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NOMINATION OF ERIC SOLOMON

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON THE

NOMINATION OF

ERIC SOLOMON, TO BE ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

JULY 13, 2006

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CONTENTS

OPENING STATEMENTS

ADMINISTRATION NOMINEE

WITNESS

ALPHABETICAL LISTING AND APPENDIX MATERIAL

NOMINATION OF ERIC SOLOMON, TO BE ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

THURSDAY, JULY 13, 2006

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Bunning, Baucus, and Wyden.

The CHAIRMAN. Before Senator Baucus and I give our opening statement, I am going to call on Commissioner Everson, here to testify in regard to Mr. Solomon. We are glad to have you do that right now, because you have to appear before the Ways and Means Committee.

So, would you proceed, please?

STATEMENT OF HON. MARK EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Commissioner EVERSON. Certainly, sir. Thank you. It is always a pleasure to be before the committee, but I want to emphasize, I am not asking you to reconfirm me today or anything like that.

But I did want to spend just a second to strongly endorse the President's nomination of Eric Solomon to take this important position.

I have worked with Eric for 3 years now. He has absolute integrity. His behaviors are outstanding. He works very collegially with people from the Service.

Actually, as I think you know, he worked at the Service for a period of time. He has a very keen appreciation of the fact that tax policy, without sound tax administration, just does not get you what you need. So, he works very well with the IRS.

We are anxious to have him confirmed and get on with the many important things that he needs to do. I hope that this endorsement helps and does not hurt him. [Laughter.] That is really what I wanted to say, and that is all, Mr. Chairman.

The CHAIRMAN. Well, if you have 15 extra minutes, Senator Baucus would like to talk about the tax gap. [Laughter.]

Commissioner EVERSON. I know. I knew I had a risk in coming over here.

The CHAIRMAN. All right. Well, thank you very much.
Commissioner EVERSON. Thank you, gentlemen.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Yes. We are here today to consider the nomination of Eric Solomon, and that is to be Assistant Secretary of Treasury for Tax Policy.

I have made a lot of comments recently in my speeches on the floor about the movie "Groundhog Day." That was a movie about a day that kept repeating itself, just like tax reconciliation does.

Today is a very different day than "Groundhog Day," in that many people thought today was a day that we would never see, a day, as I just mentioned to the nominee, that he would finally get a hearing on the nomination before us. It has been a long time, but I am glad that we are here, able to hold this hearing, and that we have before us a very strong nominee.

Mr. Solomon is a dedicated public servant, as I think you just heard the Commissioner speak about, and he is a person who served the Nation well for many years at the Treasury Department. It happened to be under both Republican and Democrat administrations that he has done this, so he has the deserved respect of the tax community.

It is natural to look at the hourglass and think that the shadows are growing long for this administration and that this job is a caretaker's job, but nothing could be further from the truth on that point. I think the next 2½ years have enormous possibility and opportunity for this administration and the Congress in the area of tax.

We have just had a very able Secretary of Treasury take his oath of office, and I am confident that he wants, as the new Secretary, to do more than just what he loves to do as a sideline, bird watching. My discussions with the new Secretary suggest that the great deal of energy that he has will bring real change and reform to the tax code in the operation of Treasury.

I think that this committee has a real interest in tax reform, and, if the administration will show leadership, we can make real and significant changes, particularly changes that will make our economy more competitive in the global market that we are in.

We will be having hearings on tax reform with former Senator Breaux, and hopefully former Senator Mack will be able to attend. These were the people that, you will remember, co-chaired the President's Tax Reform Commission.

As I promised, that hearing will take place in the last week of this work period and will be a kick-off for the Finance Committee's look at tax reform. I expect more hearings down the road.

Hand in hand with tax reform is something I just was teasing Senator Baucus about, and that is the tax gap. It is nothing to tease about, because it is a very serious problem.

The tax gap has been something that I have heard about since I first came to the Senate, and it has bedeviled both Republican and Democrat administrations. Senator Baucus is to be commended for focusing on that issue.

We have made some progress in this area with legislation that this committee has passed, but more, obviously—with more than $350 billion of that gap—needs to be done.

Senator Baucus and I have asked for a plan this fall from Treasury and the IRS on this subject. While the focus on solving the tax gap is traditionally on the IRS, I am more and more convinced that Treasury tax policy has a very significant role to provide in the guidance and regulation that can help with that gap.

The issues of reform and the issues of gap are very real, and we need to face them today, instead of hoping for some perfect opportunity way down the road.

Mr. Solomon, then, you have great possibilities before you, and I expect you to be active and engage in bringing real change. The administration must show initiative on tax reform, something I thought maybe would happen in January of this year and did not happen, and also on the tax gap, which is something that maybe the President does not talk about, but his people surely have heard Senator Baucus and I speak about. These are things that you are critical to making happen.

So with that, Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Thank you very much.

Unlike many nominees, Eric Solomon is not a newcomer. For 7 years, he has worked in the Tax Policy office, and for two long years the administration has conducted a nationwide search for the right person to run the office. They finally looked down the hall, and there was Mr. Solomon, where they found an excellent nominee.

St. Augustine said, "Patience is the companion of wisdom." So I figure, Mr. Solomon, after this long wait, you are going to be a very wise, wise man. [Laughter.]

There are two issues that I would like to raise with you today. One is a passion of mine, already referred to, and that is finding a way to close the tax gap. The other is apparently a passion of yours, that is, fundamental tax reform.

The tax gap is the difference between what taxpayers legally owe and what they actually pay. The IRS estimates the gap is about $345 billion a year, and that figure is increasing. My guess is, it is probably even higher.

Earlier this year, I asked your former boss, Secretary Snow, to provide me a plan for addressing that gap. To date, unfortunately, I have not received any plan.

So earlier this month, as referred to just a few minutes ago, I asked the IRS Commissioner for the same thing. I asked for a plan, a plan to give benchmarks, to give data points, reference points, how we are going to close this tax gap, and he promised to do so by October 1.

Last month, I asked your new boss, Secretary Paulson, to make sure that he made that happen so we can get the plan by October 1. I might say, he is very sympathetic and understood the problem,

but he said, since he was not yet confirmed, he really could not make any promises.

But I expect, frankly, him, the Treasury Department, and the administration generally to live up to the promise made by Mr. Everson to get that plan to us by October 1. It is very much in the country's best interests, obviously.

In the years that you have been at the Treasury, the Department, I might say, has responded very quickly and skillfully to a lot of crises. One that comes to mind is the Asian financial crisis. The Department did a good job in tamping that down; it could have been a lot worse.

The bursting of the dot-com bubble. That also could have been a problem, and Treasury certainly played a role in ameliorating some of the down sides of that event. Also, the tragic events of 9/11. Treasury basically has been a stellar Department, and we have high regard for it. When the Treasury Department faces challenges, it basically delivers.

I also hope that you can deliver on the promise to develop concrete ways to close that tax gap. All of us here in the Congress, along with millions of compliant taxpayers, are counting on it. But like you, Mr. Solomon, I can be a patient man, but I, too, have my limits.

Second, the Treasury Department has been considering the recommendations of the President's Tax Reform Panel. Your office performed a dynamic analysis of the two recommended plans, and a third, that is, a consumption tax plan. Officials from your division have been publicly touting the benefits of the consumption tax. It sounds like Treasury is endorsing this plan, and I would like to hear your thoughts on that.

François Rabelais wrote, "All is well in the end, if only the patience to wait." So, Mr. Solomon, it is your turn. You have been patient, and now you are rewarded with the fruits of that patience. You may not like it now that you have the job, but we look forward to working with you.

The CHAIRMAN. We welcome you. Your statement, if you have a long statement, will be put in the record.

We also give you an opportunity, and I think right now would be the best time to do that, for you to introduce family, friends, anybody who has come to support you. That is kind of a tradition of this committee. So if you want to do that, do that now.

Mr. SOLOMON. Thank you, Mr. Chairman. I would like to introduce my wife, Amy Solomon, and my daughter, Sarah Solomon, with me here today.

The CHAIRMAN. All right. Welcome. I know they are very proud of you.

Senator BAUCUS. Why don't you all stand up so we can give you a round of applause for all you are doing?

[Applause.]

The CHAIRMAN. Now, you proceed.

STATEMENT OF ERIC SOLOMON, NOMINATED TO BE ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. SOLOMON. Thank you, Mr. Chairman. Thank you, Senator Baucus. Mr. Chairman, Senator Baucus, Senator Bunning, I am honored to appear before the committee as President Bush's nominee to serve as Assistant Secretary of the Treasury for Tax Policy. It is truly an honor for me to have the opportunity to serve our country in this role.

The collegial and cooperative manner in which the Chairman, Senator Baucus, and other members of the committee work is well known. If confirmed, I hope to work with the committee and your staff in the same way on the important and difficult issues that face our tax system.

I am pleased to come before this committee at a time of sustained economic growth. The President's tax relief, including lower rates on individual income and lower tax rates on capital gains and dividends, among other provisions, has contributed to the strong performance of our Nation's economy.

Nevertheless, as we all know, there are great challenges before us. The foremost challenge is our tax code itself. It is complex, hard to understand, and difficult to administer. It imposes enormous compliance costs on taxpayers and on the government. Its numerous intricate provisions often distort economic decisions.

The tax code contains many provisions that were enacted decades ago and have not been updated to reflect changes in our dynamic and increasingly global economy. Its complexity breeds perceptions of unfairness and creates opportunities for avoidance.

A primary example of the difficulties caused by our tax code is the Alternative Minimum Tax. The reach of the AMT has expanded far beyond its original purpose. We need a tax system that is simple, fair, and promotes economic growth.

The report of the President's Advisory Panel has provided a strong foundation for consideration of ways to ensure that our tax system better meets the needs of our society and economy.

If confirmed, I look forward to working together with Secretary Paulson, the administration, this committee, and the Congress to address the challenging issue of tax reform.

Another critical challenge before us is tax compliance. We are fortunate that the vast majority of Americans fulfill their tax obligations. However, some do not, either because they do not understand their obligations or because they choose to disregard their obligations.

A critical role of the Office of Tax Policy at the Treasury Department is to work together with the IRS to provide timely and appropriate guidance so that taxpayers trying to satisfy their tax obligations know how to do so.

For these taxpayers, published guidance reduces uncertainty and prevents the burden on taxpayers and the IRS caused by audits and litigation. In the years that I have served at the Treasury Department, I have spent an enormous amount of time participating in the effort to combat abusive tax shelters.

In my view, we have made significant progress. A combination of IRS enforcement efforts against taxpayers and promoters, listing

notices, disclosure regulations, press disclosure, and other events have contributed to the decline in improper mass-marketed products.

In this regard, I particularly want to express my appreciation for the actions of Chairman Grassley, Senator Baucus, and other members of this committee, both in your public statements and the leadership that you have provided in Congress to give the Treasury Department and the IRS additional tools needed to address this problem.

An area in which we need to make more progress is the tax gap. The tax gap undermines confidence in the fairness of our tax system and fosters non-compliance. The tax gap also results in a de facto tax increase for compliant taxpayers, who pay more because others fail to pay their share.

The IRS has made headway in its efforts to improve compliance. However, we need to do more to increase the level of compliance. At the same time, we need to maintain the proper balance between enforcement efforts on the one hand, and compliance burdens and protection of taxpayer rights on the other hand.

The President's 2007 budget includes several proposals to reduce the tax gap. These proposals are an important first step in the right direction.

If confirmed, I look forward to working with Secretary Paulson, the IRS, this committee, and the Congress to consider regulatory, administrative, and legislative methods to reduce the tax gap.

In closing, I would like to thank a number of people. First, I want to recognize all of the economists and lawyers in the Office of Tax Policy. I have never worked with such a talented group of people who give so much as part of a team dedicated to public service.

I would also like to recognize Bob Carroll, our Deputy Assistant Secretary for Tax Analysis, with whom I have worked as a partner in heading the Office of Tax Policy for the last year and a half.

Finally, I would like to recognize my parents, Bob and Elaine Solomon, who could not be here today, and my brothers, Neal and Mark, to whom I owe so much.

Most importantly, I want to thank my wife, Amy, and my daughter, Sarah, for their support, patience and love during all these years that I have committed myself to public service.

Thank you again for the opportunity to appear before the committee this morning. I would be pleased to answer any questions.

The CHAIRMAN. We appreciate your thoughtful statement.

[The prepared statement of Mr. Solomon appears in the appendix.]

The CHAIRMAN. Before I ask questions and our 5-minute rounds start, I will take time to ask three questions that we ask every nominee.

Is there anything that you are aware of in your background that might present a conflict of interest with the duties of the office to which you have been nominated?

Mr. SOLOMON. No.

The CHAIRMAN. Do you know of any reason, personal or otherwise, that would in any way prevent you from fully and honorably

discharging the responsibilities of the office to which you have been nominated?

Mr. SOLOMON. NO.

The CHAIRMAN. Third, do you agree, without reservation, to respond to any reasonable summons to appear and testify before any duly constituted committee of Congress, if you are confirmed?

Mr. SOLOMON. Yes.

The CHAIRMAN. Thank you.

Now we will have 5-minute rounds. Since there are three of us here, it will be Grassley, Baucus, and Bunning, then anybody else who comes in afterwards.

Your testimony dealt with the issue of tax reform. Obviously, we commend you on that approach. I appreciate your statement that you want to work with Secretary Paulson and those of us in Congress. You heard me, in my opening statement, speak about a real opportunity to move things forward on tax reform.

I would like to be clear, though, with you. There is a reason our founding father of the Treasury, Mr. Hamilton, wrote that the need for energy in the executive branch is vital to our Nation. We need that energy on this issue of tax reform. It helps very much if the administration leads. It is not absolutely important to get things done, we can do it on our own, but it is a lot better if we have the President out in front.

So, we have the President's Advisory Committee. When that was made public, it was our understanding that the administration was going to review the findings and come forward with recommendations. I suppose I thought that would happen in January, maybe in the State of the Union message. We have not received that, so I am waiting.

I would like your commitment that we are going to see Treasury come forward with its recommendations on tax reform. I would particularly like to have you give me a date-certain. Now, maybe you cannot do it right here in two seconds of hearing me ask for it, but maybe before the Senate votes on your nomination, some sort of reasonable date that that is going to happen.

So right now, in addition to that very short request and admonition, I would like your general views on tax reform and what should be our priorities.

Mr. SOLOMON. Thank you, Mr. Chairman. Tax reform is very important. My first order of priority is to brief Secretary Paulson on tax reform. Of course, he just joined us, was sworn in on Monday. We have already met with him to begin that process.

In terms of my priorities for tax reform, there are, in essence, seven elements. The first is to simplify the tax code. Our tax code is enormously complex. It is hard for taxpayers to comply with it. It is hard to administer. It is full of very complicated provisions that give taxpayers the opportunity to not carry out their obligations. So, the first of my principles is to simplify.

Second, it is important to keep tax rates low. It is important to keep tax rates low because, when taxpayers earn money and they have more after-tax income, they can reinvest that money for the future. That is good for short-term benefits and long-term benefits for the economy. It also allows our businesses to compete in the world economy.

My third principle is that we need to deal with the Alternative Minimum Tax. The Alternative Minimum Tax, as you know, is a separate tax system. Taxpayers have to make a completely separate computation under the Alternative Minimum Tax. It is not indexed for inflation, and there are many deductions that are not allowed.

The amount of revenue collected from the Alternative Minimum Tax, as you well know, is going to increase every single year, so we need to deal with the Alternative Minimum Tax.

Fourth, our tax code needs to encourage savings and investment. Savings and investment are very important, again, so that people can reinvest their money for the future. Again, that has long-term benefits for our economy.

Fifth, we have to recognize various other priorities, for example, the priorities of home-ownership and charities. So, those need to be taken into account.

Sixth, moving to the bigger picture, we need to focus on tax reform as a whole. Much of the discussion so far with respect to some of the proposals of the Tax Reform Panel has focused on particular provisions, a particular provision regarding one particular area, or another particular provision regarding another area.

There has been a lot of focus on the details, but not on the big picture. I think it is important, in dealing with tax reform, that we look at the entire package and try to reach a consensus on an entire package rather than looking at the details.

Finally, we need to be practical. We need to come up with a tax reform plan that is practical, that will be simple, fair, and pro-growth, and that the Congress will find acceptable, and, most importantly, will help the American people.

The CHAIRMAN. Yes. I did not hear a date; I did not expect to. But would you have such a date for me before your nomination comes up on the floor?

Mr. SOLOMON. What I need to do, of course, Mr. Chairman, is to speak to Secretary Paulson first.

The CHAIRMAN. All right.

Mr. SOLOMON. So I am somewhat reluctant to give you a date without speaking to him.

The CHAIRMAN. Of course. Of course.

Mr. SOLOMON. But I do appreciate your question.

The CHAIRMAN. Of course. That is why I am giving you time.

Mr. SOLOMON. Thank you.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

As you might expect, Mr. Solomon, I am going to ask a little bit about the tax gap here. Do I have your commitment that you will work with IRS to get that report in by October 1?

Mr. SOLOMON. You have my commitment to work with the IRS and with Secretary Paulson to work as quickly as possible—as quickly as possible—to come up with a plan.

Senator BAUCUS. We are asking for something, the Chairman and I, both. We are asking for a specific date, and we are asking for something I think is very reasonable, that is, a date that is a couple of months away.

We are not asking for a total solution to the tax gap. We are asking for a plan on how to close the tax gap. The plan will include various elements. That might include recommendations for statutory changes, it might indicate resource needs, but it might indicate other actions that the Treasury would take.

But like any good business, you have to have data and dates. We are just asking for a plan. We will work with the administration, once the administration gives us a plan. We will work with the administration to make sure that it works.

We are not going to be hard, mean, and nasty about this. We are going to be fair, but we are going to be firm, because I think that is what the American taxpayers want. The American public wants us to be firm about this, too.

All the taxpayers who are paying their taxes, I am sure, are a bit upset that Treasury—more specifically, IRS—is not working as hard as it could to close this gap, that is, letting a lot of these other folks off the hook who are not paying their taxes who should be paying their taxes, particularly when it comes down to close to $350 billion a year. Three hundred and fifty billion dollars each year of taxes legally owed, uncollected.

So, can you commit to that plan, to provide a date? I am just talking about a plan now, not a total fix.

Mr. SOLOMON. I understand. I completely share your concern about the tax gap. You can see the priority that I have for it in my initial remarks. I also agree that we need to be thorough and thoughtful about strategies to reduce the tax gap, because we have to balance enforcement and other strategies with attention to taxpayer rights and minimizing burden.

We are already moving forward on addressing the issue of the tax gap. We have a working group, both at the Treasury Department and at the Internal Revenue Service, already engaged on this very important issue.

Senator BAUCUS. All right. Let us just cut through some of this stuff here.

