TESTIMONY OF

MARK A. WEINBERGER,

AMERICAS VICE CHAIRMAN - TAX SERVICES,

ERNST & YOUNG LLP,

BEFORE

THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM

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Chairman Mack, Vice Chairman Breaux, and members of the Panel, thank you for the opportunity to talk with you about tax reform from a policy perspective. My goal today is to raise some of the political and practical issues that I have observed through my experiences working in the legislative and executive branches of government, as well as in the private sector.

When the President announced his intention to form this Panel many critics were skeptical of yet another outside commission and felt that this task really should be undertaken by the Congress. I strongly disagree with those critics. When President Reagan announced in his 1984 State of the Union speech that the Treasury Department's tax reform study would be released in November of 1984 he was greeted by laughter in the House chamber. That bold initiative, however, set the framework and established the principles underlying the legislation that became the Tax Reform Act of 1986. Nearly 21 years later, this Panel established by President Bush, has the opportunity to spark a similar fundamental policy debate and to establish a framework for tax reform legislation that will have a lasting effect for many years to come.

A Panel such as this one is precisely the right way to proceed when the issues on the table reflect fundamental shifts in policy. Unlike the Congress, the Panel has the luxury of stepping back and taking a more comprehensive look at the objectives that a tax system should serve and how best to design a system that meets those goals. This Panel is not constrained by the need to respond to political considerations, by the necessity to structure legislation amidst a myriad of other priorities, or by the call to craft legislation that responds to a defined purpose (such as, an “Enron,” an economic downturn, a desire to close loopholes, or the desire to provide targeted relief to achieve certain non tax policy goals).

Unlike the Congress, the Panel can operate outside the political process in establishing the principal focus of the tax reform debate and in setting forth guiding principles. Political compromises that will be an inevitable part of the legislative process need not be an influence on the Panel’s work.

Basically, Congress has to navigate through the five “P’s”--policy, politics, process, personalities (dueling Chairman and Ranking Members), and priority. The Panel has the luxury of focusing on only one: policy.

You have heard over the course of your public meetings that the current tax system is in dire need of reform. The complexity of our tax rules has a real effect on economic growth. It imposes substantial costs on taxpayers and on the economy through the billions of dollars spent on compliance and administration. Perhaps more important, complexity raises the uncertainty surrounding business decisions, which often contributes to inefficient decision making that lowers productivity and hampers competitiveness.

This Panel has a unique opportunity to take the first step toward meaningful change by providing guidance to the Administration and to the Congress on how to formulate a better tax system that reflects the needs of the 21st century economy. I have had the privilege of participating in the tax policy process from a number of different vantage points—from the Senate Finance Committee, from a bipartisan presidential commission, from the Treasury Department as the Treasury Assistant Secretary for Tax Policy, and now from the private sector. As I thought about your work now and the experiences of the past, there are some broad, key lessons that may prove helpful as you begin to formulate your recommendations.

Seize the Opportunity and Be Bold

This Panel has the opportunity to be bold. Remember, if no one criticizes what you produce, you were not bold enough. That is not to say you won't be criticized even if you are not bold. When I was Chief of Staff of the President's 1994 Commission on Entitlement and Tax Reform, I personally received 350,000 postcards suggesting that we were destroying the social safety net; that was before we put an option on the table.

Do not be afraid to question the value, going forward, of policy decisions made in the past. I would recommend that you tackle issues that historically have been steeped in politics, like the role of tax expenditures and the issues surrounding tax-exempt status

Take, for example, a past proposal concerning a hot button issue in the present. The Treasury's 1984 tax reform proposal repealed the AMT that existed then, because "The judgment that a minimum tax is necessary reflects ambivalence about the desirability and effectiveness of the tax preferences subject to the tax." I would hope that this group would make its recommendations on grounds more solid than "ambivalence about alternative approaches," and I would encourage you to be bold and strong in setting the principles and framework for a new or improved tax system.

Your report should focus on the contributions you can uniquely make – a set of clear principles, and a few options for reform that provide a roadmap for policymakers. Clearly explain your choices and what tradeoffs you made with each option, and keep your focus on the value you are adding to the debate on fundamental tax reform. You need not get mired in the statutory drafting process that is the dominant role of Congressional Committees.

