schedule C sole proprietorship, Schedule E partnership, or S-Corporation, or going even further, into rent and royalty income, which might require some entrepreneurial activity.

So what I'm going to talk about now is a brand new study that was released just last week by the SBA, Small Business Administration, by myself and my colleague, Tami Gurley, where we asked a very simple question. Do tax rates affect small business formation and survival.

Now, when we look at this question it's a very difficult question, and we look at it with a very long file of individual tax returns, and we compare tax rates that individuals would face if they chose to enter into an entrepreneurial activity, with the tax rate they would face if they decided to simply take a wage job. And we look at the differences and the levels of those tax rates, and we see if those tax rates impacts decisions to start a new small business or to stay in that small business once I'm there. So that's the research framework.

And our results are quite clear and robust, and they suggest that if I cut the relative tax rate that I would face in the entrepreneurial choice, then I'm going to see more entrepreneurial activity. If I hold that tax in wage employment constant, if you will, and I reduce the tax rates that people would face in entrepreneurship, I'm going to see more entrepreneurial activity. It's fairly simple economics, actually. Vice versa. If I hold that entrepreneurial tax rate constant, and I reduce the tax rates that people would face on wage jobs, I'm going to see less entrepreneurial activity.

This suggests, if you look at the time period of the 1980s in which tax advantages for small businesses were gradually taken away, especially on the payroll tax side. This suggests that that leveling of the playing field might have resulted in less entrepreneurial entry and lower rates of survival than we might otherwise have seen during that period of remarkable economic growth.

It turns out that the actual tax rates themselves, the absolute tax rates matter as well. In other words, to reiterate the last slide. If I cut the tax rate that you'd face as an entrepreneur, you're more likely to become an entrepreneur. If I cut the tax rate that you would face in a wage job, you're less likely to become an entrepreneur, holding all else constant.

So the first tax effect more than offsets the second tax effect. So what this means is I can cut everybody's tax rates across the board, and I can generate higher rates of entrepreneur entry and survival. Simply, I'm comparing the results that we get on those tax rates. In other words, across the board tax cuts, blind to income, by our results would increase entrepreneurial startup and survival. And as mentioned these results are highly robust.

One of the things I like to try to do after I find a result such as this, is to try to make it go away. And no matter what we do we are very confident that this result would hold. And I'm comforted by that fact that this result really echos the growing consensus in this literature. And I've put two bodies of research up on the slide here.

The recent findings by economists who really know what they're doing with this, you know, have looked at tax return data and analyzed these questions have found very similar findings. And let me just highlight those two. The first set of three papers by Bob Carroll, Doug Holte-Eakin, Mark Rider and Harvey Rosen, suggests that if you increase marginal tax rates you will reduce three things; overall entrepreneurial firm growth, in terms of receipts; you'll reduce their investment in expenditures and capital, and you'll reduce their hiring of labor. If you cut tax rates you'll incentivize all three of those things.

And in related work by Bill Gentry, who was here this morning, and his co-author Glen Hubbard, they determined that self employment entry is highly responsive to the degree of progresscivity in the tax code. In other words, the probability of entry increases as the tax rates become less progressive. And their theory there is that the higher tax rates on higher incomes is a success tax on entrepreneurial ventures. Obviously a disincentive.

Again, thank you for this opportunity. I look forward to any questions today, and going forward.

CHAIRMAN MACK: I thank you, again, thank the entire panel.

Don, it seems like you answered your question there, is that should there be a tax break, if you will, for entrepreneurship. And I think really what you've concluded is that by lowering all rates you can enhance entrepreneurship without favoring one or the other.

Is that the wrong conclusion?

MR. BRUCE: No. I think that's a fair restatement.

CHAIRMAN MACK: Okay. Charles, you want to --

MR. ROSSOTTI: Sure. Well, first of all let me just thank all of you for your testimony. And Todd, I just want to point out that I started, you know, in 1970 with zero, starting in small business, and then for 28 years, and now I'm in the private equity business trying to find itself. It's really not that bad. So you can get some VCs that don't kill your business.

CHAIRMAN MACK: Is there anything you wanted to talk to him about?

MR. ROSSOTTI: Having been on both sides of it, just like I was both sides paying the taxes and collecting the taxes, it's an interesting... but, Roger, I just wanted to go back to some other things, and then I some other questions.