What do you think the two or three main reasons are why we are not collecting this revenue that is legally owed? You have been around a while. You have some ideas. Why is it not being collected? Two or three main reasons, in your best, personal judgment.

Mr. SOLOMON. In my personal judgment——

Senator BAUCUS. Yes. Just personal. You, Eric Solomon. What do you think?

Mr. SOLOMON. In my personal judgment, the most effective ways to collect——

Senator BAUCUS. No, no. I am asking a different question. What are the three main causes why about $350 billion is not being collected?

Mr. SOLOMON. I think there are at least two causes. One cause is that the tax code is so complex and taxpayers do not completely understand their responsibilities. That is one cause. We have a very complex tax code, very hard to understand, very hard to deal with. Some taxpayers do not understand their obligations. That is one reason.

A second reason why people do not pay their taxes is that they are frustrated with our system and they choose, voluntarily, not to pay their taxes.

Senator BAUCUS. Why are they frustrated?

Mr. SOLOMON. Frustrated by the complexity of the system, by the burdens that are imposed by the system.

Senator BAUCUS. Come on. Give me a break. Give me a break. You have to admit, most of it probably is taxpayers who are somewhat sophisticated. They know that they should report more. They know that they should probably expense more than they are, but they are not. They know what they are doing.

A lot of this is a cash-based economy. A lot of people are paying cash, independent contractors, and this and that. They know what they are doing. The IRS is just too timid to go out. They are afraid of losing in Tax Court. They are afraid of losing a case. They are afraid. They are timid. They do not have the resources. The computer systems of the IRS are a joke. They are worse than a joke, they are a travesty. You know that.

Now, come on. Give me the real reasons why you think that there is this tax gap.

Mr. SOLOMON. Senator Baucus, I must say, I do not think that the IRS is timid.

Senator BAUCUS. Oh, they are.

Mr. SOLOMON. I think the IRS has increased its enforcement capability and made strides forward in enforcement.

Senator BAUCUS. Why have they not pursued any of the disclosures that have been revealed to them of shelters? There are at least 30-some on a list that has been available to the IRS for over 2 years, and they have not pursued it. I talk to people that work at the IRS. Basically, they tell me they think the IRS is just too timid. They are afraid.

Mr. SOLOMON. In the area of tax shelters, I think the IRS has made great progress. I think there has been a substantial decrease of the sale of mass-marketed products. In my view, the IRS made a great insight in fighting tax shelters by identifying an important source of the problem as being promoters, and dealing with the promoters.

Senator BAUCUS. Well, my time is up. Mr. Solomon, I have just got to tell you, I am very disappointed. In just listening to you, reading between the lines of what you are saying, listening to the music as well as the words.

I do not get the sense, from what you have said, that you really care that much about this. I do not get the sense that you are outraged about this tax gap. I hear no outrage. I hear no passion. I hear, virtually, not much concern. I hear basically bureaucratic stuff, we are working on it, we are doing this and that. You have not.

I mean, it is getting worse every year. I can give you statistics that show that. But basically, what I am most concerned about is, I do not hear from you the passion that you care about this, that you are fighting for American taxpayers to solve this thing. I do not hear that in the tone of your voice.

Mr. SOLOMON. Senator, I left private practice, in part, to combat tax shelters. I have spent 6 years in the government, helping to combat tax shelters.

My concern about the voluntary tax system is the same as yours. I share your concerns. Just as I have those concerns about tax shelters and have spent 6 years fighting them, I have the same concerns about the tax gap in this country.

Senator BAUCUS. Well then, if that is the case, come September 30, October 1, you are going to have a cracker-jack report, you are going to have a terrific plan for how we are going to solve this, if what you say is true.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Yes, Mr. Chairman. I would like an opening statement put into the record.

[The prepared statement of Senator Bunning appears in the appendix.]

Senator BUNNING. Mr. Solomon, you may know that Senator Conrad and I have introduced life and non-life consolidated tax return legislation in the last two Congresses, picking up on the work of former Senator Thompson. I would like to work with you on this matter going forward.

Specifically, our bill deals with the fact that a group of affiliated companies, that include a life insurance company, cannot fully consolidate their taxable income. Instead, they are subject to outdated limitations that are targeted only at life insurance companies. No other business sector is faced with such issues when consolidating tax returns.

Putting revenue concerns aside for the moment, are there any sound tax policy reasons why these restrictions exist and should not be repealed?

Mr. SOLOMON. Thank you for your question, Senator Bunning. What this relates to is certain consolidated return regulations that deal with a combination on one tax return of life insurance companies and non-life insurance companies, for example, property and casualty companies.

This statutory rule dates back to 1976. It was enacted in 1976 when insurance companies were taxed very differently than the way they are taxed today. In addition, this was enacted when there was a concern about using the losses of casualty companies against the income of life insurance companies. It reflected concerns that were prevalent in the 1970s.

The world has changed a lot since the 1970s. In fact, this is an illustration of how our economy changes over the years, but we do not go back and revisit old statutory provisions.

In addition, not only is there a statutory provision, but the Internal Revenue Service and the Treasury Department promulgated regulations, extensive and complex regulations, to carry out the statutory provisions placing limitations on the consolidation of non-life companies with life companies.

This is one of those areas that perhaps we should revisit. As I said, the world has changed. Life insurance is not taxed the way it used to be, and the regulations are enormously complicated.

This is an area worthy of consideration, both for statutory change or for change of the complex regulations about consolidated

returns, life insurance companies, and non-life insurance companies.

Senator BUNNING. I had a follow-up, but you already answered the follow-up because you have admitted that there is a real problem there and it should be investigated. Maybe we can get it updated.

As you are aware, the government won a major victory yesterday with the *Coltec* decision by the Federal Circuit Court. In that decision, the Appellate Court upheld the application of the Economic Substance Doctrine by overturning a ruling by the court of Federal claims.

One tax expert said that this case has "given new vitality to the Economic Substance Doctrine." Do you believe that yesterday's decision sheds any light on the need, or lack of need, for codification of the Economic Substance Doctrine, as it has been proposed by this committee?

Mr. SOLOMON. Thank you, Senator Bunning. The Economic Substance Doctrine is a judicial doctrine. It is a doctrine formulated by the courts in particular cases. It is not in the Internal Revenue Code. Even though the Internal Revenue Code has lots of technical provisions, the courts, in various cases, to do justice, have created judicial doctrines to reach the appropriate answer.

The Economic Substance Doctrine is one of those doctrines. There are various other doctrines, such as the Sham Doctrine, the Business Purpose Doctrine, and the Step Transaction Doctrine.

There have been proposals to codify the Economic Substance Doctrine. My view has been that it is not necessary to codify the Economic Substance Doctrine. That is a doctrine created by the courts to deal with the factual situations and the legal issues directly presented. It is a very case-sensitive doctrine.

I believe that the courts have applied it in such a flexible manner in the particular cases that are before it, and have done a good job. I think the *Coltec* decision, as well as the *Black & Decker* decision, which was decided just a few months ago, show that the courts are properly applying the Economic Substance Doctrine.

Senator BUNNING. I have more questions, but my time has expired, Mr. Chairman.

The CHAIRMAN. I am not sure how many courts I can mention. You said it was court doctrine, which obviously it is, but some courts have said Congress ought to define it, economic substance. Right? Some courts have said that. My only point is, you have not said anything wrong, but I wanted to follow up.

Mr. SOLOMON. Sure.

The CHAIRMAN. Because you said you did not think we should define it. But have some of those courts not said Congress should define it?

Mr. SOLOMON. In general, the courts have applied the doctrine by themselves. There was one court—and I would have to go back and look—that in one case said it is not in the code, and therefore we should not apply it. But that may have been the lower court in this very case. That may have been the lower court in *Coltec* or the lower court in *Black & Decker*. I would have to go back and look at the lower court case.

The CHAIRMAN. Mr. Solomon, Senator Baucus and I recently sent a letter to Commissioner Everson in regard to the tax gap. In that letter, we noted that the IRS has been unsuccessful in implementing the new web-based version of an electronic fraud detection system database for the past two filing seasons.

The IRS, from the beginning of that project, did not appreciate the risk of the new system and failed to properly fund the project. This resulted in a lack of proper IT oversight throughout the life of the project.

The IRS also failed to learn from mistakes in terms of inaccurate reporting by the contractor throughout the entire process. Despite knowing of inaccurate reporting, it is our understanding that the IRS is still working with the same contractor today.

The result of this project is that the EFDS has been greatly compromised, with substantial taxpayer loss. So, I would like your commitment to look into the situation and to demand accountability from the IRS.

The IRS has had a multitude of problems with IT contracts in the past and has wasted a huge amount of money on projects that have not lived up to expectations. It is my understanding that approximately $20 million was spent on developing the new web-based EFDS, and that the web-based system never materialized. The IRS needs to be more effective in monitoring contractor performance.

Could you commit, that is, as Assistant Secretary for Tax Policy, that you would look into improving IRS oversight of IT contractors so that the government's interests are better protected from waste?

Mr. SOLOMON. Chairman Grassley, you have my commitment to work with the Commissioner to see that this happens. This relates to refund freezes.

The CHAIRMAN. Yes.

Mr. SOLOMON. The IRS is doing several things in the area of refund freezes. First, they are putting in place an improved process to prevent improper refund claims. Second, they are going to do better to notify taxpayers whose refunds have been frozen, and they are going to do better to resolve claims that have been previously frozen. The IRS is working with the Taxpayer Advocate on this issue.

As to the specific issue that you mentioned, yes, I commit to working with the Commissioner to get that result.

The CHAIRMAN. Thank you very much.

I am going to refer to the Mack-Breaux Commission on its comments bearing on who pays the corporate tax. The bipartisan panel noted that, in the long run, the burden of corporate tax is shifted to workers and consumers.

As we think about tax reform, and especially corporate tax reform, and do that in regard to our Nation's competitiveness, it is important that we understand better who actually shoulders a burden of that tax.

The Tax Reform Panel notes that Treasury and CBO still view the burden of corporate income tax being entirely on shareholders. I am concerned that this is a very old-school view, and does not reflect modern economic thinking.

So, these three points. How do you view who bears the burden of corporate income tax? Then your views on the impact of our Nation's high corporate tax rate on our ability to compete globally.

You may have answered some of that in your opening statement; I am cognizant of those comments you made. I would like your commitment to have Treasury review their current position on who bears the burden of corporate income tax and to report back at the end of the year.

Mr. SOLOMON. Mr. Chairman, I am not an economist, but I do know that there are different possible views on who bears the burden of the corporate income tax. Treasury has, in the past, viewed the burden as being borne by the owners of capital.

Working with the Tax Reform Panel, our Office of Tax Analysis, which is a part of our Office of Tax Policy, considered other possibilities. For example, perhaps some of that burden is borne by workers and consumers.

This is under continuing analysis. We are considering our position with respect to who bears the burden of the corporate tax. This is an ongoing topic that we are reevaluating.

In addition, with respect to your comments about competitiveness, high corporate tax rates do affect competitiveness. I discussed that in my opening remarks. Lower tax rates help companies reinvest and help them compete in the global marketplace.

In addition, as you know, our corporate tax system imposes a second level of tax. That is, there is a tax when a company earns money and a second tax when the money is paid out as dividends, so there is a basic distortion in our system that is imposed by the corporate-level tax.

There have been many discussions over the years, as part of the discussion of the integration of the tax system and as part of tax reform, about the extra burden that the corporate income tax imposes because of the double layer of tax.

The CHAIRMAN. Do you have any problem with my request about reporting by the end of the year, which is December 31, in regard to the Treasury's reviewing the current position on who bears the burden of the corporate income tax?

Mr. SOLOMON. We will reconsider it, and I will speak with our economists on that issue. As to what particular date, of course, I need to speak to our economists first. But we are already reconsidering that issue, and there are many different views.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Solomon, I would like to ask you a little bit about tax shelters and the degree to which the IRS and the Treasury are closing down these shelters.

As you know, the IRS and Treasury worked with this committee to develop tough disclosure rules with penalties, the basic theory being that if advisors, promoters, and taxpayers are required to tell the IRS about all these shelters, that they would be less inclined to engage in abusive transactions.

The Congress passed, in October of 2004, legislation that provided for new shelter penalties and stronger disclosure laws. But it has been almost 2 years now, and the IRS has failed to impose

a single disclosure penalty, in my judgment, from a lax systematic process to administer these rules.

So my first question is, to what extent has IRS used these new tools?

Mr. SOLOMON. I do not have specific statistics, and perhaps you have better statistics than I have on this. One thing that I am going to do, as a result of your question, which I have done before, is to sit down with the IRS, particularly with the Office of Tax Shelter Analysis, and ask them these questions.

Senator BAUCUS. Do you know how many disclosure penalties have been asserted to date?

Mr. SOLOMON. No, I do not know.

Senator BAUCUS. The answer is zero.

Mr. SOLOMON. But let me add, Senator, that this was enacted at the end of 2004.

Senator BAUCUS. Two years ago. Almost 2 years ago.

Mr. SOLOMON. Then taxpayers filed their returns. If corporations filed their returns, for example, for 2004, they were filed toward the end of 2005. If the returns are for 2005, those corporate returns have not come in yet. Taxpayers are still filing their returns.

The second point is that, in my view, a penalty's first goal is deterrence. That is, the assertion of the penalty is important, but what is even more important is deterrence. The presence of these penalties has deterred taxpayers.

Senator BAUCUS. But none have been imposed.

Mr. SOLOMON. I very much appreciate, as I said in my opening statement, the words and the actions that you have taken to assist the IRS and the Treasury Department in combatting tax shelters. I worked with your staff and the staff of this committee, to beef up——

Senator BAUCUS. That is right. And we appreciate that. That is why I am asking the question.

Mr. SOLOMON. As I said, I have been involved in this for a long time. In my view, there has been a positive impact, a deterrent effect.

Senator BAUCUS. Do you know how much the penalties are?

Mr. SOLOMON. Off the top of my head? I would have to go and open up the code and look.

Senator BAUCUS. And that will say $10,000 a day. So if those were imposed, that would be significant, I would think.

Mr. SOLOMON. Oh. This is for the listing.

Senator BAUCUS. Yes. The listing.

Mr. SOLOMON. I am sorry. I was thinking about the taxpayer failure to report as opposed to the listing requirement.

Senator BAUCUS. I am talking about the listing. Listing is $10,000 a day.

I have a lot of other questions about that basic point. But I would like, if you do not mind, Mr. Chairman, to turn to another subject. That subject is something you asked a little bit about, and that is an electronic fraud detection system, or the failures of an electronic fraud detection system. You are aware of the problem, are you not?

Mr. SOLOMON. Yes. In fact, Chairman Grassley and I just discussed it. You may have been out at that moment.

Senator BAUCUS. Do you know how many fraudulent refunds were issued by the IRS during the 2006 filing season because the IRS did not have a new refund fraud protection program in place?

Mr. SOLOMON. No. I do not know the exact number.

Senator BAUCUS. Do you know whether there will be any attempt to recoup fraudulent refunds issued in 2006?

Mr. SOLOMON. I do not know of any attempt that will be made. As I said to Chairman Grassley, it is important that this be fixed. I have said that I am going to discuss this with the Commissioner and am committed to moving forward to try to get this problem fixed.

Senator BAUCUS. The IRS has kept this committee in the dark about the failure of this program to work. Do you think it is appropriate for the executive branch to inform Congress about sensitive matters before they become national scandals? Because this is about to be a national scandal.

Mr. SOLOMON. I do not know the circumstances in this particular case of what the IRS said or did not say, so it puts me in a somewhat awkward position to comment on this.

Senator BAUCUS. Is there going to be any kind of a fraud detection program for the 2007 filing season?

Mr. SOLOMON. I certainly hope so, and I intend to talk to the Commissioner about it.

Senator BAUCUS. The amounts involved are huge.

Mr. SOLOMON. The IRS very much shares your concern about preventing improper refunds. Very much shares your concern.

Senator BAUCUS. Well, they may, and I am sure they do at one level. But a lot of it, as you know, is they try to develop new computer systems—I do not have the exact details, but the long and the short of it is, they put one system on hold while they developed a new one, and they contracted that out, and that did not work. They did not go back to the first one.

It looks like a lot of money has been needlessly spent on the contractor who developed the system that did not work. That is why all these fraudulent refunds go out and are not being collected.

Mr. SOLOMON. I believe the Commissioner shares your concern.

Senator BAUCUS. I am sure they share the concern. I am also even more concerned why they have not done more about it and why they have not kept this committee more informed about it so that this committee can help solve it, and one way would be with resources.

Mr. SOLOMON. I appreciate your comments, Senator.

Senator BAUCUS. Well, I know you appreciate it. But this whole thing, as you said earlier, is deeds, not words. We have to get solutions here.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bunning?

I need to ask my colleagues, before Senator Bunning, we are in the middle of a vote. If you want to continue this discussion, then I will go vote and come back while he is asking questions. Did you want to continue another round?

Senator BAUCUS. Yes. I have more questions.

The CHAIRMAN. All right. Senator Bunning, if you will ask your questions now, you will have time. Then we will go vote, then we will come back and finish our discussion.

Senator BUNNING. Thank you.

Late last week, an IRS official, speaking to the ABA, commented on the IRS's attempts to interpret a provision of the recently enacted tax bill. This provision created a new excise tax for exempt organizations that participate in prohibited shelter transactions.

The IRS official indicated that, in many of the provisions in which employee benefit plans are involved, the statute does not seem to require an accommodating partner. It was indicated that many of the provisions could possibly apply to State and local governments, and just about all tax-favored benefit plans.

Has your office been looking into this issue, and do you have any comments on it?

Mr. SOLOMON. Yes, Senator, we have been looking into this issue. In fact, just within the last week, the IRS and Treasury Department issued a notice reminding taxpayers of their responsibilities under this provision, but in addition, and equally importantly, asking for comments about the consequences of the provision, what collateral effects it could have, who could be implicated or who could be subject to it.

So, yes, at the present time we, in fact, are looking at this. Various interested parties have asked to speak with us to describe to us many of the issues that are raised by this provision.

Senator BUNNING. Is it because there are ambiguities in the tax code as it was written or is it because of the interpretation of the IRS in applying the code?

Mr. SOLOMON. The IRS has not yet had the opportunity to apply this provision. This is a brand-new provision. It really comes down to the ambiguities that are in the textual language that we need to interpret. Before doing that, we need to understand the circumstances, as you describe, and situations where tax-exempt organizations, or pension plans, or State and local governments could get caught up in it.

Senator BUNNING. You know, we have an awful lot of tax lawyers on this committee staff. You would think we would be able to write in clear language, that there would not be ambiguities in the code.