Rule Things Out As Well As Ruling Them In

There have been a number of thoughtful submissions to this Panel. To the extent that this Panel feels that any of them do not meet the criteria set forth by the President—simplicity, fairness and growth—the Panel should affirmatively take options off the table. Do not underestimate the value of narrowing the debate to productive, practical proposals.

Don't Let the Perfect Be the Enemy of the Good

Acknowledge that no tax reform plan can do it all. I would hate to see the opportunity for real progress on tax reform lost because of a desire for theoretical purity that can not be attained in practice. Acknowledge that a perfect tax system is one that exists only theoretically – it is best in the real world to work toward a simple system that accomplishes rough justice and fairness. A broad base with very few special benefits works better in practice than a complex one geared toward getting exactly the right economic answer. For example, an EITC that can be used by the taxpayers it's intended to benefit is better than a complex one designed to combat every possible tax avoidance scheme. Moreover, a coherent, integrated and simple savings proposal may prove more productive then a plethora of targeted incentives aimed at select taxpayers saving for specific purposes.

Remember, Taxpayers Live In The Real World Not In An Economic Model

Every tax plan looks ideal on paper because we are considering it against the backdrop of the flawed system we have now or, in some cases, because it is untested. We live in a complex, unpredictable world. The plan has to adapt to the world in which we live, and any plan that is only theoretical will look very different if it becomes the tax system of our country. Be sure you are comparing the system we know to a new system we are likely to get – not an idealized version.

No Tax Reform Plan Can Do It All; Prioritization Is Important

The 1986 Tax Reform Act tried to do it all: promote economic growth, improve fairness, and achieve simplicity. The 1986 Act reduced marginal tax rates, which was a major accomplishment, but it was not successful in creating a stable, simple tax system.

Prioritize your objectives for tax reform. Where you start not only affects where you end up but also affects every decision you will make along the way. For example, if you want a pro-growth system that is also fair and/or simple, first design a system to maximize economic growth and then alter it to make it fairer and simpler. Your April statement of principles suggested that simplicity may be your paramount goal, although you are committed to improvements along all three dimensions. If that is the case, start from a set of simple, administrable rules and then build in elements to promote growth and fairness.

A broad base and certainty are cornerstones of all three of the President's objectives--fairness, simplicity, and pro-growth. A broader base creates less distortion in business decision making. From a fairness standpoint, it would not choose winners and losers, and it would not breed the perception that some taxpayers can take advantage of special benefits. From a simplicity perspective it would limit gamesmanship and it provides transparency. Certainty allows taxpayers to make long-term decisions.

Setting Priorities Means Making Tough Choices

As you establish your priorities, understand that there are no easy choices; tradeoffs are inevitable. I want to be clear, when I talk about tradeoffs I am not referring to the political compromises that will occur during the legislative process. The tradeoffs to which I am referring are more fundamental—what are we willing to "live with" in order to have something more? For example, if we want to encourage savings, or capital formation, are we willing to acknowledge that those most able to save will benefit disproportionately (pro-growth vs. fairness)? Or, if we wish to encourage broader health insurance coverage through the tax system, are we willing to let the IRS evaluate what medical expenses should qualify (social policy consideration vs. simplification)?

In some cases, the dueling policies are both good; they just can't function together in a simple tax system and that is something I think this Panel should think through.

A tax code that only has one objective can be designed as a simple system. The more you want from the tax system, the more complex the rules will need to be. The typewriter was built to perform only one task, but I knew how to use it. On the other hand, the computer on my desk was built to perform a wide range of tasks, some are very simple like the typewriter and many are quite complex; it also requires a set of manuals and a complete IT department to make all those functions—even the most simple ones—work. A complex machine has more potential, but it is also more likely to break down.

Let me again use the AMT as an example to punctuate the point. You have heard more than once that the broadening reach of the AMT is a looming disaster that needs to be addressed. What bears noting, however, is that the AMT is the real-life result when priorities intersect. If, as a matter of policy, policymakers decide that the tax code should encourage behavior through tax incentives, fine. Where the problem arises is when the use of all these incentives lowers some taxpayers' tax liability so much that it now violates the notion of shared burden. Which priority should prevail? The AMT demonstrates a failed attempt at trying to have both, by structuring a system that offers incentives so long as people do not take advantage of too many at once.

The number one priority of a tax system should be to raise the required level of revenues in as simple and non-distortive a way as possible. Our current tax system certainly raises revenues, but it also functions as a mechanism to redistribute wealth, and to encourage or discourage certain behaviors. I think we can all agree that, in many cases, the tradeoff for using the IRS as more than just a revenue raising agency has been simplicity.