Did you say your business, you have 100,000 customers, that pretty much revenues of your customers are between like zero to $10 million, and that's pretty much the range of --

MR. HARRIS: Yes. They average about a half a million.

MR. ROSSOTTI: Half a million. And do you typically do both the accounting for those clients, you know, that they need for their normal books and records if they're managing the business and whatever reporting they have to do for lenders, as well as the tax reporting?

MR. HARRIS: Yes. We've become for these businesses really their accounting department, if you will. We handle everything from accounting to payroll to sales tax, all those things. Ultimately leading into the income tax return at the end of the year, be it their individual, business, or both.

MR. ROSSOTTI: How many of them do you get audited statements, do you think?

MR. HARRIS: Very few if any. It would be extremely rare that need an audited statement. Again, their size, their borrowing capabilities, just typically don't require that.

MR. ROSSOTTI: They don't require it. Okay.

And Todd, you did say you had an audited statement.

MR. FLEMMING: Yes.

MR. ROSSOTTI: Why did you get that?

MR. FLEMMING: Well, we felt that long term it would increase the value of our business more than it cost us to conduct the audit.

MR. ROSSOTTI: But your revenues are 16 million, right?

MR. FLEMMING: That's correct.

MR. ROSSOTTI: And so that would be pretty much larger.

And what about you, Dave, do you have an audited statement?

MR. HURLEY: Yes. We have a reviewed statement.

MR. ROSSOTTI: Reviewed statement.

MR. HURLEY: We don't see spending the percentage it would take to do a full audit.

MR. ROSSOTTI: It's reviewed statement. Okay. I was just curious.

MR. HURLEY: And one of my friends disagrees with me, but he had someone to work for him that stole more than the audit would cost.

(Simultaneous talking)

MR. ROSSOTTI: And just one quick follow up. Why did this little S-Corp cost so much for you? What was the problem that caused --

MR. HURLEY: Just to do all the tax work on, they did lose money. It was a loss this year. And to make sure you get all those losses, is part of what they were talking about. To lose some there it helps out on what you're paying in taxes on the other. Now, I've got a capital loss carry-forward and I'm trying to find a capital gain to offset it with.

MR. ROSSOTTI: Let's hope you find something to sell at a good gain.

And Professor Bruce, just on this last point you said it very interesting that your conclusion on the absolute tax breaks. I see in your statement that you quantify that to some extent? Maybe you could send that to us. But just give us a sense of, you know, I don't know how you would frame it, but quantitatively speaking what is the magnitude, relative magnitude of the impact? Did you do a correlation with rates, or how did it work?

MR. BRUCE: Well, let me just tell you some stories about some numbers. If I were to pass on across the board 1 percentage point marginal rate cut, blind income source, just for everyone, my results suggest that we would expect to see an increased probability of entrepreneurial entry among single taxpayers of 50 percent. Among married taxpayers 33 percent.

Now, I have to be very clear to quickly point out that we're talking about a low base here. The average probability of entry for single filers is only 1.6 percent.

MR. ROSSOTTI: Okay. So it would go from 1.6 to 2.4, or something like that.

MR. BRUCE: Something like that.

MR. ROSSOTTI: Okay.

MR. BRUCE: For married filers it's about 4.2 percent.

MR. ROSSOTTI: But since the rate did go down by, what was it, from about third the top rate went down from 30 to 35. That would simply imply a pretty substantial increase in the probability of -- is that right?

MR. BRUCE: And the question remains. Okay. So if we have a 4 percentage point cut, if you extrapolate that's pretty far beyond the data, first of all, so there are some cautions about doing that.

MR. ROSSOTTI: Yes. Right.

MR. BRUCE: One wonders how much of an increase in that probability of entry does it take to actually make me take the jump. All right. I can have a probability of entry on average of 1.6 percent, or 4.2 as a married filer. When do I enter, when my probability gets to 50 percent? I don't know. It's individual specific, obviously.

On the endurance side, to continue to use that word. The same tax cut, 1 percentage point, would increase the spell length, or the number of years, you spend in the entrepreneurial venture. About a third for single filers, and almost half for married filers. So these are pretty large impacts.

MR. ROSSOTTI: Just one more for Dave.

In the NFIB study you raised. Looking at

-- I don't have it here -- but the particular areas that were the greatest sources of annoyance. I notice the sales and use taxes were the biggest. There it is. Thank you. The sales and use taxes were the biggest, so I was kind of surprised at. Followed by withholding.