Mr. SOLOMON. I am always impressed at how well the drafters draft the code. The English language is inherently ambiguous, words are inherently ambiguous. I think they do an excellent job in trying to draft to eliminate ambiguities.

Senator BUNNING. Can you comment on the Schedule M–3? Has the information been reported on the new form? Has it been helpful to the IRS and Treasury in enforcement and review?

Mr. SOLOMON. Yes. The Schedule M–3, as you are aware, is a form that the IRS, with the help of the Treasury Department, put together to reveal more book tax differences. The old Schedule M was a very small schedule that really did not show many book tax differences.

But the Schedule M–3 breaks it all out. It is a very important tool, in audit, for the IRS to find potentially inappropriate transactions. It also helps the IRS to figure out who are the appropriate people to audit.

The IRS is getting information from this. I believe in the past week the IRS has said publicly that, in fact, they have found, from the book tax differences, meaningful items that need to be audited.

Senator BUNNING. In following up on Senator Baucus's question line, is it a matter of dollars and cents on enforcement as far as the basic problems that we are having, or the IRS is having, or Treasury is having in enforcing what has been written as far as shelters and things like that?

Mr. SOLOMON. Senator Bunning, I really appreciate your question, because you are getting to a very important point. In the discussions that we have been having today about the tax gap, it is not just a question of enforcement. That is, there are important concepts that need to be balanced.

It is not just about increasing enforcement. As you increase enforcement, you need to be concerned about taxpayer rights and burdens that are placed on taxpayers from increasing enforcement.

So it is not just about increasing enforcement. You have to consider these other, very important priorities in deciding how you want to address the tax gap.

Senator BUNNING. I am going to recess the committee because the Chair will be back very shortly. I have to go and make the same vote that they made. So, the committee will stand in recess until the Chair returns.

Mr. SOLOMON. Thank you, Senator.

[Whereupon, at 11 a.m., the hearing was recessed and reconvened at 11:11 a.m.]

The CHAIRMAN. Thank you for your patience, and thank you for being understanding of Senate voting.

Senator Baucus and I have a few other issues to discuss with you. I do not think it will take long.

Mr. SOLOMON. All right.

The CHAIRMAN. The IRS has engaged in significant review of charity hospitals. They have sent out an extensive list of questions to several hundred hospitals, asking questions. I am pleased to see this action, but I am concerned that this is not just a fact-gathering exercise. I hope the end result would be real changes in requirements of charity hospitals.

As you probably know, I am engaged in an ongoing review of like kind. It is clear that these hospitals have so many different policies, that they are all over the map when it comes to providing charity care, community benefit, and charges to the uninsured; some charity hospitals are doing little, some a lot, some nothing.

These charity hospitals are receiving billions of dollars each year in tax benefits. The public has the right to expect real public benefit returns. It is important to remember that the reason for this is that the IRS changed the rules. There was no change in the law.

The IRS, in 1969, I believe was the date, changed the rules because they listened to—well, these are my words—lobbyists who hoodwinked the IRS and the Treasury that the inability to afford medical care was a problem of the past, that it was not going to be something in the future. We are well aware that the inability to afford medical care is very much a problem, and maybe more so now than it was in 1969.

So, Mr. Solomon, it is clear that the IRS and Treasury decision to change the rules regarding charity hospitals in 1969 was based on inaccurate information. I would like your commitment that the Treasury and the IRS are going to go back and look at the real facts, that there is a great need to help low-income people facing medical expenses, and that the Treasury and IRS are going to put out new guidelines during this administration that put real teeth in charity care, community benefit, and charges to the uninsured, and other important issues in that area. Poor people should not have to suffer because of decisions that were made by Treasury back then.

So to that end, I request the following: a time-line for review and proposals for reforming guidance in this area; second, the individuals responsible at Treasury and IRS for reviewing the materials submitted by hospitals and for drafting and reviewing new guidance so that we can talk to them; a copy of all documents, memorandums, and materials in the possession or control of IRS that were related way back then to that 1969 decision; and a copy of all submissions from hospitals that the IRS receives, as well as the names of any hospitals that did not respond.

Mr. SOLOMON. Mr. Chairman, I very much appreciate your leadership in the charity area, including in the hospital area. I know you have been a champion of good governance with respect to charities for years, and we very much appreciate that. Our charitable community is very important to our society. Charitable giving is very important to our society.

At the same time, we need to make sure that our charitable organizations are, in fact, carrying out charitable purposes. So, I very much appreciate your concern. I have been made familiar with the issue. Apparently this dates back to 1969; I believe you are correct.

There is a community benefit standard that is used to determine whether a hospital qualifies for tax-exempt status. I want to make sure that your concerns are addressed, and we will take a fresh look at this. I will participate in taking a fresh look at this.

I do note that the IRS has sent out a questionnaire to various hospitals to try to ascertain more information. The IRS is in the fact-gathering portion of its study of this area. In using those facts, the IRS is going to decide what its next steps are. But speaking for me personally, I want to make sure that your concerns are addressed.

The CHAIRMAN. Thank you very much. I appreciate that. I am glad that the Treasury has initiated what they have already. But I want to make sure it is a useful tool, and as a useful tool, it is used then.

A few years ago—and this is not just your department, but it is going to bring us back to your department—in every department of government there was great interest in performance measures and being able to determine whether government agencies were doing the right thing, or whether they were doing enough of it, and finally whether they were doing a good job of whatever they were supposed to do.

So, how do you think that we should measure performance and success in your office? What should we be looking for as signs of accomplishment and benchmarks? What do you hope to accomplish,

and how do you think that we should be holding you accountable as you and your staff perform this work?

Mr. SOLOMON. Mr. Chairman, there is a lot to that question. First, with respect to our role, the role of the Office of Tax Policy is to provide analysis and give advice to the Secretary of Treasury, and the Secretary of Treasury makes recommendations to the President and to the Congress.

Therefore, one aspect of judging what we do is the quality of advice that we give to the Secretary, and ultimately the quality of the proposals and the recommendations that come to you. So that is one aspect of evaluating what we do, the advice we give to the Secretary and the advice and recommendations that ultimately come to you.

A second area in which you might judge us is how well we work with the Congress, how well we work with you, with Senator Baucus and others, in the responsibilities that we have to provide our views with respect to the difficult tax issues before us. So, working with you, measuring how well we interact with you, how good our advice is, what our recommendations are, I think that is the second aspect.

A third aspect of how to measure us is in implementation, the guidance process. We spend an enormous amount of time working on regulations, notices, revenue rulings, and other guidance to carry out the legislation that you have enacted.

Recent examples of that are in the 2004 JOBS Act. There were very important provisions that needed to have regulations written very quickly, including the repatriation deduction, the manufacturing deduction, and the new rules about deferred compensation.

We immediately engaged in those tasks, and we have issued an enormous amount of guidance in that area. So judging us by what we do in the guidance process is another way of judging whether we have accomplished our mission. I would also add another recent act, the Energy Policy Act. We have issued an enormous amount of guidance. That is another area in which you can measure what we do.

A final way that you might be able to measure us is what we do with respect to the public. As an example, our Office of Tax Analysis prepares studies and other documents for public review to discuss the important issues before us. So, in terms of how you might judge us, those are four ways in which you might judge how we carry out our responsibilities.

The CHAIRMAN. All right. Well, thank you very much.

Senator Baucus, I have two more points I would like to make, then I will stay as long as you want to stay for your questions.

Senator BAUCUS. All right.

The CHAIRMAN. These last two really are not questions. It is explaining something that we have asked for information on and have not gotten, and will you help us get it?

In the JOBS Act, we directed Treasury to produce several studies involving aspects of our international tax regime that are aimed at restricting the ability of multinationals to shift income outside our country. Studies on earnings stripping, transfer pricing, income tax treaties were due no later than June 30, 2005, so you can see we are 13 months behind that.

A study on the effectiveness of the corporate inversions provisions is due no later than December 31 of this year. These studies were requested by us because the issues they will address are vital to protecting our tax base.

These issues are also important to the debate that we are going to be having on tax reform. Therefore, after your confirmation, will you see to it that these studies are completed by the end of the year?

Mr. SOLOMON. Mr. Chairman, completing these studies is a very high priority for us. For the first three, which are the earnings stripping, transfer pricing, and income tax treaties, we are going to try to get those studies done by year-end, as you request.

In fact, right now we are in the fact-finding and economic analysis portion of those studies. That is moving along. That should be completed in September, so we are expecting to complete those reports by the end of this year.

The CHAIRMAN. Yes.

Mr. SOLOMON. With respect to the inversion study, we are currently in the process of issuing guidance. That is, there have been two rounds of temporary regulations that have been issued with respect to inversions, and we are working on a third round of possible guidance with respect to inversions.

An important aspect of that study is to have those guidance items interpreting the statute in place, at which time we can complete the analysis of the effectiveness of those provisions. So that study is going to follow the other three studies, but we are expecting to complete the first three studies by year-end.

The CHAIRMAN. The next one is in regard to the IRS rules on partial annuitization. I think there is some improvement needed in those rules, so I am asking you to work with us, particularly since Americans are living longer and they want to ensure that their retirement savings do not run out.

Partial annuitization is a way of avoiding that. The issue allows retirees to gradually convert portions of their annuity savings into streams of income. I believe that partial annuitization can, and should, be encouraged. There are not clear IRS guidelines on that, so that is a major barrier.

Before he left the Treasury, I wrote a letter to Secretary Snow, asking him to look at this and work with me on a common-sense solution to improving current rules. I would like to ask you to do the same thing. So would you work with me to ensure that we can improve the rules in this area and strengthen Americans' retirement security?

Mr. SOLOMON. Yes, I will, Chairman Grassley.

The CHAIRMAN. And could I also ask you to please give me a response to the letter that I sent to Secretary Snow, and then a time line for addressing that issue as quickly as possible?

Mr. SOLOMON. Yes. I will respond immediately to your letter.

The CHAIRMAN. Good.

Then one point. This is not a matter of having a debate right now, but to further state my position, where I interjected myself into your conversation with Senator Bunning on economic substance.

Regarding the earlier discussion on economic substance and the impact of the *Coltec* case, it is certainly good news for the integrity of our tax system that the Federal Circuit Court of Appeals reversed the ridiculous holding of the Court of Claims that drew the vitality of the judicial doctrine into question.

However, there is still a lack of uniformity among the circuits regarding whether a transaction needs both a business purpose and an economic reality, and what counts as non-tax benefits in determining whether a transaction has economic substance.

So while the *Coltec* case is a welcome decision by the Appeals Court, the need for uniformity in applying economic substance doctrine still remains, and that is the principal goal of codifying the definition of economic substance.

The Senate has done this four or five times in very recent years. We run into trouble in the House of Representatives, but it is something that I think both Senator Baucus and I are committed to getting done, because we ought to have the same principle of taxation on economic substance apply, regardless of whatever circuit you live in.

So, we have different circuits determining different things. We ought to have some uniformity, and that is our goal. Plus, we feel that there is an awful lot of revenue being lost.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Solomon, I am just curious. In the President's budget request, he requested an extension of AMT relief, which you have referred to a couple of times, only through 2006, but not for 2007.

You state that one of your top priorities is AMT relief. But the budget, the guy you work for, does not provide for it. So how are we going to reconcile that?

Mr. SOLOMON. Well, one of my priorities, as I stated, is tax reform. AMT is to be considered in the context of tax reform.

If one is going to deal with the Alternative Minimum Tax, which is, as we discussed, a tax that is going to result in more and more taxpayers being subject to the AMT, it has to be considered in the context of overall reform of our tax code. It is a parallel tax system. We should have a single tax system in which Americans are taxed.

Senator BAUCUS. Well, everybody agrees with you on that. But still, it is very expensive to fix, as you well know. It is not in the President's budget for next year, so it is going to be hard to fix it if it is not in the budget, I would think.

Mr. SOLOMON. As I have said, it is a very important issue, and I think we need to consider what to do about it. It cannot be viewed in isolation.

Senator BAUCUS. It cannot be?

Mr. SOLOMON. It cannot be viewed in isolation.

Senator BAUCUS. I agree with that.

I would like to turn now a little bit to tax reform, generally. The President's budget requested $500,000 for an Office of Dynamic Analysis. But as I mentioned in my opening statement, I have seen the May 25, 2006 Dynamic Analysis prepared by Treasury on the tax reform proposals. So, would I be correct that the funds for dynamic analysis have already been found elsewhere?

Mr. SOLOMON. I am sorry. Could you——

Senator BAUCUS. Have those funds already been found to pay for dynamic analysis? You requested $500,000 for the analysis. You have already done the analysis on the tax reform proposal.

Mr. SOLOMON. We have a limited capability at the present time to do dynamic analysis. As you understand, dynamic analysis measures the effect of changes in the tax law on the larger economy, and it takes into account macroeconomic effects.

Senator BAUCUS. Correct.

Mr. SOLOMON. We have some limited capability at the present time, but not very much.

Senator BAUCUS. But it is very difficult to do.

Mr. SOLOMON. But it is very difficult to do.

Senator BAUCUS. And there are a lot of assumptions.

Mr. SOLOMON. As in all.

Senator BAUCUS. As in all. Even static, lots of assumptions.

Mr. SOLOMON. There are a lot of assumptions. So with our limited resources, we have attempted to do some dynamic analysis, but we would need more resources to do a better job in this area.

Senator BAUCUS. Has Treasury sought outside expert advice before publishing its new dynamic analysis on its work with the Tax Reform Panel? Has Treasury sought outside advice?

Mr. SOLOMON. Treasury believes that its work on dynamic analysis needs to be credible and transparent. In my view, to the extent that a dynamic analysis office gets up and running, it would be very important for the credibility and the transparency of it to engage and discuss this with outside people.

Senator BAUCUS. I am a little concerned about transition relief required under one of the panel's recommendations, and that is the consumption tax, the second of the two recommendations.

I do not believe, frankly, that the transition rules for any of these plans are fully understood, certainly not by the private sector. Maybe by some academics, by some theoreticians, but not by a lot of companies who actually have to pay taxes.

For instance, under the panel's transition rules for the growth and investment plan of the progressive consumption tax, a taxpayer with existing inventory would presumably lose all deductions with the cost of purchasing these goods for resale or purchasing materials or processing. With one-quarter of inventory currently valued at $1.7 trillion, any partial transition relief would be extremely costly. Is that not accurate?

Mr. SOLOMON. Transition issues are extremely important in any tax reform proposal. Depending upon what provisions are enacted in tax reform, you will have to consider transition relief. Depending upon what the provisions are, yes, some could be much more difficult than others. It is one of the most important issues, one of many important issues, in considering tax reform.

Senator BAUCUS. But in this case, the dollar amounts are stupendous that a business would have to pay.

Mr. SOLOMON. Well, in any kind of tax reform, you have to consider transition relief.

Senator BAUCUS. I do not think business understands that at this point. You have people in Treasury saying this is the greatest thing since sliced bread, this consumption tax, in theory.

Mr. SOLOMON. Are you referring specifically to a consumption tax approach?

Senator BAUCUS. The consumption tax approach.

Mr. SOLOMON. My comments were more general, that in any tax reform, you have to consider the issue of transition. The Treasury Department has not adopted any view at the present time as to how tax relief should go forward, if that is the question.

Senator BAUCUS. That is correct. That is correct.

Mr. SOLOMON. All right.

Senator BAUCUS. I am not talking about the consumption tax, the consumption tax proposal in the Tax Reform Panel. It is true, Treasury has not made a recommendation in that regard. But I am just asking the basic question, is it not true that transition relief under that proposed consumption tax——

Mr. SOLOMON. Under the Tax Panel's proposal——

Senator BAUCUS. Yes. The Tax Panel's proposal.

Mr. SOLOMON [continuing]. The transition relief with respect to the growth and investment tax. It is a very important issue. You have to consider it both from the simplified income tax and the growth and investment tax.

If you are moving to a consumption tax, yes, it is a very important issue. I do not personally, at this moment, recall exactly what the number is. But I agree with you, transition is an issue that needs to be given lots of consideration.

Senator BAUCUS. The numbers are just out of sight. They are not understood by the business community. That is why I am making this point to you, right now, today. Hopefully, somebody in the business community might take note, that some of the theoretical proposals by some within the Treasury—in fact, one person sitting behind you is one of the major persons doing this—is flawed.

That is, it has huge complications, huge implications for business, and I do not know that business understands that, with respect to the consumption tax proposed by the Tax Reform Panel.

Mr. SOLOMON. I understand. Again, it goes back to a comment I made before. We should look at the entire packages and consider all the issues in entire packages and not just focus on one of the issues.

Senator BAUCUS. You mentioned five or six goals when you first made your statement, and I appreciate those. But as you were listing them, I was just struck by how you do all of this, that is, including AMT relief, to keep tax rates low, protect home-ownership and charities, and so forth, how that fits within the context of the budget. We have to pay for some of this, too. We have to balance things out. At least, that is the theory, here.

Mr. SOLOMON. That is part of the challenge. I listed these as goals. Some of those goals may be more achievable than others. But you have to take all the pieces, all the parts, and put them together to make a practical package. That was my final point.

Senator BAUCUS. I appreciate that.

Do you believe that tax cuts pay for themselves?

Mr. SOLOMON. I am not an economist, but, in my view, tax cuts affect behavior. Appropriate tax cuts can affect behavior that helps the economy grow and affect tax revenues.

Senator BAUCUS. I appreciate that. But do they pay for themselves?

Mr. SOLOMON. Again, in my personal view, not being an economist, I would say that the way I described it is my personal view of what tax cuts do.

Senator BAUCUS. I am just saying, we are warning everybody that there is a limit here. Your boss, about-to-be boss, Secretary Paulson, sitting where you are now, when that question was asked of him, said, no, tax cuts do not pay for themselves. He did go on to say some of what you have said.

I am just saying, we have to be careful, not going down this road of assuming that tax cuts are the salvation of everything, the old supply side stuff. I am just asking us to get off the partisan rhetoric here and look at the actual factual analysis, the degree to which tax cuts add to the deficit, or do not.

I am not talking about the *Wall Street Journal* editorial page. They have one ideological view and they cannot see anything else besides their one view. I am, rather, talking about just trying to be honest and analytic and being factual about all this.

Sure, tax cuts are great, but we have also got to pay for a lot of things, too. So just lowering taxes alone is not going to balance the budget. You have to also have tax revenue to balance the budget when you are going through all your tax reform.

Now, let us finish on that one final point. I do not know this, but it may be the administration is thinking about, next year, proposing some kind of entitlement commission, some way to address the question of entitlements.

I am just suggesting to you, Mr. Solomon, as strongly and as effectively as I can, when the subject comes up to the administration, that you counsel the administration to do this the right way, not for partisan political purposes.

The President, regrettably, set up a commission for Social Security. It was a partisan, ulterior-motive operation to privatize Social Security. It was dead on arrival. There have been other proposals.

