U.S. SENATE COMMITTEE ON
Finance
SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN
http://finance.senate.gov

Remarks of Chairman Chuck Grassley
Before the Tax Council
Tuesday, April 4, 2006

Thank you for inviting me to speak today. As chairman of the Finance Committee, I should hear the tax concerns of the corporate business community. I would like to walk through a few legislative matters that I'm sure are of interest to you, including: tax reconciliation; the pension bill; and a general tax legislative outlook. I will also take this opportunity to respond to some recent criticisms of the tax policy and the political process surrounding the 2004 JOBS or "FSC-ETI" bill.

First, I'll make some comments on the status of tax reconciliation. The first meeting of conferees took place on March 15, where the conferees gave their opening statements. As I said at that meeting, I think our objective should be to produce a bicameral, bipartisan compromise that both houses can pass. This means the cornerstone of each bill – the AMT hold harmless and an extension of the dividends and capital gains rates – should be accommodated, and that the common extenders package should also be taken care of. And we should produce a bill that provides as much tax relief as possible by using appropriate revenue offset measures.

It's no secret that there are some significant issues that the conferees have to deal with, but I am confident we can resolve them. I see three primary issues facing the conferees: The first issue is compliance with reconciliation rules. It is also known as the "Byrd Rule". This has been the biggest obstacle so far. The reconciliation rules permit a maximum of $70 billion in tax cuts over the 5-year budget window ending in 2010, but each year outside the window must be deficit neutral. This rule is a problem for the dividend and capital gains extension, because the provision scores as losing over $30 billion outside the budget window, mostly in 2011 and 2012. In order to overcome this procedural hurdle, either (1) the revenue losses must be offset, or (2) we have to get 60 votes to overcome a point of order. I have continued to keep both of these paths open.

The second issue facing the conferees is the scope and number of tax vehicles to use in addressing the issues in each bill. The idea has been floating out there to move some provisions outside of reconciliation to make it easier to fit under the $70 billion limit. For example, there has been some talk of moving AMT on its own outside of reconciliation, as the House has done, and there have been press reports about including AMT in the pension bill. But it is not clear that we would have the votes to pass a reconciliation bill that does not include AMT, so I don't think either of these strategies is viable at this point.

There has also been talk of moving an extenders package outside of reconciliation later in the year. I know this would cause some concern in the business community, particularly those claiming the research credit. Companies have already had to report their first quarter earnings

without the research credit. It is unfortunate that these routine extenders have gotten held up by the partisan politics of extending the dividend and capital gains rates, as has the AMT hold-harmless. But that's the reality. Even so, there is little risk that the extenders won't be retroactive to January 1.

The third issue relates to each of the first two issues, and that's the extent of revenue offset provisions to be included. Most Senate offsets have been rejected by the House in previous conferences, the biggest one being clarification of economic substance. I continue to believe that there should be a uniform rule to deny tax benefits where taxpayers hide behind literal compliance in transactions that have little or no economic effects. The same people who argue for a rule-based tax system to provide certainty argue that making a uniform rule to apply the economic substance doctrine would create uncertainty. The principal goal of codifying economic substance is to provide uniformity in application. Critics acknowledge that this is an important goal. So I doubt these critics would complain if the Supreme Court decided a case based on the economic substance test proposed in the Senate bill. But that would be the effect of clarifying the economic substance doctrine by statute. So that's the third major issue, what revenue offset provisions will be used to maximize the tax relief we provide.

As for timing, I have been pushing to accelerate the negotiating schedule, and I hoped to make significant progress before the April recess. But the House conferees have, so far, not been interested in an accelerated schedule. Once those three major issues are resolved, I don't expect the process to take very long to finish.

I want to make just a few brief comments on the pension bill. My goal has been pretty simple – to protect the vast majority of us (including the vast majority of us here in this room) from the actions of a small group of companies that have taken advantage of the moral hazard in our current pension rules to dump their compensation costs on innocent third parties. Today, those innocent third parties are other employers who end up picking up the tab for dumped pension costs through higher PBGC premiums. Tomorrow, the innocent third party may turn out to be the American taxpayer. That's no way to run a pension system, and it's no way to run a capitalist economy. We need to give companies the certainty they need to make rational business decisions about whether to continue sponsoring pensions for their workers. We need to remove the moral hazard from the system. We need to make sure that companies honor their promises. And we need to make sure that companies in distress do not terminate their pensions. We can haggle about the best way to remove the moral hazard in our current rules from now until eternity – although just between us, I hope it doesn't take that long. I'd hoped we'd have a conference report to the President by now. And I'm extremely disappointed in the lack of progress we've made. I can tell you one thing that I'm not going to allow. I'm not going to allow tens of billions of dollars of more pension liabilities to be dumped on the federal government, other pension plan sponsors, and ultimately the taxpayer. We owe it to the taxpayers, we owe it to the workers, and we owe it to all of you here in this room who have funded your pensions responsibly and honored your promises.

Next, I'll make some remarks about the general tax legislative outlook. The deficit situation continues to have an impact on how the congressional bodies approach tax legislation, and has been an obstacle to the Senate's ability to pass un-offset tax legislation. The long-term budget outlook presents problems for the revenue base and tax policy. Economic growth, by itself, cannot remedy the long-term fiscal problem. But at the same time, issuing large amounts of debt or raising taxes could significantly reduce economic growth.