Could you just elaborate on two of those, what in particular -- I mean neither of those directly has to do with the income tax, actually. And I was just interested, why do you think those two came out so high?

MR. HURLEY: I believe what happens here, they gave them five distractors to choose from; A. B,. C, D, or E. And those first five were the things that they could choose from. So some people just went, okay, well that's worse than any of the others. Whereas the things that were written in were the things that people said, no, you missed me completely, here's what it is.

MR. ROSSOTTI: But still, an awful lot of people among the top five, sales and use --

MR. HURLEY: The small corporation does the sales tax, and it's a pain in the neck.

MR. FLEMMING: If you do business in more than one state too, it gets very difficult.

MR. HURLEY: Because in Florida you have to know what county you're talking about, because a lot of them have local option sales tax, and some have a half percent up to 1, and some don't have it at all. So the recordkeeping for it is a little more onerous than it really should be.

MR. ROSSOTTI: It's too bad Governor Bush is not here.

MR. HURLEY: Actually, we'll see him Thursday.

MR. ROSSOTTI: But on the withholding. What about that one?

MR. HURLEY: I think on the small businesses -- remember NFIB, probably the 95 percent of the people probably have 5 or fewer employees.

MR. ROSSOTTI: Yes, which they do.

MR. HURLEY: You know, with 80 employees we have QuickBooks Entrepreneurial Edition, which I'm not doing any ads for, but it can run around and do all these things and we get online. It automatically downloads what the new tax rates are, so it's kind of transparent to us when it changes.

But for mom and pop, they get their little book out for Schedule E and see, okay, it's between here and here, and it means it's this much plus a percentage of that over there, an they have to keep track of all that stuff. And if you're doing that by hand it becomes quite an onerous task.

And that's who we're talking about, the small business that's really got to get through there. I mean all of us -- I started off as a very small business and we were doing it that way at the beginning. I'll tell you, it's a tough thing. I wrote a few little programs for some of the early -- things we had over 20 years ago that would do that kind of work, and made it somewhat easier. But if you're a beginner, it's a real hard thing.

MR. ROSSOTTI: Thank you.

MR. HURLEY: You're welcome, sir.

CHAIRMAN MACK: Bill.

MR. FRENZEL: I want to thank the entire panel for splendid testimony. You've been very helpful to us I think.

I would ask Dr. Bruce. If we want some more entrepreneurship we got to cut everybody's tax rate? Not just the entrepreneurs.

MR. BRUCE: The results suggest that a targeted tax rate reduction would do the job, as well as an across the board tax rate reduction. My response to that would be, why try to target a tax break and create potential equity problems, and maybe complexity problems, when you can accomplish the very same thing, perhaps at a smaller level, with a tax rate cut that accrues to everyone.

MR. FRENZEL: If we cut the taxes down to nothing why our revenues will probably be infinity.

CHAIRMAN MACK: He's debating the laughter that occurred here.

MR. FRENZEL: Everything comes with a cost. As these gentlemen have suggested, they have all these terribly onerous reporting requirements and choices to make, when there sometimes isn't the right information to make the choice.

But those things that you're complaining about did not come into the tax code by accident. NFIB or somebody else wanted them. And so next year they want it some more and some different ones. They do get billed up. I am very sympathetic to you. Before my feet got set on the path of crime and politics I was a small businessman myself. As you have described the problem, I certainly couldn't survive today. I'm glad I'm a retiree.

But thank you very much. You've helped us a great deal.

CHAIRMAN MACK: As I listened to the

discussion this morning, and the complexity of the tax code with respect to business, and to have seen some of data that you showed with respect to how small business pay their tax, if you will.

It seems to me that there really is a -- there's a perception problem in the country, and I would say that that probably is reflected in the Congress as well. There is a tendency to think of tax reform from the perspective of, let's reform the individual tax code, and then let's reform the corporate tax code, and not really understanding that there's a whole range of issues in between those that can affect the small business depending on what decisions that they make.

And so, I mean I come away from this discussion with a much broader perspective on looking at what our challenge is, and a better understanding of the issues that small businesses face.

I think I would ask a general question of you all, because again, what we're trying to eventually come up with is a notion about -- I said last week, that from my own personal perspective, and I suspect it's shared by other members of the panel, my motivation, having a frustrated economist, a former banker, member on the budget committees at various times, I really -- the economic issues really are of great interest to me, and so it's not surprising that probably the area that I would have focused on the most would be, what do we do to increase growth in our economy. Everybody benefits as a result.