The Medicare Commission also had ulterior motives. That, too, was dead on arrival. This Tax Reform Panel, frankly, is another one. It is very, very questionable because the deck was stacked. There were various ulterior motives when that was put together. Let me put it this way.

In a tax bill, several years ago, I suggested an honest-to-goodness, true Tax Reform Panel, a commission to look at just some of the things you mentioned, namely, the complexity of the code, the inconsistencies in the code, inefficiencies of the code, et cetera, and let us figure out a way to get a much better system.

I suggested a bipartisan panel, Republicans and Democrats, and this and that. I talked to the Chairman about it, and he thought it was a good idea. Senator Voinovich from Ohio was really excited about it, and we offered to put that amendment in.

In conference, guess what happened? Lo and behold, it was taken out in conference. You know why? Because the administration wanted to have its own, and its own was the Tax Reform Panel we have just been talking about.

They did not want to do it the right way, the right way being non-partisan, both ends of Pennsylvania Avenue working together.

Rather, they wanted to do it their way, their way or the highway, and that is why it is not getting very far, and that is why it is not doing terribly well.

So we have a commission—if we do, if the administration suggests one—on entitlements, I strongly suggest, it has to have everything on the table. It has to have entitlement reform, as well as other spending on the table, discretionary spending, as well as revenue. You have to have it all on the same table. It has to pass the "smell" test. It cannot be political, it cannot be partisan.

I just strongly urge you to push for that point of view, a commission very similar to the Commission on Social Security back in the 1980s when Social Security was in very tough shape.

President Reagan appointed Alan Greenspan, a bipartisan outfit. They shook hands. They were going to do this together. It was not partisan, it was not political. We got a good solution. That is the only way, in my judgment, we are going to be able to address true tax reform, true entitlement reform, and get a handle on our finances.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

I want to begin by expressing my thanks to you, Mr. Chairman, for the announcement that today we are going to begin the effort to look at tax reform. As you know, you and I have talked about this on many occasions, you, I, and Senator Baucus.

I want to thank Senator Baucus as well, because I think this is really welcome news, Mr. Chairman and Senator Baucus, that we are going to have a chance to look at this in a bipartisan kind of way. I appreciate all of the conversations both of you have had with me over the last few months.

Mr. Solomon, as you know, I introduced the Fair Flat Tax Act to try to begin the effort to develop, on a bipartisan basis, tax reform. I want to begin by asking you about what I think is an awful lot of common ground that can exist on this tax reform issue. Let me give you some examples.

My simplified 1040 tax form, in my Fair Flat Tax, is 30 lines long; the President's panel has one that is a few lines longer. For purposes of government work, they are the same. I mean, this is not something that needs to be a huge partisan bicker-fest. In my Fair Flat Tax proposal, a one-page 1040 form; the President has got one that, for all practical purposes, is almost the same.

In my Fair Flat Tax, we take the brackets from six to three; the President's commission goes from six to four. The reason I chose three is, I chose the same ones Ronald Reagan began with when he began this effort in 1986. So again, for purposes of government work, we are about at the same place.

I proposed abolishing the Alternative Minimum Tax; Chairman Grassley, Senator Baucus, and I have been working together on that. The President proposes that as well. Is it not a fact that, as we begin this debate on tax reform, beginning with the Chairman's hearing, there is a lot of common ground that exists right now that could bring Democrats and Republicans together and get us started on this?

Mr. SOLOMON. Senator Wyden, thank you for raising this. I appreciate the prior opportunity that we had to discuss these issues.

I believe there is a lot of common ground. Before you came in, I was talking about some of the elements.

Chairman Grassley asked me, what are some of the important elements that I would see in tax reform? Interestingly enough, they correspond to many of the items that you have discussed. For example, simplification, trying to keep rates low, dealing with the Alternative Minimum Tax. There are many elements that can be the basis for common ground for discussing this important issue.

Senator WYDEN. What did you think about the basic philosophy of what was done in 1986? I do not want you to go through everything, but the basic philosophy of 1986 was to try to drive down rates, keep progressivity, get rid of clutter. I mean, that was essentially what was done in 1986.

What do you think, just your own personal judgment? I recognize it is not an administrative position. But just, what is your sense about that kind of approach?

Mr. SOLOMON. I think the approach of trying to keep rates low, trying to simplify the code, are very important priorities.

Senator WYDEN. How about progressivity?

Mr. SOLOMON. And progressivity is important as well. One additional element that we have today is dealing with the Alternative Minimum Tax.

Senator WYDEN. Right.

Mr. SOLOMON. The Tax Act of 1986 did the things that you said, lowered rates, broadened the base, maintained progressivity. Today, we have an additional challenge, which is dealing with the Alternative Minimum Tax.

Senator WYDEN. Since 1986, there have been more than 14,000 changes to the tax code. It comes to three for every working day for the last 19 years. If, on a bipartisan basis, we can get tax reform accomplished this time, I am looking at ways to keep us from sliding back, if we can get it done.

Do you have any thoughts on that? I mean, obviously tax policy is one where, given the nature of changes in the economy, you always have to be prepared to deal with those, and this is the committee that deals, of course, with the code and has a huge role over what happens in American economic life.

But do you have any thoughts on what can be done as part of a tax reform effort this time to keep the Congress, if we can get there again as we did 20 years ago, to keep from sliding back and just having another 14,000 breaks in the next 20 years, then starting all over?

Mr. SOLOMON. Senator, as someone who works extensively in published guidance, I can completely appreciate the 14,000 changes that have occurred since 1986. One of our primary responsibilities is to draft regulations to try to interpret those 14,000 changes.

I also agree with your point for the need for stability in our tax code. Stability is very important for planning, for individuals, for small business, for large corporations. So, stability is very important as well.

One of the challenges we face is to try to create a stable tax code. Part of the issue is, in fact, our democratic process. One of the great aspects of our democratic process is that the Congress can respond to the needs of various constituencies. But one of the chal-

lenges we face is, if we simplify the law, perhaps that there will be more reluctance to change it through 14,000 changes over a period of 20 years.

Senator WYDEN. I am going to be asking you some more about this, because the Congress is now moving with earmark reform to crack down on some of the foolish budget spending. I think we ought to be having a debate on a bipartisan basis about tax breaks and tax rules that also do not really get us a lot of value for the break, since it is the American people's money.

I want to ask you about one other issue. Again, it relates to the changes since tax reform the last time. On the corporate side, in my Fair Flat Tax proposal, one of the major differences between what I did and what was done in 1986 is, I was a bit more cautious about real estate, given all the changes that have taken place in the real estate sector over the last 20 years.

But I was tougher on energy subsidies, because I am convinced that these energy subsidies, particularly after I asked all the oil company executives whether they needed them and they all said no, I think we can look to make some savings there.

What is your reaction to that philosophical kind of bent? Again, not the administration taking a position, but particularly as it relates to history? I think a lot has happened in the real estate and the housing sector which has caused me to be more cautious there. I think a lot of these energy subsidies—I mean, we are spending $20 billion on royalty relief alone—have lost their historical basis.

What are your thoughts on those two changes, in particular?

Mr. SOLOMON. I think one of the important aspects of any tax reform proposal is to try to have consistent treatment among different economic activities. That is, to try to prevent tax-related distortions. One of the issues that we have in our current code is that there are many tax-related distortions.

In a perfect world, the tax code would not create any economic distortions. There are situations, though, where it is important to social policy to have certain preferences, to encourage certain behavior.

It gets into this balancing, that is, the equal treatment of all versus whether or not certain preferences should be extended to certain groups or certain industries. Not only would you have to consider that for real estate, and oil and gas, but you would have to consider that across the board.

Senator WYDEN. Let me ask you one other question. The Chairman has been very gracious, as always, to give me the time.

The session, for all practical purposes, as it relates to big tax reform and the like is over. So here we are in July, and fortunately Chairman Grassley is stepping up and we are going to have the hearing with former Senators Breaux and Mack, and that will be useful. We have had some useful discussions with Secretary Paulson.

But the next 6 months are going to be critical, this period between July and January especially, because that is the period of time the Congress will not be here much of that session, and of course, that is the period where you really frame the debate.

Hopefully, in the next State of the Union address the President will have an opportunity, on a bipartisan basis, to challenge the Congress and the country to step forward and work together.

What are you going to be doing, as of now, between this period and early next year to help us advance the cause? For example, are you all starting to model various scenarios? If you are, of course, I hope that one of the first models will be on the Fair Flat Tax Act and the like.

But kidding aside, tell me how you are spending your time, whether you are modeling, now, various kinds of scenarios, and what are you all doing in this period between July of 2006 and January of 2007, which is when the key prep work gets done, so that hopefully we can move forward?

Mr. SOLOMON. There are many questions in your question. Our first order of business, as I mentioned before, is to brief Secretary Paulson on tax reform, to bring him up to speed on all the issues that we have been considering.

In the time since the Tax Panel issued its report, we have been studying the report, and we have been considering alternatives to the proposals that the Tax Panel has brought forward.

But I agree with you, we need to consider this issue shortly. I think it is an important time, and I think we need, at the Treasury Department, to move forward with our consideration of this as quickly as possible.

Senator WYDEN. But are you doing the modeling? I mean, for example, there are a variety of reform proposals that have been offered. I have made one, Senator DeMint has one that I am sure he will want to have considered; a variety of Senators have them.

We want to make sure, to accelerate this debate, when we call you, that you will be able to get into the nuts and bolts of those proposals. To do that, you have to model them.

Mr. SOLOMON. Yes. We have considered, among ourselves, various alternatives. Is that economic analysis or in terms of revenue?

Senator WYDEN. Right. It is both.

Mr. SOLOMON. To others, we have given some consideration, but we also have been considering internal alternatives.

Senator WYDEN. What is an "internal alternative"?

Mr. SOLOMON. We have been considering options. We have been considering our own possible options with respect to tax reform.

Senator WYDEN. Well, I hope that you will look at both, because there are Senators on both sides of the aisle who have proposals that they feel strongly about, both on and off this committee.

You all have thoughts on it, and it is going to be essential that, certainly as we move towards the end of the year, when we get down to looking at various ways that we might be able to proceed on this, that you can give us both revenue and essentially economic analysis to some of the implications. You can be sure you will be getting a number of calls from me about this after you are in place.

Mr. Chairman, thank you. Again, when I read the comments you had in the last paragraph of your statement, Mr. Chairman, I think that is really good news. I think it is good news that we are going to be moving ahead. You have had many conversations with me about this, and I am really glad to see that.

The CHAIRMAN. We have not had our last one.

Senator WYDEN. I thank you.

The CHAIRMAN. I did have another question about tax cuts paying or not. I do not disagree with anything you said, so do not take it wrong. In fact, a lot of it is in agreement.

But on the question, do tax cuts pay for themselves, as you know, and as you have heard, some have alleged that they do not pay for themselves. I just told you, I agree with what you said. I guess I would go at this a little bit differently than you did, but not disagreeing with you.

I would ask the question this way: can you, or anybody, I would ask, prove that tax cuts do not pay for themselves? A fair answer is the answer you gave in your testimony. The truth is, opponents of the relief cannot prove that tax cuts do not have behavioral effect.

The opponents cannot prove that point, that is, that tax relief does not produce positive economic impact.

That obviously does not prove that it does not lead to more revenue.

So I am reminded of something that George Yin said, who has now left our committee as Director of Joint Tax. He had an exchange with Senator Schumer, asking a question about the unused tax benefits for the Liberty Zone legislation that we passed after September 11, 2001 to help New York City recover.

Mr. Yin said, to that question, the point of incentives was to spur activity. The activity did occur, which is a good thing. So the point that I am making is, the revenue estimating is important, but it is not the whole story.

So, I would like to keep this dynamic in mind as we approach now what is going to be—some in July, and then some again in September—the debate of reform as we hold some hearings before this committee.

Now, if you would like to comment, you could comment, but you do not have to.

Mr. SOLOMON. What I would add, Mr. Chairman, is that tax relief, as I said, affects behavior, which helps the economy. In part, it goes to dynamic analysis. Dynamic analysis takes into account larger macroeconomic effects in understanding the impact of tax relief.

The CHAIRMAN. For staff of any members, or any members listening elsewhere on television, if you have written questions of this nominee, I would like to have them submitted by tomorrow.

Then, of course, an admonition to you is, we usually make sure that every question is answered before we bring up your nomination. Thank you very much.

Mr. SOLOMON. Thank you, Mr. Chairman.

The CHAIRMAN. And good luck to you in your new endeavor.

Mr. SOLOMON. Thank you, Mr. Chairman.

[Whereupon, at 11:53 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement for Senator Bunning
Senate Committee on Finance
Solomon Nomination Hearing
13 July 2006

Thank you, Mr. Chairman.

I would like to welcome Mr. Solomon before our committee today as we consider his nomination to become the new Assistant Secretary for Tax Policy at the Treasury Department.

I am very pleased with this nomination. This is an important post within the Treasury Department, and I am sorry that it has been vacant for so long.

In nominating Mr. Solomon, the President has made a sound decision. This committee is very familiar with Mr. Solomon, given his many years of service to the Treasury Department. My office has found him to be very knowledgeable and responsive to our inquiries.

I support Mr. Solomon's nomination to this post. I look forward to continuing to work with him once he is confirmed by the Senate.

Thank you.

Statement of Senator Gordon H. Smith
U.S. Senate Committee on Finance Hearing
Nomination of Eric Solomon as Assistant Secretary of the Treasury for Tax Policy
July 13, 2006

I am very pleased to support the nomination of Eric Solomon as Assistant Secretary of the Treasury for Tax Policy.

Mr. Solomon is extremely qualified for this position. He has over 20 years of tax policy experience in both the public and private sector. Mr. Solomon has worked at the Treasury Department since 1999, where he currently serves as Deputy Assistant Secretary (Regulatory Affairs). He also headed the IRS legal division with responsibility for all corporate tax issues. In addition, Mr. Solomon spent years in private practice working for individuals and businesses.

Mr. Solomon is very well respected in the tax community. He is described by many as a solid tax attorney with excellent technical expertise. Mr. Solomon has a strong understanding of many aspects of tax policy – a critical attribute for this position.

Mr. Solomon played a key role in designing and implementing tax relief legislation over the past few years. Thanks to these pro-growth economic policies, we have a strong U.S. economy today. According to virtually every economic indicator, the U.S. economy is thriving. Our economy grew at a 5.6 percent rate for the first quarter of 2006. This is the fastest rate since 2003 and faster than any other major industrialized nation. In addition, we have an unemployment rate of 4.6 percent, which is below the average rate for each of the past four decades.

The Bush pro-growth policies also have been positive for my home state of Oregon. Total employment in Oregon reached 1.7 million in May, which is 3.6 percent higher than last year. This expansion includes an additional 4,000 new jobs that were created by Oregon employers in May. Furthermore, our unemployment rate has fallen to 5.6 percent from 6.3 percent a year ago. Oregonians also are paying less in taxes. In all, Oregonians are paying $9.8 billion less in taxes thanks to the Bush tax cuts.

I also hope to work with Mr. Solomon on my tax reform priorities. One issue that I'm particularly concerned about is ensuring Americans are financially secure in retirement. The personal savings rate in the U.S. has declined dramatically over the last two decades, reaching minus 1.6 percent in April. This is the eleventh consecutive month that the savings rate has been negative. This is a very disturbing trend that needs to be reversed.

To address our savings problem, last June I introduced the Retirement Savings and Security Act of 2005. This bill will increase Americans' retirement savings, encourage the purchase of lifetime annuities and simplify the retirement plan rules. In addition, I'm currently developing a new bill that will focus on the retirement security of women. This is because women face greater financial risk than men in retirement. Women tend to live longer and women receive significantly less income during retirement than men. I look forward to working with Mr. Solomon to enact these important bills.

Mr. Solomon will be both a strong and effective Assistant Secretary for Tax Policy. I am very proud to support his nomination.

Thank you.

Prepared Statement of Eric Solomon
Nominee for Treasury Assistant Secretary for Tax Policy
July 13, 2006

Mr. Chairman, Senator Baucus, and Members of the Senate Finance Committee, I am honored to appear before the Committee as President Bush's nominee to serve as Assistant Secretary of the Treasury for Tax Policy. It is truly an honor for me to have the opportunity to serve our country in this role.

The collegial and cooperative manner in which the Chairman, Senator Baucus, and the other Members of the Committee work is well known. If confirmed, I hope to work with the Committee and your staff in the same way on the important and difficult issues that face our tax system.

I am pleased to come before this Committee at a time of sustained economic growth. The President's tax relief, including lower tax rates on individual income and lower tax rates on capital gains and dividends, among other provisions, has contributed to the strong performance of our Nation's economy.

Nevertheless, as we all know, there are great challenges before us. The foremost challenge is our tax code itself. It is complex, hard to understand and difficult to administer. It imposes enormous compliance costs on taxpayers and on the government. Its numerous intricate provisions often distort economic decisions. The tax code contains many provisions that were enacted decades ago and have not been updated to reflect changes in our dynamic and increasingly global economy. Its complexity breeds perceptions of unfairness and creates opportunities for avoidance.

A primary example of the difficulties caused by our tax code is the alternative minimum tax (AMT). The AMT is a parallel tax system that, for many taxpayers, requires a second computation of tax liability. It was enacted in 1969 to ensure that a small group of high-income individuals who paid no income tax would pay at least some tax. The reach of the AMT has expanded far beyond its original purpose.

We need a tax system that is simple, fair, and promotes economic growth. The Report of the President's Advisory Panel on Federal Tax Reform has provided a strong foundation for consideration of ways to ensure that our tax system better meets the needs of our society and economy. If confirmed, I look forward to working together with Secretary Paulson, the Administration, this Committee and the Congress to address the challenging issue of tax reform.

Another critical challenge before us is tax compliance. We are fortunate that the vast majority of Americans fulfill their tax obligations. However, some do not, either because they do not understand their obligations or because they choose to disregard their obligations. A critical role of the Office of Tax Policy at the Treasury Department is to work together with the IRS to provide timely and appropriate guidance so that taxpayers

trying to satisfy their tax obligations know how to do so. For these taxpayers, published guidance reduces uncertainty and prevents the burden on taxpayers and the IRS caused by audits and litigation.

In the years that I have served at the Treasury Department, I have spent an enormous amount of time participating in the effort to combat tax shelters. In my view, we have made significant progress. The combination of IRS enforcement efforts against taxpayers and promoters, listing notices, disclosure regulations, enactment of the Sarbanes-Oxley Act, press disclosures, and other events have contributed to the decline in improper mass-marketed tax products. In this regard, I particularly want to express my appreciation for the actions of Chairman Grassley, Senator Baucus and other members of this Committee, both in your public statements and in the leadership you have provided in Congress to give the Treasury Department and the IRS additional tools needed to address this problem.

