Testimony Before The US Senate Finance Committee
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Simplifying Taxation of Business in America

Mr. Chairman   Thank you for inviting me to talk about how we can simplify taxation of business in America.

My involvement in the tax world has been more than a bit strange. For the first 30 years of my career I was a businessman and taxpayer, but not at all a tax expert. By a quite unexpected turn of events, I then ended up spending five years as IRS commissioner. When I left the IRS I went happily back into the business world, while repeatedly explaining to my new colleagues that indeed I was not the one to consult on technical tax matters. Last year the totally unexpected happened again when President Bush asked me to serve on his advisory panel on income tax reform. Despite these occasional forays into the tax world, I remain a person whose main life experience has been that of a businessman.

After traveling on this unexpected path through tax territory, one observation overwhelms all others, and that is that the US tax system is astoundingly inefficient as a result of mind-numbing and unnecessary complexity.   I find it remarkable that the time and money that taxpayers in this country spend trying to comply costs them 140 billion dollars per year.

And the complexity continues to get worse every year.

Since the adoption of 1986 tax reform, Congress has passed 14, 400 amendments to the tax code. That's an average of 2.9 changes for every single working day in the year for 19 years.

When you add in the 300 billion dollars per year in taxes that should be paid but are not, in part because of the complexity of the Code, you arrive at an overhead burden on honest taxpayers of around 450 billion dollars per year.   That's about what we spend on social security and more than one third of what we actually pay in income taxes.

While all taxpayers suffer from this inefficiency, it is a fact that the majority of the cost is borne by businesses, especially small businesses. Of the 140 billion dollars per year spent on compliance, approximately 75% of the total is shouldered by businesses, including self-employed individuals.

Beyond this staggering compliance cost, businesses suffer from inefficiency because the actual tax burden on businesses is capriciously uneven and often unpredictable. Many businesses pay the full statutory rates on their income. But many other businesses, sometimes in the same competitive industry, pay far less, and that is for two reasons. One, they fail to report what they should and simply get away with it because of lack of resources in the IRS; or, two, they happen to be better able to take advantage of special provisions and complexities in the code to reduce their actual tax rate. This situation is not only unfair; it creates great inefficiency by distorting the business playing field and diverting scarce attention from improving efficiency to planning how to minimize taxes.

I have personally experienced the implications of this terrible inefficiency on both sides of the table, as business man and tax administrator, and have often reflected to myself that America is indeed a rich and productive country if it can afford the monumental burden of such an inefficient tax system. But that begs the question of whether it has to be that way. There may be political factors at work that lock in this inefficiency. I can't judge that question because I'm not a politician. But I do know that there is a better way available, if our political leaders wanted to adopt it. And that is to adopt a much, much simpler system that would even the playing field among businesses, and would enable lower statutory rates in the process, while raising the same amount of revenue.

The tax reform panel has laid out in some detail how this could be done so I will not repeat that here. I would only summarize four principles that I think are essential to making a simpler, fairer and more efficient system of business taxation.

1. Lower rates are better than special preferences.

Over the years a large number of special preferences for particular kinds of business activities have been put into the code. Some of these, such as the R&E credit, are substantial in size and affect a significant percentage of businesses, and others are much smaller and affect only a few businesses. But each of this long list of preferences requires complex rules and regulations to define who is entitled to get these preferences; they are the source of enormous controversy and often confusion between taxpayers, Treasury and the IRS, and they all have the effect of raising the rates for all businesses. In addition, I should note that in a world of increased scrutiny of financial reporting, they are also a source of great complexity and potential error in reconciling tax accounts with financial reporting.

Nearly every witness at the numerous hearings held by the tax reform panel supported this principle: eliminate preferences, lower rates. As an incentive for investments, lower rates are clear cut factors that improve the calculation of the return on almost every investment decision. Special preferences may or may not be taken into account when investment decisions are made. Their impact is not only uneven and unpredictable; it is often weak or non-existent in practice.

This is why the tax reform panel unanimously proposed eliminating nearly all special preferences for businesses in favor of lower rates.