"Revenue Neutral" Means Different Things to Different People

I think it will be important for the Panel to think outside the box on issues like revenue neutrality. That is not to say that fiscal responsibility should be cast aside, but there are a number of ways to analyze revenue neutrality and I would encourage the Panel to look at this issue from more than one perspective.

The Advisory Panel has been directed that any proposal it recommends be "revenue neutral." That sounds harmless enough. However, remember every poker game is revenue neutral. At the end of the day, the same amount of money leaves the table but in vastly different pockets. Even a revenue neutral package will have different effects on different categories of taxpayers.

One question to consider is, in a revenue neutral system, which set of taxpayers have a higher burden and which have a lower burden? Is there a shift of burden from individuals to business entities or vis versa? Is there a shift between business sectors? Knowing how the tax burden is distributed should not drive policy choices but it should inform them.

In addition, I would encourage the Panel to consider revenue neutrality over different time periods—during the transition period and when fully implemented. It may be necessary for there to be fluctuations in the overall level of revenues collected because of the effect that changes in the tax rules have on economic decisions and behaviors.

Also, I would hope that tax reform legislation could be crafted without the need to stringently adhere to numbers on a 10-year revenue spreadsheet. Be mindful of the long-term fiscal effects; both positive and negative.

Just as revenue neutrality is not as simple as it seems, it is important to point out that distribution tables are not always as informative as they may appear. When considering distribution tables in your reform options, you should also consider the effect of business taxes on individual burdens. For example, during the 1986 Tax Act, the distribution tables showed income tax reductions for every income class, because the tables did not include the increased corporate income taxes. Since corporate taxes are borne by individuals, either as employees, consumers, or shareholders, the distribution tables did not show the comprehensive effect of the 1986 Act on individual taxpayers.

Conclusion

What you propose will not be enacted without change; a reality that everyone acknowledges is an evitable part of the process. Even the simplest system will likely grow more complex over time. That fact, however, does not diminish the importance of the role that this Panel will play in setting the legislative process on the right course. I believe the opportunity exists to make real progress toward a new or vastly improved set of tax rules that will contribute—not interfere with—economic decision making and that will be understood and respected by taxpayers.

As you move forward with your report, I offer whatever assistance I can provide. I have attached to my written statement a non-exhaustive list of 40 questions that raise some additional, more specific, areas to contemplate as you assess your options for tax reform.

Thank you. I welcome your questions.

ATTACHMENT

Checklist of Economic and Business Issues
To Consider in Tax Reform

Note that all issues are not applicable to all reform proposals. List is not meant to be comprehensive.

I. ECONOMIC ISSUES

1. **Macro-Economic Effects:** What are the intended and anticipated effects of the various proposals on savings, investments, interest rates, economic growth, product pricing, etc.? What are the short-term versus long-term ramifications?

2. **Incidence of Tax:** Who is likely to bear the burden of the taxes to be imposed by the various regimes (workers, consumers, owners of capital)? What are the short-term versus long-term ramifications?

3. **Distribution of Tax:** On the individual side, is the distribution of the tax burden shifted under the proposals? If so, in what way? Does the distribution of the tax burden include the burden of taxes paid nominally by business?

4. **Sector Variations and Economic Neutrality:** Similarly, on the business side, is the distribution of the tax burden shifted under these proposals from some business sectors to others? If so, in what way? Does the tax burden shift between corporate and non-corporate businesses? Does it favor some industries at the expense of other industries? Does it level the playing field?

5. **Impact of Border Adjustability:** What is the impact of a tax regime that exempts exports and taxes imports (so-called border adjustability)? How does it impact the balance of payments and national income accounts; foreign exchange rates; and different business sectors (e.g., importers and exporters)? Does the tax change improve the competitiveness of U.S. business in the global marketplace?

6. **Effect on Compliance Burden and Uncertainty:** Taxes also impose economic costs in the form of compliance burden and uncertainty. How much does the proposal reduce the compliance burden of households and

business? How much does the proposal reduce the current uncertainty of the tax rules?

7. **<u>Scoring of Future Economic Benefits:</u>** How will the benefits of a reformed tax system (economic growth, lower compliance burden, increased certainty) be measured? How will they be reflected in a "revenue-neutral" analysis?