An area in which we need to make more progress is the tax gap. The tax gap undermines confidence in the fairness of our tax system and fosters noncompliance. The tax gap also results in a de facto tax increase for compliant taxpayers who pay more because others fail to pay their share.

The IRS has made headway in its efforts to improve compliance. However, we need to do more to increase the level of compliance. At the same time, we need to maintain the proper balance between enforcement efforts, on the one hand, and compliance burdens and protection of taxpayer rights on the other hand.

The President's 2007 Budget includes several proposals to reduce the tax gap. These proposals are an important first step in the right direction. If confirmed, I look forward to working with Secretary Paulson, the IRS, this Committee and the Congress to consider regulatory, administrative and legislative methods to reduce the tax gap.

In closing, I would like to thank a number of people. First, I want to recognize all the economists and lawyers on the staff of the Office of Tax Policy. I have never worked with such a talented group of people who give so much as part of a team dedicated to public service. I would also like to recognize Bob Carroll, our Deputy Assistant Secretary for Tax Analysis, with whom I have worked as a partner in heading the Office of Tax Policy for the last year and a half.

Finally, I want to recognize my parents, Bob and Elaine Solomon, and my brothers, Neal and Mark, to whom I owe so much. Most importantly, I want to thank my wife Amy and my daughter Sarah, for their support, patience and love during all these years that I have committed myself to public service.

Thank you again for the opportunity to appear before the Committee this morning. I would be pleased to answer any questions.

SENATE FINANCE COMMITTEE
STATEMENT OF INFORMATION REQUESTED OF NOMINEE

A. BIOGRAPHICAL INFORMATION

1. Name: (Include any former names used.)

   Eric Solomon

2. Position to which nominated:

   Assistant Secretary (Tax Policy), U.S. Treasury Department

3. Date of nomination:

   May 9, 2006

4. Address: (List current residence, office, and mailing addresses.)
   Residence &
   Mailing address: 3934 Highwood Court NW
   Washington, DC 20007

   Office: U.S. Treasury Department
   1500 Pennsylvania Ave. NW, room 3104
   Washington, DC 20220

5. Date and place of birth:

   January 6, 1954, Princeton, NJ

6. Marital status: (Include maiden name of wife or husband's name.)

   Married to Amy Durant

7. Names and ages of children:

   Sarah Solomon, 14

8. Education: (List secondary and higher education institutions, dates attended, degree received, and date degree granted.)

School	Dates Attended	Graduation Date	Degree
Princeton High School	1967-1971	1971	
Princeton University	1971-1975	1975	A.B.
Univ. of Virginia Law School	1975-1978	1978	J.D.
NYU Law School	1979-1984	1984	LL.M.

9. Employment record: (List all jobs held since college, including the title or description of job, name of employer, location of work, and dates of employment.)

- 6/75 to 8/75: Camp counselor; Camp Susquehannock; Brackney PA
- 6/76 to 8/76: Law clerk; New Jersey Attorney General, Antitrust Section; Trenton NJ
- 6/77 to 8/77: Summer associate; Kilpatrick, Cody, Rogers, McClatchey & Regenstein; Atlanta GA
- 9/78 to 1/83: Associate; Breed, Abbott & Morgan; New York NY
- 1/83 to 8/86: Associate; Cadwalader, Wickersham & Taft; New York NY
- 9/86 to 11/90: Associate and then Partner; Drinker Biddle & Reath, Philadelphia PA
- 11/90 to 2/96: Assistant Chief Counsel (Corporate) and then Deputy Associate Chief Counsel (Domestic Technical), Internal Revenue Service, Washington DC
- 2/96 to 10/99: Partner; Ernst & Young; Washington DC
- 10/99 to present: Acting Deputy Assistant Secretary (Tax Policy), then Deputy Assistant Secretary (Tax Policy), then Deputy Assistant Secretary (Regulatory Affairs), then also Acting Deputy Assistant Secretary (Tax Policy); Washington DC
- 1/96 to present (each spring semester): Adjunct Professor, Georgetown University Law School (co-teacher of course in tax LL.M. program).

10. Government experience: (List any advisory, consultative, honorary, or other part-time service or positions with Federal, State or local governments, other than those listed above.)

See answer to question A.9. above

11. Business relationships: (List all positions held as an officer, director, trustee, partner, proprietor, agent, representative, or consultant of any corporation, company, firm, partnership, other business enterprise, or educational or other institution.)

None presently. I was a partner at Ernst & Young LLP from 1996 until I joined the Treasury Department in October 1999. I was a partner at Drinker Biddle & Reath from 1988 to 1990.

12. Memberships: (List all memberships and offices held in professional, fraternal, scholarly, civic, business, charitable, and other organizations.)

None presently. (From 1990 to 2001, I was on the board of directors of the Susquehannock Fund, a nonprofit corporation that provided scholarships for needy children to attend summer camp. I was Treasurer of the Susquehannock Fund from 1996 to 2001.)

13. Political affiliations and activities:

a. List all public offices for which you have been a candidate.

None

b. List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None

c. Itemize all political contributions to any individual, campaign organization, political party, political action committee, or similar entity of $50 or more for the past 10 years.

None

14. Honors and Awards: (List all scholarships, fellowships, honorary degrees, honorary society memberships, military medals, and any other special recognitions for outstanding service or achievement.)

Distinguished Service Award presented by Secretary Lawrence Summers, January 2001

Secretary's Honor Award presented by Secretary John Snow, July 2005

15. Published writings: (List the titles, publishers, and dates of all books, articles, reports, or other published materials you have written.)

"The Continuity of Interest and Continuity of Business Enterprise Regulations," Vol. 9 of Tax Strategies for Corporate Acquisitions (Practising Law Institute 2005)(with Rose Williams)

"Acquisitive D Reorganizations," Vol. 10 of Tax Strategies for Corporate Acquisitions (Practising Law Institute 2005)(with Philip Wright)

"Intercompany Transactions," Vol. 1 of Consolidated Tax Return Regulations (American Law Institute – American Bar Association 2005)(with Mary Heath and Joseph Pari)

"A Primer on Structuring Taxable Corporate Acquisitions," New York University 57th Institute on Federal Taxation (1999)(with Stephen Rose and Todd Molz)

"Corporate Combining Transactions," 73 Taxes 829 (Dec. 1995)

16. Speeches: (List all formal speeches you have delivered during the past five years which are on topics relevant to the position for which you have been nominated. Provide the Committee with two copies of each formal speech.)

I have given numerous speeches on behalf of the Treasury Department during my terms of service from 1999 to the present (as an employee of the Office of Tax Policy) and from 1990 to 1996 (as an employee of the Internal Revenue Service). None of these speeches have a written text.

17. Qualifications: (State what, in your opinion, qualifies you to serve in the position to which you have been nominated.)

I have spent many years in private practice, which gives me an understanding of how our tax system applies to and affects individuals and businesses. I have spent many years in government service, both at the Internal Revenue Service and at the Office of Tax Policy at the Treasury Department, which gives me an understanding of tax administration, tax policy and tax legislation.

B. FUTURE EMPLOYMENT RELATIONSHIPS

1. Will you sever all connections with your present employers, business firms, associations, or organizations if you are confirmed by the Senate? If not, provide details.

I have severed all connections with nongovernmental employers. (I do, however, continue to have section 401(k) retirement plan accounts with respect to my former employment at Drinker Biddle & Reath and Ernst & Young. I ceased making contributions to these accounts when I left employment at each of these firms.)

2. Do you have any plans, commitments, or agreements to pursue outside employment, with or without compensation, during your service with the government? If so, provide details.

No

3. Has any person or entity made a commitment or agreement to employ your services in any capacity after you leave government service? If so, provide details.

No

4. If you are confirmed by the Senate, do you expect to serve out your full term or until the next Presidential election, whichever is applicable? If not, explain.

Yes

C. POTENTIAL CONFLICTS OF INTEREST

1. Indicate any investments, obligations, liabilities, or other relationships which could involve potential conflicts of interest in the position to which you have been nominated.

I am not aware of any potential conflicts of interest. Any potential conflict of interest will be resolved in accordance with my Ethics Agreement with the assistance of Kenneth R. Schmalzbach, the Designated Agency Ethics Official. Should any potential conflict arise in the future, I will seek guidance from a Treasury Department ethics official.

2. Describe any business relationship, dealing or financial transaction which you have had during the last 10 years, whether for yourself, on behalf of a client, or acting as an agent, that could in any way constitute or result in a possible conflict of interest in the position to which you have been nominated.

I am not aware of any potential conflicts of interest. Any potential conflict of interest will be resolved in accordance with my Ethics Agreement with the assistance of Kenneth R. Schmalzbach, the Designated Agency Ethics Official. Should any potential conflict arise in the future, I will seek guidance from a Treasury Department ethics official.

3. Describe any activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat, or modification of any legislation or affecting the administration and execution of law or public policy. Activities performed as an employee of the Federal government need not be listed.

In the spring of 1997 I assisted AirTouch Communications in its unsuccessful efforts to delay the effective date of tax legislation under Code section 355(e) that affected spinoff transactions.

4. Explain how you will resolve any potential conflict of interest, including any that may be disclosed by your responses to the above items. (Provide the Committee with two copies of any trust or other agreements.)

I am not aware of any potential conflicts of interest, but should any potential conflict of interest arise, I will seek guidance from a Treasury Department ethics official. I will resolve any potential conflict of interest in accordance with my Ethics Agreement with the assistance of Kenneth R. Schmalzbach, the Designated Agency Ethics Official.

5. Two copies of written opinions should be provided directly to the Committee by the designated agency ethics officer of the agency to which you have been nominated and by the Office of Government Ethics concerning potential conflicts of interest or any legal impediments to your serving in this position.

To be provided

6. The following information is to be provided only by nominees to the positions of United States Trade Representative and Deputy United States Trade Representative:

Have you ever represented, advised, or otherwise aided a foreign government or a foreign political organization with respect to any international trade matter? If so, provide the name of the foreign entity, a description of the work performed (including any work you supervised), the time frame of the work (e.g., March to December 1995), and the number of hours spent on the representation.

Not applicable

D. LEGAL AND OTHER MATTERS

1. Have you ever been the subject of a complaint or been investigated, disciplined, or otherwise cited for a breach of ethics for unprofessional conduct before any court, administrative agency, professional association, disciplinary committee, or other professional group? If so, provide details.

No

2. Have you ever been investigated, arrested, charged, or held by any Federal, State, or other law enforcement authority for a violation of any Federal, State, county or municipal law, regulation, or ordinance, other than a minor traffic offense? If so, provide details.

No

3. Have you ever been involved as a party in interest in any administrative agency proceeding or civil litigation? If so, provide details.

No. (However, I was a partner at Ernst & Young LLP, which was a party in interest in litigation, and I was a partner at Drinker Biddle & Reath, which might have been a party in interest in litigation.)

4. Have you ever been convicted (including pleas of guilty or nolo contendere) of any criminal violation other than a minor traffic offense? If so, provide details.

No

5. Please advise the Committee of any additional information, favorable or unfavorable, which you feel should be considered in connection with your nomination.

None

E. TESTIFYING BEFORE CONGRESS

1. If you are confirmed by the Senate, are you willing to appear and testify before any duly constituted committee of the Congress on such occasions as you may be reasonably requested to do so?

Yes

2. If you are confirmed by the Senate, are you willing to provide such information as is requested by such committees?

Yes

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

SEP 18 2006 1:00

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
Washington, DC 20510-6210

Dear Chairman Grassley:

At the Finance Committee's July 13, 2006, confirmation hearing regarding my nomination as Assistant Secretary (Tax Policy) of the Treasury Department and in follow-up questions for the record, questions were raised regarding the subject of partial annuitizations. I want to provide you with the following additional response on this topic.

In Conway v. Commissioner, 111 T.C. 350 (1998), the Tax Court concluded that the direct exchange of part of an existing annuity contract for a new annuity contract issued by an unrelated insurer can qualify for tax-free treatment under section 1035 of the Internal Revenue Code. In Rev. Rul. 2003-76, 2003-2 C.B. 355, the Internal Revenue Service and the Treasury Department adopted this position and provided guidance on how the policyholder's investment in the original contract should be allocated to the new contract. Notice 2003-51, 2003-2 C.B. 361, requested comments in this area. That notice also provided additional interim guidance, including a description of circumstances under which a partial exchange will not be treated as a distribution taxed under the income-first rule of section 72(e)(2).

The 2006-2007 Treasury Department Priority Guidance Plan includes an item for "Guidance on the taxation of certain annuity contracts under section 72." Although existing guidance specifically addresses only partial exchanges of annuity contracts, as we move forward with additional guidance in this area, we will consider whether to implement similar rules for partial annuitizations.

Thank you for your question on this important matter.

Sincerely,

Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)

Confirmation Hearing Questions for the Record Assistant Secretary Nominee Eric Solomon

Office of Tax Policy
August 25, 2006

TABLE OF CONTENTS

From Chairman Grassley

Grassley Question 1

Commissioner Everson in a letter to the Finance Committee last year identified Supporting Organizations and Donor Advised Funds as top areas of abuse in TE/GE. Both of these types of activities are significantly dictated by IRS/Treasury guidance. I would like your commitment that Treasury/IRS will make a priority to review and issue guidance this year in these areas and correct the abuses identified by the IRS and Congress. In particular, there should be a focus on donations that are made (usually of closely held stock or real estate) in which the donor realizes a charitable donation yet retains control of a business or property providing significant benefit to the donor and yet there is little to no monies (less than the amount under a private foundation) actually going to a public charity and for the common good. Poor guidance by Treasury and IRS has allowed individuals to plan around the anti-abuse rules passed by Congress in 1969.

Answer

A donor advised fund typically is a separate fund or account established and maintained by a public charity to receive contributions from a single donor or a group of donors. Donor advised funds encourage charitable giving by allowing donors to play an ongoing role in advising the sponsoring charity on future charitable distributions. For many donors, these funds offer a practical alternative to establishing a private foundation. The term "donor advised fund" does not appear in the Internal Revenue Code or the Treasury regulations. However, the basic rules governing charities and charitable contributions apply equally to donor advised funds. For example, for a payment to a donor advised fund to qualify as a completed gift to the charity, the charity must have ultimate authority over how the assets in the account are invested and distributed in furtherance of its exempt purposes. The donor may recommend charitable distributions from the account, but the charity must be free to accept or reject the donor's recommendations.

Supporting organizations are a type of public charity described in section 509(a)(3) of Internal Revenue Code. These organizations are classified as public charities (and therefore are not subject to the more restrictive private foundations rules) based on their close relationship to one or more public charities (supported organizations). Over 30 years ago, the Treasury Department and the IRS issued regulations implementing section 509(a)(3). Consistent with the statute and the legislative history, these regulations set forth three types of supporting organizations. Like donor advised funds, supporting organizations offer certain advantages to donors over private foundations. However, an organization does not qualify as a supporting organization if it is controlled directly or indirectly by one or more substantial contributors to the organization or by certain other disqualified persons.

Commissioner Everson testified last year about abuses involving the improper use of purported supporting organizations by taxpayers for personal gain. Examples of these abuses include the diversion of assets "contributed" to these entities to pay the taxpayer's

personal expenses or to provide a purported "loan" to the taxpayer that may never be repaid. As Commissioner Everson has testified, the IRS has an active examination program underway. The Government is also pursuing abuses under current law. *See, e.g., New Dynamics Foundation v. United States*, 70 Fed. C1 782 (Fed. C1. 2006) (relating to abuses involving so-called "donor advised foundations").

If confirmed, I will make it a priority to work with Commissioner Everson and IRS Chief Counsel Korb to provide greater clarity with regard to the rules that apply to donor advised funds as well as appropriate modifications to the rules governing supporting organizations, taking into account provisions in the recently enacted Pension Protection Act and the results of the Service's ongoing examination initiatives. In doing so, I am mindful that certain of the changes you identify, such as limiting the types of property that may be contributed to these entities, may require a statutory change.

Grassley Question 2

I have asked the IRS' Chief Counsel, Mr. Korb to revisit current guidance on executive compensation at exempt organizations based on the recent IRS review. I would like your commitment that you will make a priority to review the IRS findings and that you and Mr. Korb will work together to provide guidance in the area of executive compensation of exempt organizations as quickly as possible. Every week this is another media story about outrageous pay and perks at a nonprofit entity. IRS and Treasury must give clear rules of the road that business as usual is over at these charities that believe that officers, directors and trustees can have gold-plated lifestyles subsidized by the taxpayer.

Answer

If confirmed, I will make it a priority to work with the IRS Chief Counsel to assess the results of the IRS' ongoing review of compensation paid by exempt organizations. The IRS currently is exploring what practices exempt organizations use to set compensation and how exempt organizations report compensation to the IRS and the public. I understand that the IRS compensation review is systematically gathering data about compensation practices and using that data to focus examination resources. The results of the IRS review may indicate areas where increased education or additional rules are needed. An exempt organization is entitled to pay reasonable compensation for the services it receives. However, the payment of unreasonable or excessive compensation inappropriately diverts assets from exempt purposes. In addition, the failure by an exempt organization to report accurately compensation paid to its executives misleads government regulators and the general public.

Grassley Question 3

I appreciate your testimony about the need to encourage savings. It is my understanding that beginning in 2001 Treasury has conducted some internal studies and reviews about ways to encourage savings, particularly by low-income families and individuals. So that Congress can be better informed as it makes decisions in this area, please provide copies of those studies or reviews.

Answer

I am not aware of the studies to which you are referring. In preparing the response to this question, we searched our records, and I checked with several other offices in the Treasury Department to see if I could locate the studies you describe, but no one I spoke to knew of such studies. I will be happy to work with your staff to clarify this matter in an effort to provide the information you are seeking.

Grassley Question 4

Please provide an estimate of the amount of illegal source income that is not taxed. That is, what is the tax gap for illegal source income currently and what do you view as the trend. Please detail what are the significant components of illegal source income. Please discuss how the administration is addressing the taxation of illegal source income and the accomplishments in this area. What are your priorities in this area?

Answer

Our estimates of the tax gap relate to legal-sector activities only. We do not have estimates of the amount of illegal-source income that is not taxed. There is very little good data upon which to base such estimates. Illegal-source income, by its very nature, is much harder to detect than legal-source income. It would include income from activities such as selling illegal drugs, illegal gambling, racketeering, prostitution, money laundering, embezzlement, and smuggling. Any estimate we might make would be subject to such uncertainty and error as to make it misleading and unhelpful. Furthermore, since the government combats these activities not to collect tax on them, but to stop them altogether, success would not be characterized by full tax compliance on the part of those who receive illegal income, but by the elimination of the illegal income altogether. My priorities in this area include continuing to work with the IRS' criminal investigation function to ensure that a robust program is in place to address the tax aspects of criminal activity.