2. Rules for small businesses should be and can be far simpler than for large businesses.

It makes no sense to impose the complex rules needed to measure income in a multi-billion dollar global business on a local business with a few employees. Attempting to do so imposes large unnecessary costs on small business. It also impedes compliance by diverting IRS resources into technical issues at the expense of the major compliance problem with small business, which is to ensure that all income is reported.

During my tenure as commissioner, we took steps toward simplifying IRS tax reporting rules for small businesses. The tax reform panel went further and proposed very simple rules that would apply to almost 98% of all businesses. Taxpayers for the most part would report taxes as they keep their check-books, cash in minus cash out and report the difference. This would not only be enormously simpler and easier to understand, it would facilitate increased compliance. As part of the plan, the panel proposed increased reporting requirements by credit card companies and banks, which would aid businesses in knowing what to report and the IRS in spotting potential underreporting.

3. Double taxation of businesses should be reduced or eliminated, but all business income should be taxed once at approximately the same rates.

Because businesses take different legal forms, some, but not all, businesses pay tax at the business level while their shareholders also pay tax at the individual level. To mitigate this problem, the tax code now provides for lower rates on capital gains and most dividends. As our tax reform witnesses noted, this blunt method means that some business income may still be taxed twice, once at the 35% corporate rate and again at the capital gain or dividend rate. On the other hand, it can also mean that some business income is taxed only at the lower capital gain and dividend rates even though it was taxed very little or not at all at the corporate level.

Solving this problem in a way that does not impose even more complicated rules is not easy. The tax reform panel in its Simplified Income Tax plan did propose a workable solution. Gains on sales of stock held for more than a year in corporations that pay tax at the corporate level would receive a 75% exclusion from the individual income tax, meaning that the top rate would be only 8.25%. The double taxation of dividend income from US taxpaying corporations would be eliminated, since there will be a 100% exclusion from income of individuals for dividends received on the US income of US corporations. All other business income would be taxed once at ordinary rates. The net result is that double taxation would be nearly eliminated but single taxation would be achieved in all cases.

It is important to note that this proposal would only work if most special tax preferences are eliminated. Otherwise, some income would escape all taxation, or much more complicated rules would be required.

4. The tax system should be updated to reflect the reality that a large fraction of business is now routinely done on a global basis.

Most large businesses and many smaller ones now do business inside and outside the US in ways that go well beyond simply exporting or importing commodities and finished goods. Companies source their purchases globally, locate service as well as manufacturing operations where they can get the greatest efficiency, raise capital in markets around the world, and increasingly depend on intellectual property as a principal source of income.

In this context, the US tax code, which in principle taxes worldwide income of US corporations, has grown to have so many exceptions and complexities that it raises very little revenue from this theoretically worldwide reach, but it does so at tremendous cost in the form of tax planning and compliance. Furthermore, this aspect of the code more than any other gives rise to the remarkable unevenness among businesses in the tax rate they actually pay.

The tax reform panel proposed to deal with this issue in a manner similar to that proposed by the Joint Committee on Taxation. It would exempt from US taxation income earned abroad by US corporations except certain categories of highly mobile passive income. This would eliminate much complexity, would cost little or nothing in revenue, and would actually eliminate some opportunities for manipulations that reduce US tax. It would be a big improvement over the current system

The tax panel proposal would, however, still depend on separating the worldwide income of multi-national corporations into that earned in the US and that earned elsewhere, an inherently complex and unreliable process. A more far-reaching approach, which I would personally favor, would be to shift the entire measurement of taxable income of large corporations to that reported under Generally Accepted Accounting Principles on a worldwide basis, with a simplified system for crediting foreign taxes paid. This system would allow the same amount of revenue to be raised with a much lower corporate tax rate, no more than 25% and possibly lower. It would make the system simpler, more reliable, and would greatly reduce the opportunity and the need for businesses to move income producing activities based on taxes.

The conclusion I hope you will come to, Mr. Chairman and members of the Committee, is that the US tax system does not have to be as complex and inefficient as it is. While it would take considerable political leadership to make a major reform, the benefits for the taxpayers of the US would be worth it.

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