8. **<u>Institutional Framework:</u>** What institutional changes to the tax policy process would increase the likelihood of maintaining the tax reforms, and increasing the likelihood of a future tax system that stays in sync with the changing economy?

9. **<u>Relationship to the Budget Process:</u>** Many tax reform proposals eliminate provisions that are similar to government spending or credit programs ("tax expenditures"). What mechanism is used to evaluate whether these programs have a positive benefit-to-cost ratio, and whether they are best delivered as a tax, spending, or credit program?

II. <u>INTERNATIONAL ISSUES</u>

10. **<u>The WTO Rules on Border Adjustability:</u>** Whether a tax is border-adjustable is largely determined by the WTO rules. What are these rules and their implications for various reform proposals? Is there room to accommodate wage-based credits (e.g., payroll taxes, R&D related outlays)? Can a flat tax that is the same as a subtraction method value-added tax (except that wages are deductible to businesses and taxable to wage earners) be border adjustable under WTO? If not, is there any policy reason why the WTO rules cannot be changed?

11. **<u>Mechanics of Border Adjustability:</u>** How would a border-adjustable tax work mechanically upon the sale of technology, goods and services?

    (i) **<u>Royalties</u>**: For example, goods made in the U.S. and exported are exempt and goods made outside the U.S. and imported are not. If technology is developed in the U.S. (i.e., through R&D) and the know-how from that developed technology is licensed outside the U.S., will the royalty income also be exempt? Will the U.S. then tax royalty payments paid by the U.S. taxpayers to non-U.S. persons?

    (ii) **<u>Service Payments</u>**: Similarly, will service providers only be taxed on the income they make if the recipient resides in the U.S.?

12. **Sourcing Rules:** What are the implications of a border-adjustable system for our current sourcing rules? What are the implications of a territorial system for our current sourcing rules? For example, how should royalties be treated?

13. **Treaties:** A value-added tax is not covered by existing income tax treaties. Would a flat tax be treated any differently? If so, would making it border-adjustable change the result? If our existing treaties were to apply, how would a unilateral change in the rules for determining the source of income harmonize with these treaties, since they are intended to avoid double taxation? For example, if the U.S. begins taxing royalties paid by U.S. payors to non-U.S. payees (i.e., because they are not deductible in computing U.S. tax liability), and the foreign governments tax those same royalties when received by their residents, what are/should be the treaty implications?

14. **Behavioral Responses:** If a new flat tax is not harmonized internationally, will the potential new incidence of double taxation and potential new incidence of total tax exemption skew behavior? How will that affect today's marketplace? For example, on its face, it seems that the U.S. will become a tax haven for the manufacture of export products. What behavioral changes will such a regime generate?

III. CORPORATE ISSUES

15. **Corporate Integration:** To what extent do the proposals move our tax system toward the goal of an integrated tax system (i.e., a single level of tax on any given income)? How is the distinction between debt and equity determined and does the new system eliminate any biases between different types of funding mechanisms?

16. **Corporate Mergers and Acquisitions:** To what extent are corporate acquisitions/dispositions tax-free or not tax-free under the proposals? How is the acquisition of stock treated? How is the disposition of stock treated? Should asset acquisitions be treated the same as stock acquisitions?

17. **Choice of Entity Issues:** How will the various proposals impact a taxpayer's choice of entity for conducting a business? How will flow-through entities (e.g., partnerships, Subchapter S corporations) be dealt with in the various proposals?

18. **Recordkeeping Requirements:** What will the new recordkeeping and reporting requirements be under the various proposals? Can they be simplified with new technology and software?

IV. CAPITAL MARKETS AND FINANCIAL SERVICE ISSUES

19. **Treatment of Dividends and Interest:** Many of the current proposals provide that dividends and interest are not deductible, and are not included in income.

    (i) What are the corporate finance implications (e.g., debt versus equity financing; dividend policies)?

    (ii) What are the "product" implications for various financing transactions (e.g., residential mortgages; insurance and annuity products)?

    (iii) What are the implications for international capital markets (e.g., location and structure for corporate financing activities; capital flows)?

    (iv) How does this compare to the implications of a mirror image system, where dividends and interest were deductible and subject to a creditable withholding tax?

20. **Leasing Transactions:** How would the different proposals treat lease financing transactions (cost of the asset can be expensed currently, lease payments are deductible and treated as income)? What are the implications for the leasing market?