Grassley Question 5

I have had a long history in the area of whistleblowers. Whistleblowers are a huge part of my success in oversight and through the False Claims Act – legislation I updated and had

enacted – whistleblowers recover billions of dollars for the taxpayers. One loophole in the False Claims Act is that it doesn't apply to tax matters.

While I think there are good reasons why we should be cautious about having the False Claims Act apply to whistleblowers in tax matters, it is clear that the federal government can benefit significantly from making good use of whistleblowers in tax cases.

The IRS and Treasury already have clear legislative authority to have a broad based program to reward tax whistleblowers. What the IRS and Treasury hasn't had is clear sighted management that has taken full advantage of the possibilities of tax whistleblowers.

The recent TIGTA report on this matter has only made it all the more clearer that there are great benefits to rewarding tax whistleblowers and that the IRS and Treasury have fallen down on the job.

Based on the TIGTA report, cases based on whistleblowers are far more productive for the IRS than others cases. The return to the Treasury for dollars per hour worked of cases from whistleblowers is $946 as compared to $548 for IRS' regular cases.

In addition, the no-change rate is about a third lower for whistleblower cases – meaning that whistleblower cases are more likely to target tax cheats and not bother honest tax payers as compared to regular IRS audits.

TIGTA recommends that there be a centralization of whistleblower work at the IRS and other points. But I would say to you, Mr. Solomon, that is the tip of the iceberg, we need to have leadership committed to making this program a success.

I want your commitment that you will ensure there is the leadership to make this program a success and that the necessary reforms will happen NOW to make this a success. Secretary Paulson has committed that he will look into this area "very, very quickly. . . . I will follow up with you on it." I asked for a timeline from Mr. Paulson of making changes and he nodded his head in agreement at the confirmation hearing.

I want a timeline for this important work being done -- when it is going to happen; what changes are going to take place and who is responsible. The changes necessary are reflected in the language on whistleblowers that has passed the Senate several times, including this Committee just a few days ago.

Answer

The IRS has recently completed an internal review of its Informants' Rewards Program and reached conclusions that are consistent with the recent findings of the Treasury Inspector General for Tax Administration ("TITGA"). As a result of that review, the IRS has taken the following steps to improve the management and oversight of this program:

- By January 31, 2006, each IRS Operating Division designated a coordinator responsible for oversight and management of the program in their Division.

- After designating Operating Division Coordinators in January 2006, a National Oversight Committee comprised of the division coordinators and the senior adviser to the Deputy Commissioner for Service and Enforcement was established to centralize management and oversight. The Committee held its first meeting on June 13, 2006, and met again on July 27, 2006. The Committee will meet on a monthly basis going forward.

- By May 31, 2006, all informant claims were consolidated at the Ogden Campus in order to standardize claims control and tracking, expedite claims processing and foster development of staff expertise in evaluating informant claims.

- A new nationwide web-based system to track, monitor and control claims will be operational by December 31, 2006, which will streamline informant claims research, inventory control and reporting.

In addition to these steps, the IRS has evaluated a number of the findings made in TIGTA's report. As you note, in its report, TIGTA found that examinations involving informant information often result in a higher yield than examinations initiated using the IRS' discriminate index function (DIF) methodology. The IRS agrees with this finding and anticipates that, with the improvements in the program noted above, together with careful screening of the numerous informant leads that are received every year, the program will continue to be a valuable source for audit information.

TIGTA's report also noted that an informant waits an average of 7 ½ years from the filing of a claim to receive a payment when IRS utilizes the information in an examination. In part, this delay results from the statutory requirement that the IRS not pay a reward until taxes have actually been collected. This requires completion of the administrative examination and appeals process, any judicial challenges to the IRS' examination determination, and payment by (or enforced collection from) the taxpayer. Nonetheless, the IRS is committed to taking appropriate administrative action to shorten the time to complete this process in order to make the informant program more efficient.

The Office of Tax Policy is working closely with the IRS and other stakeholders to ensure that appropriate administrative steps are taken to make the Informants' Rewards Program as effective as possible. I will continue to work with the IRS to follow up on the steps it has taken to improve the program.

Grassley Question 6

Section 803 of the American Jobs Creation Act amended section 845 of the Code to clarify Treasury's regulatory authority with respect to the reinsurance of U.S. risks in foreign jurisdictions. What are the principal issues that Treasury has identified regarding

this matter? Does Treasury have any current plans to issue regulations under this authority? If not, why not?

Answer

The authority provided by the American Jobs Creation Act gives the Treasury Department greater flexibility to address issues concerning the proper tax treatment of related-party reinsurance and, in particular, the reinsuring of U.S. risks in foreign tax jurisdictions. In such transactions, there are potential issues concerning transfer pricing and the sourcing of income. These issues have proven particularly troublesome in the case of large quota share contracts between related parties.

The Treasury Department is continuing to study this provision, particularly how to implement the Congressional intent expressed in the legislative history without adversely affecting the general reinsurance market. Treasury staff intends to set up a meeting with your staff and other Congressional staff to discuss this issue.

Grassley Question 7

Temporary Regulations under section 469 of the Code treat all partnership interests with limited liability under state law as "interests in limited partnerships" and thus not materially participating in the activity of the partnership, unless certain tests are met. However, a partnership interest that is not a limited partnership interest can qualify as materially participating under several other tests not available to limited partnership interests. These regulations were written before the prevalence of limited liability companies, which are generally treated as partnerships for tax purposes, but in which all members enjoy limited liability. As a result, a literal reading of the regulations would preclude any member of a limited liability company from being treated as anything but a limited partner for purposes of section 469. Since the purpose of treating limited partners more restrictively than general partners is based on state law limitations to a limited partner's participation in the partnership business, treating an LLC member as a limited partner may not be appropriate in all cases. In fact, the district court in *Gregg v. U.S.*, 186 F.Supp. 2d 1123 (D.Ore) 2000) concluded that a member of an LLC should be treated as a general partner in determining whether pass-through losses were passive under section 469. Will Treasury reconsider these rules in their application to LLC members?

Answer

I recognize that the proper classification of LLC members as either general or limited partners has given rise to confusion and controversy under the passive activity rules of section 469. As you note, the court in *Gregg v. United States* concluded that a member of an LLC could be treated as a general partner for purposes of the passive loss rules. Although the court reached this conclusion, in part, because it did not think the regulations provided that an LLC member must be treated as a limited partner of a

limited partnership, I agree that the regulations can be read in the manner you suggest. I believe it would be appropriate to consider clarifying the rules in this area.

The applicability of self-employment taxes to LLC members raises similar issues. Proposed regulations issued in 1997 generally would have treated as general partners LLC members who participate in the LLC's trade or business for more than 500 hours during the taxable year or who have authority to contract on behalf of the LLC. These regulations were very controversial and Congress provided in the Taxpayer Relief Act of 1997 that they could not be finalized before July 1, 1998. In addition, a floor amendment not included in the Act expressed the sense of the Senate that the proposed regulations defining a limited partner for purposes of the self-employment tax should be withdrawn. Although the prohibition against finalizing the proposed rules has not been renewed, the proposed rules still have not been finalized. The proposed rules may, however, be an appropriate starting point for clarifying the passive activity rules relating to the material participation of LLC members. Since the passive activity rules already include a 500-hour rule under which limited partners can qualify as material participants, the principal clarification under this approach would involve LLC members who have authority to contract on behalf of the LLC.

Grassley Question 8

Mr. Solomon, it is clear that the IRS and Treasury decision to change the rules regarding charity hospitals in 1969 was based on inaccurate information. I would like your commitment that the Treasury and the IRS are going to go back and look at the real facts, that there is a great need to help low-income people facing medical expenses, and that the Treasury and IRS are going to put out new guidelines during this administration that put real teeth in charity care, community benefit, and charges to the uninsured, and other important issues in that area. Poor people should not have to suffer because of decisions that were made by Treasury back then.

So to that end, I request the following: a time line for review and proposals for reforming the guidance in this area; second, the individuals responsible at Treasury and IRS for reviewing the materials submitted by hospitals and for drafting and reviewing new guidance so that we can talk to them, and a copy of all documents, memorandums, and materials in the possession or control of IRS that were related way back then to that 1969 decision, and a copy of all submissions from hospitals that the IRS receives, as well as the names of any hospitals that did not respond.

Answer

Prior to 1969, the IRS took the position that a hospital qualified as a charitable organization if the hospital accepted patients without regard to their ability to pay, to the extent of the hospital's financial ability. Rev. Rul. 56-185, 1956-1 C.B. 202. The "financial ability" standard set forth in the 1956 revenue ruling was criticized at Congressional hearings in 1969 for its imprecise standards concerning the extent to which

a hospital must accept patients who are unable to pay (see H. Rep. No. 91-413, 91st Cong., 1st Sess. Pt. 1, at 43 (1969)). Congressional consideration of the issue led to inclusion in H.R. 13270, 91st Cong., 1st Sess. (1969), of a provision amending section 501(c)(3) to clarify the tax-exempt status of hospitals. Specifically, the bill passed by the House of Representatives in August 1969 treated as charities organizations organized and operated exclusively "for the providing of hospital care." This provision was never enacted into law. According to a later Senate Report, the provision was dropped after the IRS issued Rev. Rul. 69-545, 1969-2 C.B. 117, in October 1969, which included the "community benefit" test. See S. Rep. No. 91-552, at 61, 91st Cong. 1st Sess. (1969).

Since the publication of Rev. Rul. 69-545, the IRS has applied the community benefit test. The IRS considers a number of factors to determine whether a hospital operates for the benefit of the community. Over the decades, the community benefit standard has been applied by the courts. As you note, the Senate Finance Committee has recently raised questions about whether nonprofit hospitals are meeting this community benefit standard, and whether the standard itself needs to be changed. The Committee on Ways and Means has raised similar concerns.

The IRS recently sent approximately 550 compliance check letters to nonprofit hospitals asking detailed questions about their operations. The questions focus on whether and how hospitals are meeting the community benefit standard, and on hospital compensation practices. The IRS will analyze responses to these letters, gather any additional information necessary, and prepare a report. I will work with the TE/GE Commissioner to keep you apprised of the progress of this project.

After reviewing the IRS findings, I intend to consult with the IRS Office of Chief Counsel and the TE/GE Commissioner to consider the current exemption standards for nonprofit hospitals.

Any possible revisions would be considered in a project under the annual Priority Guidance Plan of the Treasury Department and the IRS, which is updated periodically during the year. With respect to the individuals responsible for published guidance, if confirmed, I will lead the effort of the Treasury Department in this area and will work closely with the TE/GE Commissioner, Commissioner Everson, IRS Chief Counsel Korb, and a staff of professionals working for each of them.

With regard to your document request, the Office of Tax Policy does not receive copies of the submissions made by nonprofit hospitals to the IRS. However, I have asked the TE/GE Commissioner to provide you with copies of submissions received, and identify hospitals that did not respond, in accordance with section 6103(f). In addition, we are in the process of searching our files for documents relevant to your inquiry about the 1969 revenue ruling. Certain Treasury files relating to exempt organization issues that were created during this time period have been transferred to the National Archives. Those documents are also included in our search efforts. In addition, we also have asked the IRS to search its own records. However, due to the recent flood and inaccessibility of the main IRS building, that process is continuing.

From Senator Hatch

Hatch Question 1

Mr. Solomon, current Treasury regulations deny flow-through treatment to banks that are organized as Limited Liability Companies (LLCs). This denial apparently was based on federal banking rules which were subsequently changed in 2003. The Treasury regulations have not yet been modified to reflect this change and to allow flow-through treatment to bank LLCs. Several states, including Utah, now allow banks to organize as LLCs, and this flow-through treatment would be particularly beneficial to small banks. I, along with several other senators, wrote a letter to Secretary Snow about this matter in July 2004 and again in December 2005 and I received replies to both letters indicating that Treasury was reviewing the issue. Can you give me a timetable for when Treasury will complete this review and update the regulations to provide appropriate treatment for banks organized as LLCs?

Answer

Current regulations require corporate, rather than flow-through federal tax treatment for any "State-chartered business entity conducting banking activities, if any of its deposits [is] insured under the Federal Deposit Insurance Act . . . or a similar federal statute." These regulations are sometimes referred to as "the bank *per se* rule" and are part of a broader set of "check the box" regulations promulgated in 1996. The check the box regulations generally allow limited liability companies (LLCs) to choose whether to be treated for federal tax purposes as a corporation or as a partnership. A threshold question under consideration is whether authority exists to permit banks to be treated as flow-through entities for federal tax purposes.

Section 581 of the Code defines the term *bank* to mean an entity that, among other things, is "incorporated ... under the laws of the United States ... or of any State." Under the current regulations, this requirement is satisfied by an LLC bank being treated as a corporation for federal tax purposes as a result of the bank *per se* rule. If that rule were to be removed or modified, however, there would be a question as to whether LLC banks that choose to be taxed as partnerships would fall within the definition of a bank under section 581.

In addition, the Internal Revenue Code contains numerous provisions governing the tax treatment of banks, some of which are perceived as favorable and others that impose restrictions or limitations on banks. Were the Treasury Department and the IRS to modify or withdraw the bank *per se* rule, the consequence would be that flow-through treatment could be chosen by state-chartered LLCs that conduct banking activities and that offer their depositors federal deposit insurance. Before acting in this area, it is important that we understand the consequence of flow-through treatment with respect to the numerous special bank-related provisions in the tax law, most of which were enacted decades before the existence of the LLC as a juridical entity under state law. Were the Treasury Department and the IRS to modify or withdraw the bank *per se* rule, it would be

necessary to decide which special bank-related provisions would have flow-through effects on the LLC owners and, where appropriate, what those effects are. This determination might be better left to Congress.

Our consideration of the bank *per se* rule includes determining whether its removal would deprive state-chartered, federally insured LLC banks of the bank-specific benefits, and free them from the bank-specific burdens, that otherwise apply under the Code. This also involves evaluating whether that result is consistent with sound tax policy and with Congress' intent in having enacted a comprehensive set of rules governing the taxation of banks that appear premised on an assumption that banks are incorporated.

In considering this important issue, the Treasury Department and the IRS have had a number of meetings internally and with taxpayers and their representatives. We will continue to study this important issue to decide whether a change to the *per se* rule is appropriate and, if so, how that change could be effected.

Hatch Question 2

Treasury is rolling out a new program pursuant to last year's energy bill called the Clean Renewable Energy Bond. I understand the program has received an overwhelmingly positive response, though the funding is limited to $800 million over two years. How many applications under this program has Treasury received, and what is the total dollar amount represented by those applications?

Answer

The IRS received over 720 applications for volume cap allocations for Clean Energy Renewable Bonds ("CREBs") under Code Section 54 by the April 26, 2006, application deadline. The total dollar amount represented by those applications aggregates to over $2.6 billion.

Hatch Question 3

I know many projects are waiting for Treasury to announce whether they will receive an allocation of the Clean Renewable Energy bonds. I have some concerns about how long projects that are ready to go will need to wait, as the application deadline passed over two months ago and the legislation was enacted almost a year ago. When does Treasury plan to announce the awards?

Answer

The IRS plans to announce the volume cap awards for this significant new CREBs program as soon as possible, hopefully by early this fall. Prudent processing of volume cap awards will take some time, based upon considerations that include the large volume

of applications, the fact that this is a new program with new project eligibility criteria, and the attendant need to review the technical aspects of the various types of proposed projects.

Hatch Question 4

I understand that other than some notices, formal regulations on the Clean Renewable Energy Bond program have not yet been prepared. When do you anticipate Treasury will release these regulations?

Answer

The Treasury Department and the IRS previously provided initial CREBs guidance on a priority basis in IRS Notice 2005-98, 2005-52 I.R.B. (December 27, 2005) and IRS Notice 2006-7, 2006-8 I.R.B. (March 6, 2006). A CREBs regulation project is included on the Treasury-IRS priority guidance plan for the 2006-2007 plan year (July 1, 2006-June 30, 2007). We presently are working actively on a CREBs regulation project, and hope to publish regulations by the end of 2006.

From Senator Santorum

Economy/Savings

Santorum Question 1

The Congressional Budget Office reports that federal tax revenue has averaged 18% of GDP since 1962. What are the implications for the economy if the federal government were to spend 18 percent of GDP on Social Security, Medicare, and Medicaid alone, as is projected by 2040? What effect would that likely have on the tax rates?

Answer

I have discussed this question with the economists in our Office of Tax Analysis and in the Treasury Department's Office of Economic Policy, and they have contributed to the following response.

In the scenario you mention, taxes as a share of the economy would have to rise, meaning tax rates would have to rise to finance the benefits. If marginal tax rates rise, it would depress the incentives for work, entrepreneurial activity, and risk taking, all of which would dampen economic growth and hurt future living standards.

The Medicare and Social Security Trustees Reports shed light on the growing burden caused by the Social Security, Medicare and Medicaid programs in the absence of reforms. The combined Social Security and Medicare Hospital Insurance Trust Funds currently run a surplus of 1.46 percent of taxable payroll. By 2040, the balance will have turned sharply negative, coming to -8.59 percent of taxable payroll. Another way of looking at it is in terms of cost rate, or the share of taxable payroll that is required to finance Social Security and Medicare Hospital Insurance on a pay-as-you-go basis. In 2006, the cost rate is expected to be 14.35 percent of taxable payroll, while in 2040 it is expected to be 25.22 percent of taxable payroll.

Similarly, the budget pressure of Medicare Parts B and D will increase sharply. In 2005, Parts B and D consumed 9.6 percent of federal income taxes. By 2040, they will consume 29.5 percent of federal income taxes. Similar projections are not calculated for Medicaid, but growth rates of spending are likely to be similar to those for Medicare.

All of this highlights the urgency for entitlement reform. The sooner we act, the easier it will be to make the necessary adjustments. Moreover, making program adjustments now will give workers the opportunity to prepare for those changes.

Santorum Question 2

Has lowering the cost of capital – through the dividend and capital gains reductions in the jobs and growth package – resulted in increased investment in our economy? Has this

played a role in the ensuing job creation? Has this played a role in increasing the revenues to the federal government?

Answer

I believe the economy has benefited from the lower tax rates on dividends and capital gains as indicated by the strong increases in investment, job creation, and GDP growth that have occurred since these rates were enacted in the Jobs and Growth Act in mid-2003. The lower rates helped stimulate capital formation and business investment at a key point in the business cycle by lowering the cost of equity capital. Real private nonresidential investment has increased at an average annual rate of just over 9 percent since passage of the 2003 Jobs and Growth Act, after declining for nine consecutive quarters prior to the second quarter of 2003. Since passage of the 2003 Jobs and Growth Act, more than 5.5 million jobs have been created and the economy has grown at a 4 percent real annual rate.