But I also know that if we don't address the issue of simplicity that we're not going to get anywhere. The average American, I think when we get into a discussion about taxes, is not really necessarily concerned about the growth of the economy, they are thinking about it from the perspective of their own experiences; whether that be an employer or employee.

So in your own way and from your different perspectives, if you could point out one or two or three different things that would help simplify our tax code, I think it would be very helpful to us. And so if you just give it some thought.

Roger, are you prepared to go first?

MR. HARRIS: Yes, I'll go first. Other than the obvious one that everyone has mentioned, something like an AMT repeal, which is just again unfair.

I think what small business and everybody wants is a system that is understandable. Meaning that when you get into -- and I mentioned earlier -- the phasing-in, the phasing-out, the thresholds, the not understanding whether I qualify for this deduction this year but maybe I will next year. So I think if you look to where the Code was a little more straightforward in that area.

I think you should look, again, as it relates to business particularly. All the issues relating around timing of deductions and reporting of income and deductions and the complexity that we bring into the system, not to create any additional deductions but to determine when they are deductible, and the complexity that's brought in there.

So I think if you looked at timing, if you again looked at all the phasing-in, the phasing-out, sort of thing. Because I think small business is a very -- every person that's on this panel and everyone I've ever met, they're very hard working and adaptable. And as long as you tell them what the rules are, they don't mind playing by them. The problem is, they don't know what the rules are and the rules are always changing. So the game to them is, I give up.

And so I think the biggest thing you could do is give them a system they understand, that they can live with, if there's some consistency stop changing it every day, and they'll adjust and adapt. Then they'll have to go work on their business and make it better. And that's what we need for the economy.

CHAIRMAN MACK: Todd.

MR. FLEMMING: I'd echo that. I think certainly something that we can hang our hats on, having some good idea of what -- if we make so much money what we can expect to pay on taxes. Something along the lines of either a flat tax or a national sales tax. Either of those I think would work, providing the economists could support that the numbers made sense and that we didn't lead ourselves any further into deficit, maybe we spent less.

I think we really have to get out of the notion of taxing investment, if you will. I think we need to do other things to encourage investment and grow our economy. And I think when you place an abnormally high taxes on -- or taxes at all for that matter, on capital and returns to capital, I think you stagnate growth.

The only hesitancy I would have is that if we make our tax code very very simple, one of two things. Either our Congressmen and Senators won't have anything to do in Washington because they spend a lot of time monkeying around with the tax code --

CHAIRMAN MACK: I can guarantee you they will find something to do.

MR. FLEMMING: -- or what will happen is ultimately it will evolve over time and we'll sort of be back to where we were. But we've got to create some disincentives for the Senate and the Congress to constantly monkey with the tax code, if you will.

I mean you mentioned it, whether it's a special interest group I'm involved in or somebody else. At some point if we're going to have certainty, clarity, consistency, and all those things, we've got to make it a little bit more difficult to constantly change the tax code.

CHAIRMAN MACK: David.

MR. HURLEY: I think there would be better conformance and I think you'd have fewer problems with enforcement.

CHAIRMAN MACK: Let me clarify what I was looking for. I was hoping that you all would come back to me and say --

MR. HURLEY: Well, I'm getting ready to do that.

CHAIRMAN MACK: Okay.

MR. HURLEY: I've got a thing that I think they should do is on the small business, maybe have a laundry list of the things that are permissible expenses -- I'm talking about the little sub S thing I've got going -- and you have a revenue in, a revenue out, and what's left over and there you go. You know, you don't need -- and I think the thing turned out to be about 12 pages for that little bitty thing. Really, it was ridiculous.

It could have been on one eight-and-a-half by eleven sheet, and should have been filled out in 20 minutes because all the information -- and as Mr. Frenzel said, all those things have happened because of special interest groups, but every special interest group represents a lot of people. And I think that the tax code is the lobbyists full employment act. It keeps them busy forever.

MR. BRUCE: And one wonders how much of that full employment is among small businesses.

Let me just echo on those themes. Building on the research, which shows that you'd like as low rate as you possibly can have to fund your obligations and not generate long run permanent deficits. You could buy a lower marginal rate by simply cleaning the base and simplifying the structure. And as was said earlier this morning, if we believe in the intent of the alternative minimum tax to address the failure among the upper income levels to achieve optimum progressivity -- or something along those lines.