21. **Taxation of Financial Services Intermediaries:** Should financial intermediaries be exempt from the tax regime if interest income is no longer taxable? Under a VAT-type regime, does exemption result in a greater tax burden? Should such entities distinguish interest income from financial services income?

V. HIGH-TECH ISSUES

22. **Research and Development Activities:** Should there be a permitted deduction for R&D labor costs as an investment in capital? Does it matter to R&D intensive businesses if the wages are taxed to the wage recipient at a rate that offsets the benefit of any deduction? Can other tax incentives (or subsidies) for R&D be permitted under the WTO regime?

VI. EMPLOYEE BENEFIT ISSUES – Pension and Health Plans

23. **Employee Benefits:** What are the effects of the various proposals on various employee benefits (e.g., pension plans, employer-provided health care, other fringe benefits)?

VII. TAX ADMINISTRATION ISSUES

24. **Tax Administrator:** Will the IRS administer any new tax system? Will its budget over the transition and beyond have to be increased?

25. **Timing of Implementation:** How much time is needed after enactment to prepare for administration of a new or revised tax? What about the creation, processing and gearing up for new forms, instructions, and administrative guidance?

26. **Tax Administration:** What government resources should be devoted to compliance activities under the new or revised tax?

VIII. FINANCIAL STATEMENT ISSUES

27. **Financial Accounting for the Various Proposals:** What are the financial accounting rules governing the various proposals? What are the implications of those rules? Are we willing to relinquish some tax policy decisions to accounting standards boards, including international groups, to achieve conformity between book and taxable income?

28. **Book/Tax Conformity:** What will be the interaction of financial reporting and tax reporting? Will there be differences? If so, how will they be addressed? Will there be different rules for public and private companies?

29. **Internal Controls and Disclosure Requirements:** What impact will the various proposals have on current internal control and disclosure requirements?

IX. STATE AND LOCAL TAX ISSUES

30. **National and State Retail Sales Tax:** Would a national sales tax force States and local governments to conform to Federal rules? Should a national retail sales tax be used to collect the tax for the States and localities?

31. **State Income Taxes:** How would States and local governments administer their tax systems in the absence of the Federal income tax?

X. TRANSITION ISSUES

32. **Depreciation:** How will investment made prior to the enactment of a new regime be treated?

    (i) If a system provides for expensing, should the remaining basis be deductible in the year such a plan is enacted? Can/will the regimes provide this benefit and keep the tax rates at the desired levels?

    (ii) Assuming they do not provide for current year expensing, what phase-in rules are appropriate/practical from a cost standpoint?

    (iii) What special industry issues arise (e.g., normalization accounting for public utilities)?

    (iv) Does/should the consideration of fundamental tax reform affect capital investment decisions?

33. **NOL and Minimum Tax Credit Carryforwards:** How will the various proposals treat net operating loss, capital loss and minimum tax credit carryforwards?

34. **Foreign Tax Credit Carryforwards:** To the extent the new regime does not have a foreign tax credit system (as a result of a decision to exempt foreign income), how will foreign tax credit carryforwards be treated?

35. **Outstanding Debt:** As interest payments become non-deductible and interest income is exempt, what will happen to existing debt instruments?

36. **Leasing Transactions:** How will the treatment of unrecovered basis in existing assets, and interest deductions with respect to existing debt, affect "tax indemnity" and "tax gross-up" provisions in existing transactions?

37. **Financial Accounting Issues:** Under current financial accounting standards, deferred tax liabilities can be tax effected, thus reducing the financial statement impact of the liability (e.g., for retiree benefits). How will the change in the tax effect of these liabilities affect financial accounting? How would deferred tax assets be affected by a new tax system?

38. **<u>DRD Gross-Up:</u>** How will the treatment of dividends affect existing financing transactions where the dividends received deduction is an important consideration?

39. **<u>Private Party Contracts:</u>** Are there private party contracts that could be affected by fundamental tax reform (e.g., joint venture and partnership tax allocations agreements; labor agreements; natural resources contracts; tax sharing and tax indemnity agreements)? How should they be treated?

40. **<u>Economic Impact of Transition:</u>** What will be the economic effect of transition? Would a consumption based tax have adverse pre-enactment effects? Will taxpayers delay capital purchases until the date the new system takes effect in order to expense their purchases? Will taxpayers delay exports, and rush imports, before a border adjustable regime takes effect?