I believe the lower tax rates on dividends and capital gains have contributed to the current strength of the economy and that the strong economic growth we have experienced in the past 3 years is largely responsible for the recent increases in federal tax revenues. Year-to-date tax receipts are now running 12.9 percent above the same period last year. In turn, last year's receipts were 14.6 percent higher than the prior year.

Santorum Question 3

Over the past decade, the percentage of after-tax, disposable income saved has declined precipitously; the latest recorded personal-savings rate in the U.S. fell to an embarrassingly low negative 0.5%. This low savings rate lags far behind that of other industrial nations, constraining national economic growth and keeping many Americans from entering the economic mainstream. What benefits might Individual Development Accounts or KIDS accounts have for the low-income individuals in improving the lives of these individuals. What other asset building provisions have you explored that might benefit individuals and families?

Answer

I agree with your concern about the nation's low savings rate and the need to increase it. As you know, the President has made a number of proposals to encourage greater savings. One of these proposals would increase federal support for Individual Development Accounts (IDAs). IDAs are specifically designed to help low-income households save for higher education, buy a home, or start a business. The Administration's proposal would allow the program to be established more broadly.

The Administration has also proposed Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs). The LSA proposal would allow taxpayers to save for any purpose tax-free. The RSA proposal would simplify and consolidate the three types of

Individual Retirement Accounts (IRAs) into a single RSA where taxpayers could save for their retirement tax-free. These proposals would expand and simply tax-free savings opportunities. Moreover, these proposals, especially the LSAs, may be particularly helpful to lower income individuals who may find the current set of complex rules a major obstacle and may not want to lock up their savings for retirement. The simple and easily accessible LSAs provide a tax-free alternative for low income savers.

The Administration's Employment Retirement Savings Account (ERSA) proposal would consolidate employer-sponsored contributory defined contribution pension plans such as 401(k) and 403(b) plans into ERSAs with simplified qualification requirements. The complexity and compliance costs associated with administering a retirement plan are often cited as reasons the pension coverage rate is low among small employers. The ERSA proposal would encourage the adoption of retirement plans, making this important savings option available to more individuals and families.

In addition, starting in 2006, taxpayers will be able to split their refunds and deposit them directly into up to three accounts, including savings accounts and IRAs. The Treasury Department and the IRS have worked together to implement split refunds. Making it easier for taxpayers to set money aside through direct deposit complements the Administration's commitment to programs focusing on encouraging savings.

I believe that addressing the Nation's low savings rate is an issue that needs to be considered carefully as we work to reform the tax system, and it is very important that we continue to study proposals regarding this matter, including KIDS accounts.

Incentives for Charitable Giving

Santorum Question 4

We have seen the amazing role charities have played in the relief effort after Katrina and Rita. In fact it was their performance that was lauded over that of the respective governments. As you know I have been working for years to pass the CARE Act – including the non-itemizer, the IRA rollover, the food donation and the S Corp provisions, all of which at one point have been supported by this Administration. What will you do as Secretary to support increased charitable giving? Will you support the enactment of the CARE Act?

Answer

The charitable sector makes vital contributions to our society. Increasing incentives to give will improve the charitable sector's ability to serve Americans in need. The Administration's Fiscal Year 2007 budget includes several proposals to promote charitable giving, including proposals to permit tax-free rollovers of IRA assets made directly to a charity, to encourage donations of food inventory, and to permit S corporation shareholders to obtain the full benefit of a charitable contribution deduction

for appreciated property donated by the S corporation. In addition, when President Bush created the President's Advisory Panel on Federal Tax Reform in January 2005, the President instructed the Panel to recommend options that would recognize the importance of charity in American society. The Panel's November 2005 report includes a recommendation to permit all taxpayers to deduct charitable contributions above a certain floor. The Treasury Department is considering the Panel's recommendations as it considers tax reform options. If confirmed, I look forward to working with my colleagues in the Administration and with you and other members of Congress on efforts to promote charitable giving in a manner consistent with the Administration's proposals.

Santorum Question 5

Some have linked increased charitable giving incentives to so-called "charitable reforms." While the charitable sector supports increased transparency, and, as you know, the CARE Act addresses this concern, there is a fear within the sector that charitable reforms that have been proposed will go too far and actually have a negative impact on charitable giving. Do you believe that incentives for charitable giving must be linked to "reforms"? or do you think we should pass incentives now and reforms when they are ready and supported by the entire charitable community?

Answer

The charitable sector is a vital part of our society. The vast majority of charities perform important work that improves people's lives. The vast majority of charities also do not abuse their tax-exempt status. Increasing the incentives for taxpayers to donate to charity, consistent with the Administration's budget proposals, will improve the sector's ability to provide needed services. However, the whole sector is hurt when donors claim improper deductions and when charitable organizations abuse their tax-exempt status. The Administration supports targeted reforms. For example, the Administration's Fiscal Year 2007 budget includes a proposal to penalize charities that accept donations of conservation easements but fail to enforce them. Current law provides a charitable contribution deduction to taxpayers who donate conservation easements (including historic preservation easements) to a qualified charity. Charities qualified to receive such contributions must have the commitment and the resources to enforce the restrictions for which the deduction was taken. A penalty on charities that fail to monitor and enforce the restrictions for which a charitable contribution deduction was allowed and which they have committed to enforce is consistent with the intended goal of protecting conservation purposes in perpetuity. Thus, I believe that the goals of encouraging donations to charity and encouraging good practices by charities and donors are consistent ones. If confirmed, I look forward to working with you and other members of Congress in an effort to promote charitable giving and to protect charitable resources from misuse.

Telephone Excise Tax

Santorum Question 6

You may know that the Treasury's recent decision to concede the telephone excise tax cases that were collected but were not based on time and distance has left only the "local plans" covered. As such, that means this tax is hitting the lower-income families – those that can't afford the more expensive flat rate plans – the hardest. Do you support the full repeal of the telephone excise tax? And do you support expediting that repeal to coincide with the current July 31st deadline for collecting the non-local taxes?

Answer

In response to a similar question, Secretary Paulson said that he supported repeal of the telecommunications excise tax on local service and that he looked forward to working with Congress on legislation to repeal this tax. I agree. We need to work to repeal the tax on local service as soon as possible.

Teleworking

Santorum Question 7

Nearly 40 million Americans telework today – whether a few days a week or their entire work schedule – and according to experts, 40 percent of the nation's jobs are compatible with telework. My Telework Tax Incentive Act to provide a $500 tax credit for the employer or employee, whomever absorbs the expense for setting up the at-home worksite. An employee must telework a minimum of 75 days per year to qualify for the tax credit. In my opinion, the best part of telework is that it improves the quality of life for everyone – the employee, the employer and the community. What is your view of teleworking and would you support the passage of the Telework Tax Incentive Act?

Answer

Providing appropriate incentives for telecommuting is consistent with the Administration's broader goals of providing tax and other incentives to reduce dependence on foreign oil. In 2001, the General Accounting Office prepared a report summarizing many of the barriers to increased telecommuting. The report discussed a number of tax provisions, including a credit similar to the credit your Telework Tax Incentive Act proposes. Although I share your interest in promoting telecommuting, in considering a tax credit in this area we must carefully evaluate whether the incentive provided by the credit is appropriate in light of the cost to the Federal government in lost revenue. In addition, the appropriateness of a credit must take into consideration the complexity it would add to the tax law. As the Finance Committee continues to consider the Telework Tax Incentive Act, if confirmed, I will work with you to evaluate these factors in developing the Administration's position on the legislation.

Section 29 Private Letter Ruling

Santorum Question 8

For several years, through letters, phone calls and meetings, I, along with Senators Specter and Rockefeller, have communicated with the IRS and the Department about the IRS' existing guidelines for the issuance of private letter rulings under Section 29 as they relate to Steel Industry Fuel. The IRS has said it is no longer issuing PLRs for "new processes," although I am told that it has issued three PLRs for a new process.

Despite repeated requests for the IRS to reconsider these guidelines because they appear not to be consistent with the guidance to taxpayers provided in an earlier Revenue Procedure, the IRS has refused to change its position.

Throughout the process of trying to get the PLR process moving for Steel Industry Fuel, IRS staff and officials indicated that the threshold for action was Congress clarifying that SIF was intended to be eligible for Section 29. Despite intense congressional interest and a clarification of congressional intent in the Energy Policy Act of 2005, IRS and Treasury have still refused to change their ruling position. Chairmen Grassley and Thomas also sent a joint letter to Treasury calling the IRS to consider such rulings and guidance on an expedited basis to those taxpayers who had pending ruling requests at the time of the IRS-imposed moratorium.

Why is congressional intent regarding this matter being ignored?

Will you agree to take another look at this decision, taking into account congressional intent and the merits of this process?

Answer

As your question suggests, this issue has a long history. Beginning in 1986, the IRS issued private letter rulings holding that processes in which coal was treated with various chemicals and then subjected to elevated temperature and pressure to produce briquettes, pellets, or an extruded fuel product resulted in a significant chemical change and qualified for the section 29 (now section 45K) credit. Most of these rulings were issued in the late 1990's.

In 2000, the Treasury Department and the IRS became concerned that processes approved in private letter rulings issued before 2000 permitted taxpayers to claim the credit in circumstances that were not intended by Congress.

The Treasury Department and the IRS carefully reviewed the IRS ruling practice and concluded that processes approved in pre-2000 private letter rulings did not satisfy the requirements of the statute. This conclusion was explicitly stated in the most recent IRS guidance on section 29 issued in 2003 (Announcement 2003-46, 2003-30 I.R.B. 222).

The 2003 guidance also noted that many taxpayers had relied on the longstanding private letter ruling practice of the IRS to make their investments. Despite the conclusion that the pre-2000 rulings were not consistent with the statutory provision, the guidance announced that the IRS would continue issuing rulings, but only for processes that had received a ruling before 2000 (i.e., processes in which taxpayers had invested relying on the IRS ruling practice). The IRS assures me that it has not issued rulings for any processes that did not receive a ruling before 2000.

Steel industry fuel is produced by processing waste coal and byproducts of coke production. The IRS has refused to rule on steel industry fuel because the process was not approved in a pre-2000 private letter ruling.

The IRS uses private letter rulings to provide guidance to taxpayers by interpreting and applying the tax law to a taxpayer's particular set of facts. The private letter ruling program is a discretionary function. The IRS ordinarily issues rulings only when appropriate in the interest of sound tax administration. Taxpayers are not entitled to a private letter ruling, and are not required to have a private letter ruling to claim a section 29 credit if the applicable requirements of the statute are satisfied.

Historically, the IRS has reserved the right to decline to issue private letter rulings in appropriate circumstances, and often refuses to rule on factual issues. Whether coal undergoes the substantial chemical change required for the credit is an inherently factual question that requires complex scientific analysis, rather than legal expertise, to resolve. Because the issue in this situation is so factual and scientific and the IRS is not well-equipped to answer this particular question, pursuant to Announcement 2003-46, the IRS has declined to entertain requests for private letter rulings in this situation.

From Senator Smith

Smith Question 1

Congress has repeatedly extended the Research & Development Tax Credit as a way to create high-paying and high-value research and development jobs in the United States. This has been our national policy for many years, and this policy has broad bipartisan support in both the House and the Senate.

Despite this clear national priority, I recently learned that the IRS may reverse a 17 year old rule regarding the R&D treatment of inter-company sales between a U.S. corporation and its subsidiaries. Specifically, the IRS has just begun advising its field agents in Chief Counsel Advice 200620023 that the term "gross receipts" for purposes of calculating the R&D credit now must include inter-company sales, reversing its prior position published most recently in 2002. For many U.S. companies, this change will diminish, if not eliminate, the R&D tax credit.

First, it would artificially and retroactively increase the gross receipts of companies that brought home foreign earnings during 2005 under the Homeland Investment provisions. As a result, their R&D credit will be diminished or wiped out in current and future years. As a strong advocate of the repatriation dividend in the Jobs Act, I can assure you it was not Congress' intent to punish U.S. businesses in this manner. Second, on a prospective basis, the ruling could push U.S. R&D activities offshore to countries which provide a more favorable tax regime for research activities. Finally, the ruling could lead to the export of more manufacturing jobs, as U.S. based multinationals leave their foreign earnings abroad rather than repatriate them just to see their research credit penalized. This will reduce the number of new jobs created in the U.S.

I urge you to review this matter carefully and prevent this misinterpretation from pushing R&D and jobs offshore.

- What is your position on this matter?

Answer

I am aware of this important issue. Let me first note that the Office of Tax Policy is not involved in the issuance of Chief Counsel Advice, which relates to specific taxpayer matters. However, the Office of Tax Policy and the IRS have a regulation project on our 2006-2007 Priority Guidance Plan that would provide rules for the treatment of gross receipts in intra-company transactions. The Treasury Department is cognizant of the concerns regarding the consequences of the treatment of intra-company transactions. If confirmed, I look forward to further participation on this important regulation project.

Smith Question 2

I commend the Treasury Department for recently issuing proposed regulations permitting pension payments from defined benefit pension plans under qualified phased retirement programs.

Americans are living longer and healthier lives, and many older workers are interested in staying in the workforce longer. In fact, a 2004 AARP survey found that about 80 percent of baby boomers plan to work in some capacity during their retirement years. If older workers stay in the workforce longer, it will have many positive implications, including lessening the impact of potential labor shortages and easing pressure on the federal budget.

Phased retirement is a best practice that some employers have already implemented to retain their older workers. According to a 2005 AARP survey of older workers, almost 40 percent indicated that they would be interested in participating in phased retirement. Of those workers who expressed interest in phased retirement, almost 80 percent expect that its availability would encourage them to work past their expected retirement age. Therefore, not only are a significant number of older workers interested in phasing into retirement, but phased retirement may also extend older Americans' working careers.

A significant barrier to phased retirement programs for employers with defined benefit pension plans is the restriction that active employees who have not yet reached normal retirement age (as defined in the plan) may not receive any pension payments. This is problematic for older workers who are interested in moving from full-time to part-time employment with their current employer and need to supplement their income with some of their pension benefits. Due to this obstacle, many employees simply retire or leave their current employer (at least temporarily) so that they can begin drawing benefits while continuing to work, either for a different employer or for the same employer (e.g., as a consultant or independent contractor).

Treasury's proposed regulations move in the right direction towards addressing this impediment to phased retirement. However, a number of employers have commented that many of the regulations' requirements would be administratively complex and burdensome, with the result that few employers would actually implement phased retirement programs under the regulations. Clearly, no matter how well-drafted or well-intentioned the regulations are, they will not serve older workers if employers are simply unwilling to implement phased retirement programs.

- What is your position on these regulations?
- When do you anticipate the regulations will be finalized?

Answer

We have received a number of comments on the proposed regulations expressing support for the basic approach, but recommending that the restrictions be loosened, especially the administrative burden of compliance. We are far along in the process of drafting a final version of the regulations and are considering a number changes that would reduce the administrative burden.

However, I note that section 905 of the Pension Protection Act of 2006, enacted into law on August 17, 2006, provides a blanket provision for in-service distributions from pension plans beginning at age 62. We are analyzing the effect that this provision may have on the proposed regulations. Enactment of this provision may result in a delay in finalizing the regulations.

Smith Question 3

For over 30 years, the IRS has interpreted the limits imposed by Section 415 of the tax code on annual benefits payable under a defined benefit plan to take into account a participant's highest three years of compensation while the participant was employed by the plan sponsor. This was in apparent conflict with Section 415(b)(3) which applies the highest three years of compensation limit to only those years when the employees was an active participant in the plan. The IRS in newly proposed regulations followed this interpretation of the statute rather than the IRS' previous position.

I understand that the IRS' new position will reduce the incentives for small businesses to establish defined benefit plans since these earlier years of compensation are ignored. In the interests of fostering the establishment of pension plans for small businesses, I am suggesting legislation be added to the current pension reform bill in conference which would change the determination of an employees highest three years of compensation under Section 415(b). Under this legislative change, the highest three years of compensation would include compensation earned while the participant was employed by the plan sponsor and while the participant is receiving past service credit under the plan.

- What would be the Treasury Department's view on such an amendment and would the Administration support such a change?

Answer

I agree that taking into account only compensation during the years that an individual is an active participant in the plan reduces the incentive for small business owners to establish defined benefit plans for their employees. If it were not for the clear wording of the statute on that issue, we could continue the past position of allowing pre-participation compensation to be taken into account. Accordingly, I agree with your legislative proposal to conform the statute to the long-time practice.

From Senator Baucus

Tax Gap

Baucus Question 1

At your confirmation hearing, I asked you to make a commitment to work with IRS Commissioner Everson to submit a credible plan by September 30, 2006 to close the $345 billion annual tax gap. You responded that you would provide one "as quickly as possible", but you stopped short of committing to the September 30 deadline. Commissioner Everson already has committed to this time frame.

a. Do I now have your commitment that you will work with Commissioner Everson to develop a credible plan to close the tax gap containing baselines, goals, benchmarks and timelines that will be delivered to this Committee by September 30 of this year?

b. Reducing the tax gap will require a comprehensive set of strategies with action on many fronts – from a simpler tax code and more complete income reporting to better enforcement and quality customer service. Increasing IRS resources and expecting the tax gap to shrink is not a credible strategy. What do you think a credible strategy should include?

Answer

I share your concern about the tax gap. I am committed to continuing to work with the IRS with regard to a strategy to increase the level of compliance. The staff of the Office of Tax Policy and I have been working closely with the IRS in connection with this strategy.

I also agree that a strategy to increase compliance must be comprehensive. The strategy must recognize that noncompliance reflects both unintentional errors and intentional evasion and must contain policies designed to address both of these problems. The strategy must target the particular sources of noncompliance. The policies must include enforcement activities as well as taxpayer service. The policies must be sensitive to taxpayer rights and must minimize the imposition of taxpayer burden.

A practical and effective overall strategy should include at least seven elements.

First, the strategy should focus on IRS resources and their efficient allocation. The funding level for the IRS is established in the annual budget process. In addition, the IRS should continue its actions to align its enforcement resources to focus on areas of greatest noncompliance, and should re-engineer examination and collection procedures to make its audit and collection activities as effective as possible.

Second, the strategy should emphasize the importance of research. Research is essential to identify areas of noncompliance so that IRS resources are properly targeted. Research is also essential to evaluate the effectiveness of IRS efforts.

Third, the strategy should maintain and improve taxpayer service. Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The statutorily mandated Taxpayer Assistance Blueprint, which is expected to be released in October, will establish a five-year taxpayer assistance improvement plan. The IRS should continue its efforts in the areas of education and outreach, to help taxpayers understand their tax obligations. The IRS should also continue to pursue opportunities to reduce taxpayer burden, including electronic filing and payment.

Fourth, the strategy should include improvements to the IRS technology infrastructure. Such improvements would provide the IRS with better tools to improve compliance through early detection, better case selection and better case management.