If we believe in the earned income tax credit to adjust the progressivity at the lower income levels, if we believe in these sort of parallel tax systems that are running, let's incorporate them into the underlying rate structure. It's just a table that we look to at the end of the process anyway.

There are already numerous incentives in the Code for saving, and I think that's important to talk about with regard to small businesses because of liquidity constraints. Access to financial capital. Continually one of the most insurmountable hurdles for these folks.

Do we need numerous incentives -- more than six or seven for eduction. Do we need another half dozen for retirement savings. Do we need another couple of new ones for health savings. Can we not just promote saving in general. Maybe we want to promote saving for entrepreneurial ventures. Do we need to create a new self employment IRS for entrepreneurial ventures? I don't think so. I think we want maybe a more general treatment of saving incentives.

Clearly what's been emphasized here today is the desire, the absolute desire for a very clear system of reasonably permanent rules, around which small businesses can plan, and fewer of what you might call targeted tax incentives or tax breaks. Each of which certainly has a constituency.

But the idea here that I'd like to leave you with is that the ultimate goal ought to be an environment, a fertile environment for small business creation and survival. Not necessarily trying to choose winners and losers, but creating the playing field upon which anyone can achieve this version of the new American Dream really, and resist the urge, as it's been said, to continually tinker with this revenue raising instrument for the purposes of social policy.

CHAIRMAN MACK: Either of you have further questions?

If not, again, as I mentioned earlier, Ed Lazear is listening to -- it's being webcast and he is observing this through that process. And he has a question he would like to ask Don Bruce.

Are the effects of progressivity of the

tax code, and high rates in general, more pronounced on small businesses than on large businesses?

MR. BRUCE: Well, that's an excellent question but it's unfortunately one that I haven't addressed in this research. I'd be more than happy to look into that for you, but I'm not prepared really to answer it right now.

CHAIRMAN MACK: All right. Let me see if I can understand. He has a follow-up he'd like to --

Is it more important to remove impediments to small business through income tax reform than to remove impediments to large business investment from high corporate tax rates?

MR. BRUCE: Well, I think both of those would be admirable goals for this group to have. I'm not sure I would come down as saying one is more important than the other. I think what we have to realize is that the vast majority of businesses are small businesses. And the vast majority of those small businesses are paying their tax through the individual tax code. So a small change to the individual tax code will have far more wide reaching effects on businesses in general than a small change, or even a large change to the corporate tax code.

CHAIRMAN MACK: I think that probably

leads me to the last question that I wanted to ask, which is really kind of more information.

Is there a breakdown as to the type of -- for small business the type of tax return that they file, that is what percent files as Chapter S and so forth. Do we have that information?

MR. BRUCE: Well, the IRS publishes information along those lines. It's often difficult to find that very specific number for any given tax year. In fact what we often do is work across different tax years; how many Schedule C filers were there in each year. But the IRS statistics of income division does produce that.

MR. HARRIS: Senator Mack.

CHAIRMAN MACK: Yes.

MR. HARRIS: Senator, I'm not sure if your database is completely representative, but I did look at those numbers before we came.

To the extent that it's representative, 45 percent of our clients file as an S-Corporation, 30 percent as a Schedule C or sole proprietor. That's where the 75 percent -- 15 is a C-Corporation, and the other 10 are mixed in with everything else. Again, not that that's necessarily representative of the base as a whole, but of our client base that's how they filed.

CHAIRMAN MACK: Okay. Yes.

MR. BRUCE: I was just going to follow-up and say that it sounds to me that his client base is under representative of Schedule C sole proprietors. Those probably represent a lot more as a share of all businesses than your client base.

CHAIRMAN MACK: And what do you think that number might be close to?

MR. BRUCE: Sixty to seventy percent.

CHAIRMAN MACK: Oh really.

MR. BRUCE: Yes.

CHAIRMAN MACK: Which I think makes my point about the perception of how to get to the -- if you want to start talking about tax issues from the small business perspective, you're really looking more at the individual tax code as opposed to any other aspect of the tax code.

MR. BRUCE: Right.

CHAIRMAN MACK: Okay. If there are not any other questions to be raised by the panel, again, I want to thank you for participating and providing us with this valuable information.

I just also want to extend my appreciation to all of you that came out today and participated in this as well.

At this point the meeting is adjourned.

(Whereupon, at 2:18 p.m., the above-entitled matter concluded.)