The individual AMT problem must also be dealt with over the long-term. It is now a $30 billion a year problem. Hitting Americans with a stealth tax is wrong. Clearly, the AMT should be abolished. At a very minimum, we should keep our promise to make certain that no additional taxpayers are brought into the AMT system on an annual basis. The deficit situation and the AMT problem must each be dealt with in the up-coming debate on tax reform.

The tax reform debate will give us a chance to take a fresh look at our tax system. I appreciate the President's Advisory Panel's months of study and analysis. It seems the panel members were apolitical in their work, and that's good. It's important to have a comprehensive starting point that will get everyone talking and thinking. The next step in that process is for Treasury to evaluate the proposals and make a recommendation to the President. From what I've heard, this won't happen this year. To date, the committee has not yet focused on the proposals in detail, as other legislative business taken up our time. However, I expect the committee to evaluate the alternatives presented by the tax reform panel and have hearings. The committee isn't necessarily going to limit its consideration to the proposals recommended by the tax reform panel. I have instructed my staff to continue to evaluate and develop proposals to simplify the tax system.

American businesses need a fair tax code that will allow them to make decisions based more on economic merit, and less on distortions generated by the tax system. So we ought to focus on two principal areas: simplifying the taxation of domestic income, and improving the efficiency of our international tax regime. We should consider how our tax system impacts the competitiveness of American companies doing business here in the U.S. and overseas. But we should also have a system in which corporations pay their fair share of tax. I recognize that, in the global economy, tax policy is not so neatly put into domestic and international categories. Our quote "domestic" tax policy influences international business decisions of multinational corporations as much as our quote "international" tax policy.

For example, our corporate tax rate is typically thought of as domestic tax policy. But when it ranks at or near the top among OECD countries, it influences international business decisions, like where to build a plant. So I think we should look for ways to lower our corporate tax rate. We should also look at ways to broaden the corporate tax base by eliminating loopholes and special interest preferences. The lower rate ought to apply across the board to all business income, rather than favoring one income producing activity over another.

This leads me to recent criticisms of the JOBS bill. Recently, there has been a revival of the criticisms of the FSC-ETI replacement regime put in place in 2004. The criticisms are not new. The criticism can be boiled down to this: The manufacturing deduction was an unwise segregation of one category of business income. The complaints about complexity and tax administration are well-known. I will not go through them now, but also recognize that the criticisms are well-founded from a tax policy standpoint. If we were considering tax policy only, perhaps we might have gone the way of the critics.

Having acknowledged the legitimacy of the criticisms of the policy of the 2004 law, let me clarify one point. It was a point the critics repeatedly ignored. There is a distinction for manufacturing income embedded in federal tax law. It is derived from the Domestic International Sales Corporation ("DISC") regime and the Foreign Sales Corporation ("FSC") regime. From 1974 through 2004, thirty years, the tax law included a distinction between income derived from manufactured exports and other domestic income. Let me go back to the basic criticism that the tax

benefit should have been available to all businesses. Congress does not legislate in a tax policy vacuum. This is a key point. I will repeat it. Tax legislation is not created in a vacuum. Very important real world economic and political factors come into play.

Two factors affected the tax policy underlying the manufacturing deduction. The first factor was the class of companies benefiting from the FSC-ETI regime. The FSC-ETI benefit was directed at exporters of domestically manufactured products. The benefit roughly translated into a significant rate reduction of five percentage points. Because of the European Union challenge, domestic manufacturers were facing a tax increase of five percent. What the critics suggested was a single point tax reduction on all business income offset by a tax increase of at least five times that on manufacturers. There is no way to get around it. The critics' regime would have put in place a significant tax increase on manufacturers. So, that's the first factor, the critics' position was a dramatic tax increase on domestic manufacturers that export.

The second factor was the political consequences of the tax increase. As one who represents a state that prides itself on manufacturing, this tax increase was not something I could simply brush off in an "ivory tower" of tax policy. To do so would be to not represent the workers and communities in my home state. I was not alone. An overwhelming majority in the Senate and a significant majority in the House were likewise concerned about an increase in taxes on domestic manufacturers. In some ways, with the loss in manufacturing jobs, this tax increase was perceived in the manufacturing communities as "piling on" those companies, workers, and the communities that were built up around those businesses.

Frankly, in the political environment of the 2004 elections, with a focus on the loss of manufacturing jobs, it would have been a disaster for Republicans to have been identified with the critics' position. As one who comes from a very competitive state in the heartland, I think I speak with some credibility on this point. I'd note, for the record, that, not many of the critics were elected officials, or, if they were, they tended to not come from politically competitive areas.

I don't see how we could have produced a bill that ignored the reality of a tax increase on domestic manufacturers. We are where we are because the Congress recognized this fundamental political reality. But now, with the debate on tax reform being teed up, we will continue looking at ways to make our system simpler and more efficient. I hope that politics will not get in the way of developing sound tax policy. With that, I would like to open our discussion to any questions.