Fifth, the strategy should include legislative proposals and regulatory changes to improve compliance. The Administration's Fiscal Year 2007 budget includes five legislative proposals to reduce avoidance opportunities. The staff of the Office of Tax Policy and I are working with the IRS to develop additional legislative proposals for consideration as part of the Fiscal Year 2008 budget process. Furthermore, regulatory guidance and other administrative actions would address both procedural and substantive issues relating to compliance.

Sixth, the strategy should include legislative proposals to reform and simplify the Internal Revenue Code. Reform and simplification would reduce the number of unintentional errors caused by a lack of understanding of the tax law. In addition, reform and simplification would reduce the opportunities for intentional avoidance that are currently provided by the complex technical rules. Reform and simplification would also make it easier for the IRS to administer the tax law.

Seventh, the strategy would include coordination with state, local and foreign governments to share information and strategies. It would also include coordination with practitioner organizations, including bar and accounting associations, to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice.

Baucus Question 2

Mr. Solomon, during your tenure at Treasury, the cumulative tax gap exceeded $2 trillion. You have been at Treasury long enough to understand the causes of noncompliance and, in your new position, you will have even more influence to fix them. I want to know what you are going to do about this very serious problem.

a. Why do you think the tax gap has been allowed to grow so large in just the past few years?

b. What, in your opinion, are the five most serious root problems (other than the complexity of the tax code) causing the tax gap?

Answer

It is important to note first that most Americans are fully compliant with their tax obligations. The American tax collection system is a tribute to the honesty and responsibility of our citizens and businesses. Although the dollar amount of the tax gap has increased, the IRS believes that compliance rates have essentially remained constant at least since the early 1980s. With generally unchanged compliance rates, the dollar amount of the tax gap has increased with the increasing amount of tax revenues. Nevertheless, I share your concern about the magnitude of the tax gap, which effectively places greater tax burdens on our compliant taxpayers.

I would prefer to divide the underlying causes of the tax gap into three categories. The first category is unintentional errors. Many taxpayers have difficulty understanding and determining their tax obligations, particularly because the tax law is so complicated. The second category is intentional avoidance. Some taxpayers intentionally choose to disregard their obligations. Underreporting of income is the largest aspect of intentional avoidance. Enforcement activity and taxpayer service represent a third category. Enhanced enforcement has the direct effect of collecting more revenue and the indirect effect of deterring noncompliance. Taxpayer service helps taxpayers understand and comply with their obligations.

Baucus Question 3

When the IRS reported that the voluntary compliance rate (VCR) was 85%, I challenged the agency to reach a 90% VCR by the end of this decade. The IRS now reports the VCR is 83.5%.

a. What will it take to reach a voluntary compliance rate of 90%?

b. How long do you think it will take?

Answer

Substantially increasing the level of compliance will require a comprehensive strategy. The elements of such a strategy are described in my response to Question 1. As indicated there, the strategy must recognize that noncompliance reflects both unintentional errors and intentional evasion and must contain policies designed to address both of these problems. The strategy must target the particular sources of noncompliance. The policies must include enforcement activities as well as taxpayer service. The policies must be sensitive to taxpayer rights and must minimize the imposition of taxpayer burden. To increase the level of compliance to as high as 90 percent by the end of this

decade, it would be necessary to consider dramatic increases in the IRS enforcement budget in these times of budgetary constraints. In addition, it would be necessary to consider other substantial steps, for example regarding audits and collection, withholding and information reporting, that will likely raise serious questions regarding compliance burdens and perhaps taxpayer rights.

Baucus Question 4

Former IRS Commissioner Rossotti reported that IRS knows the identity of taxpayers who owe back taxes. IRS has more work than it can handle. Why isn't the IRS pursuing the cases that it knows about?

Answer

The IRS' recent update of the tax gap estimated the gross tax gap at $345 billion for 2001, reduced by $55 billion through late payments and enforced collection activity to a net tax gap of approximately $290 billion. Of the $345 billion gross tax gap for 2001, $33.5 billion represents the underpayment of taxes. As you note, the IRS generally knows the identities of these taxpayers and enforced of late collection from them represents a significant portion of the $55 billion that the IRS ultimately collected to reduce the gross tax gap for 2001 to a net tax gap of $290 billion.

Based on current IRS resources, it is not possible to actively work all known taxpayer accounts. Nevertheless, the IRS continues to enhance its work selection systems to maximize coverage, yield and efficiency. Because taxpayer accounts vary in complexity, the IRS continues its efforts to identify the most cost effective collection method for each taxpayer and direct them first to that function (notice, phone, or field collection). The IRS also employs decision analytic models that help identify high and low yield taxpayers for either accelerated assignment to field collection or placement in non-work status. While the IRS is not able to actively work all taxpayer accounts, its inventory selection and delivery protocol allows it to focus on the most productive work.

With Congress' assistance, the IRS has taken a number of steps to increase collection from taxpayers with outstanding, assessed tax liabilities. Among the more significant steps is the current effort to implement authority provided by the American Jobs Creation Act of 2004, which enacted Code section 6306 and authorized the IRS to use private collection agencies (PCAs) to assist in pursuing certain unpaid tax debts. On March 9, 2006, contracts were awarded to three PCAs pursuant to this statutory authority. Protests of those contract awards have now been resolved and the IRS anticipates placing collection cases with the PCAs by early September.

Baucus Question 5

The Administration's proposed FY 2007 budget plan included a handful of suggestions to close the tax gap. The five proposals would raise $3.5 billion over 10 years. With an annual tax gap of $350 billion, this seems like a drop in the bucket.

In January of 2005, the Joint Committee on Taxation issued a "Tax Gap Report" in response to a request from Chairman Grassley and me. It contained six dozen ideas that, if adopted, would close the tax gap by $400 billion over ten years. I am interested in Treasury's position on these proposals.

a. I am requesting that you to provide Treasury's position on each of these JCT proposals by August 1, 2006. If you agree with the proposal, tell us. If you disagree with the approach taken by JCT, tell us why. If you think the proposal would be useful if modified, tell us how to fix it. Do I have your commitment that you will do this?

Answer

The staff of the Office of Tax Policy and I have been working closely with the IRS in the development of a strategy to increase the level of compliance. As part of the Fiscal Year 2008 budget process, we are considering various legislative ideas. We are reviewing and analyzing many legislative proposals, including the proposals included in "Options to Improve Tax Compliance and Reform Tax Expenditures" prepared by the staff of the Joint Committee on Taxation.

Tax Reform

Baucus Question 6

It seems that Treasury has only been releasing selective information, which was prepared for and provided to the tax reform panel in order for the panel to devise its recommendations. This Committee will be holding hearings in the very near future on those recommendations and would benefit from that background data, including much more detail on revenue estimates since these proposals were all reportedly revenue neutral. Chairman Grassley and I requested that any recommendations be forwarded to the Joint Tax Committee for their analysis since we rely on their estimates in developing tax bills. Can you provide such information to the Finance Committee and the Joint Committee on Taxation?

Answer

All of the publicly available information prepared for use by the President's Advisory Panel on Federal Tax Reform was included in the Panel report issued on November 1, 2005, or made available on the Panel's web site. The Panel members emphasized that

their recommendations related to each of the entire tax reform plans and not to their separate components. As you know, because of stacking order issues, the revenue estimates for individual components of the plans may not be very meaningful or useful in isolation.

Baucus Question 7

At your confirmation hearing, I asked you about the complex transition issues that would arise under the President's tax reform panel's recommendation for a progressive consumption tax and you agreed that these issues must be more fully examined and detailed. Following up on that question, can you please share with me any assumptions and analysis that Treasury has made to date in evaluating these proposals, including assumptions regarding 1) the treatment of tax-deferred retirement savings, both contributions and withdrawals, 2) the value of deductions for existing home mortgages, 3) the treatment of existing inventories and other assets, and 4) the treatment of existing liabilities. Also, please explain the effects that these transition issues will have on any purported efficiency gains from shifting to the progressive consumption tax.

Answer

Transition issues will arise with tax reform plans that make substantial changes to the tax code. Any proposal for a major overhaul of the tax system needs to be cognizant and sensitive to these types of transition issues as we attempt to move to an improved tax system. At this stage, we are working with Secretary Paulson to consider practical and viable tax reform options. In that context, we are actively considering transition issues.

Baucus Question 8

The Treasury Department used to routinely provide distribution tables for tax legislation. Those tables can be helpful to policymakers in crafting such bills. However, these tables have become scarce. Can you tell the Committee why Treasury has not provided them regularly, and could you also detail for us the differences in the few tables that have been provided with those issued by Treasury in the period prior to this Administration?

Answer

The Treasury Department has provided standard distribution tables for the major tax bills enacted under the current Administration. The methodology for constructing the tables, including the incidence assumptions, income measure, family unit and focus on fully phased in law, has been largely unchanged. Because the major tax relief proposals under this Administration have focused on the individual income tax, the distribution tables for these proposals have likewise focused on the individual income tax. As before, these tables show the distribution of the proposed tax change. Similar to tables produced by

the Joint Committee on Taxation, they also present tax shares with and without the proposal.

The final Report of the President's Advisory Panel on Federal Tax Reform also presented Treasury Department distributional analysis. These charts were primarily for all income taxes, not just individual income taxes because the Tax Panel's proposals affected both individual income and corporate income taxes. These charts also considered different incidence assumptions, and different charts for the short-run (2006), "fully phased-in law" (2016), and multi-year tables. Finally, the Report also included some charts distributing all federal taxes for comparison purposes.

Dynamic Analysis

Baucus Question 9

With regard to the dynamic analysis of tax reform options published by your office at Treasury, my staff has spoken with Jane Gravelle of the non-partisan Congressional Research Service, a highly regarded expert on tax policy and dynamic analysis. She cites many very serious flaws in the Treasury analysis. For example, she indicated that:

- The assumptions used by Treasury for the response of labor supply to changes in wage rates are much higher than most empirical estimates of this response.
- Much of the savings response to tax rate changes reflects an assumption of a significant shift of labor from far in the future into the present in response to a change in interest rates. Unfortunately, there is no empirical evidence of such a response that is available to researchers today. In fact, one economist, Charles Ballard from Michigan State University, said this was akin to "shooting in the dark."
- One of the models that is used by Treasury -- the Ramsey model --employs totally unreasonable assumptions: people never marry, the tax system is not progressive, there is no global (open) economy and there is no difference in tax rates among states. Given that these assumptions are totally unreasonable, the results from the model are essentially meaningless.

How can we place any faith in these or future dynamic analysis estimates from Treasury when the methodologies contain all of these serious flaws?

Answer

The Treasury report, released on May 25, 2006, presenting dynamic analysis of the tax reform options discussed in the President's Tax Panel Report, uses models and methodology that are commonly applied in other research on the macroeconomic effects of tax reform. Moreover, we used a range of models to, in part, reflect the different modeling approaches and acknowledge the uncertainty in both underlying assumptions and results. The non-partisan staffs of the Joint Committee on Taxation and the

Congressional Budget Office have employed similar approaches for addressing the uncertainty in these models. Nevertheless, we believe the results from these models are consistent with existing knowledge in the economics profession.

As stated in the Treasury report, the different models are calibrated to generate results that provide a reasonable range of results, given the uncertainty that economists have regarding the responsiveness of taxpayers to tax changes. With regard to labor supply, the Solow growth model was calibrated to generate a zero labor supply response, which is at the lower end of the likely range of behavioral responses. The parameters for the Ramsey growth model were set to generate a labor supply response near the upper end of empirical estimates. The parameters for the overlapping generations (OLG) model were set to generate labor supply responses that fall in between those two models. Thus, the assertion that the analysis uses labor supply responses that are much higher than most estimates of this response is inaccurate.

Similarly, some of the short-run savings response in the OLG and Ramsey models is the result of the intertemporal shift in labor supply, but this is not the dominant explanation for the increase in savings and capital formation in these models, and it explains none of the savings response in the Solow model. The primary explanation for the increase in savings is the change in consumption over time, and the parameter that governs the degree to which households are willing to substitute consumption over time is set well within the range of existing empirical estimates. The OLG model also includes adjustment costs to changing investment levels, which helps to moderate the initial savings response in the model. Furthermore, other research has shown the long-run savings response when moving to a consumption-based tax in both of these types of models is essentially the same whether or not labor is held fixed or allowed to vary over time.

Economic models always employ simplifying assumptions and the value of a good model is to capture the primary determinants of economic decision making while abstracting from less important details. The models used in this analysis, though admittedly stylized, are structured to account for the changes in the effective tax rate on capital and labor income and the consequent effects on economic growth. For example, in the Ramsey model, households save because they desire to smooth consumption over different time periods, the main reason why most people save. The Ramsey model is widely used in the macroeconomics literature and has been consistently used by the Congressional Budget Office in their dynamic analysis.

Further, in many cases changing the model's simplifying assumptions may not have an economically meaningful impact on the result of the policy being evaluated. For example, it is unlikely that any of the Tax Panel's recommendations would lead to significant differences in marriage rates, and even if that difference would occur, that it would lead to significantly different labor supply or savings responses on aggregate. Similarly, given that the analysis focuses on the economic effects of reforming the federal tax system, allowing for differential tax rates across states would provide very limited additional information, but would create great uncertainty and complexity.

The lack of a progressive tax system in the Ramsey model is potentially a more important issue, as taxpayers in different tax brackets may be more or less responsive than taxpayers on average. However, given that the model is not being used for distributional analysis, the lack of a progressive tax system should have only a minor impact on the macroeconomic results generated by the model. Only one of the models used by the Treasury Department (the OLG model) included international capital flows, albeit a very simple representation. This is an area where we agree that our models could be significantly improved.

Finally, we believe the results presented in the Treasury analysis provide a reasonable range of likely economic effects of the tax reform options that were analyzed. References are provided in the paper to peer-reviewed articles in professional journals that generate similar results for tax reforms, where the differences stem mostly from the details of the tax reform plans being analyzed. Our models have limitations, and we hope to make several improvements to them over time. For that reason, the Administration requested funding in its Fiscal Year 2007 budget for a new Dynamic Analysis Division in the Office of Tax Policy.

It is important to note that the Treasury Department intends to be transparent with respect to its methodology in this area. The Treasury Department released its detailed report on May 25, 2006, summarizing the dynamic analysis conducted on behalf of the President's Tax Panel. On July 25, 2006, Treasury released a second report detailing its methodology for preparing the dynamic analysis of the President's proposals to permanently extend the tax relief enacted in 2001 and 2003. Releasing the details of the Treasury Department's dynamic analyses – the models, the underlying assumptions, and the results – allows other researchers to understand and evaluate our analysis and will help inform the broader work on quantifying the dynamic effects of tax policy at the Treasury Department, the Joint Committee on Taxation, and the Congressional Budget Office.

Research Credit

Baucus Question 10

As a strong supporter of the research and development tax credit, I have pursued legislation to ensure both that taxpayers can use this incentive effectively and that IRS can properly oversee the program. However, it has come to my attention that a lack of clarity has made use of the credit difficult for research on software development costs. In fact, no regulations have been written to clarify the treatment of internal use software, and to help taxpayers determine the difference between general and administrative functions and software development that enhances economic growth in the U.S. Regulations to narrow the definition of internal use software could provide taxpayers greater assurance that the new software they are developing will be eligible for the R&D tax credit. Do you expect to issue proposed regulations in this area this year?

Answer

The Treasury Department and the IRS have a regulation project on the 2006-2007 Priority Guidance Plan that would provide proposed rules regarding the definition and treatment of internal-use software. The Treasury Department and IRS anticipate issuing proposed regulations regarding internal use software by the end of 2006.

Section 199

Treasury and the IRS recently issued comprehensive final regulations under section 199, which were welcomed by many taxpayers. However, there are a few areas that may need additional clarification:

Baucus Question 11

The regulations generally continue to adopt an "entity" approach with respect to partnerships, disallowing partnerships to attribute production activities to its partners and resulting in partnerships being treated worse than corporations. Do you believe that Treasury has the authority to provide for aggregate treatment under this law, which could resolve this situation?

Answer

The final regulations adopt an entity approach for section 199. In taking this position, the final regulations reflect a determination by the Treasury Department and the IRS that not attributing the activities of a pass-through entity to its owners is consistent with section 199(c)(4)(A) (which requires that gross receipts must be derived from the taxpayer's own qualified production activities in order to qualify as domestic production gross receipts) and with section 199(d)(1)(A) (which contemplates computation of the section 199 deduction at the partner level by reference to a pass-through of the entity's items).

The Gulf Opportunity Zone Act included a technical correction allowing aggregate treatment for partnerships wholly owned by members of an expanded affiliated group. Since the technical correction for expanded affiliated groups would not have been necessary if an aggregate approach generally applied, the Treasury Department and the IRS believe that Congressional action in this area confirms the appropriateness of entity treatment.

Adopting an aggregate approach could also result in excessive section 199 deductions to the partners. For example, consider a situation where a large retailer is not engaged in any qualifying section 199 activities, but the retailer's suppliers are engaged in qualifying activities. Under an aggregate approach, the retailer could enter into a partnership with a supplier for the sole purpose of being attributed the qualifying manufacturing activities of the partnership. The retailer could then claim a manufacturing deduction on the income

generated by distribution of the products produced by the partnership and sold by the retailer. Permitting such an attribution under the aggregate approach would significantly increase the section 199 deduction over the amount permitted under the entity approach.

Because of these concerns, the Treasury Department and the IRS have not adopted an aggregate approach and have not addressed the question of whether authority exists under the statute to provide broader aggregate treatment than the regulations already provide.

Baucus Question 12

To determine whether a film has met the 50% threshold for domestic production, the final regulations require the taxpayer to treat compensation paid by others as part of the denominator, but do not include such amounts paid for services performed in the United States in the numerator. As a result, under these regulations, compensation paid by others with respect to domestic production activities will count against whether a film is qualified and thus certain films/television shows that are produced domestically will be ineligible for section 199 benefits. This may frustrate our legislative intent to encourage domestic film production. Do you agree this may be the result, and if so, could we expect further guidance in this area?

Answer

To fit within the definition of a "qualified film" under section 199, not less than 50 percent of the total compensation relating to production of the film must be compensation for services performed in the United States. The final regulations reflect a determination by the Treasury Department and the IRS that excluding compensation paid by others from the numerator in determining whether the definition is met follows the statutory requirement that a qualified film must be "produced by the taxpayer" (emphasis added). The final regulations interpret the definition of a qualified film to mean that "not less than 50 percent of the total compensation relating to the production of such property [must be] compensation [paid by the taxpayer] for services performed in the United States by actors, production personnel, directors, and producers."

By allowing compensation paid by others to be included in both the numerator and denominator, an entire film could qualify for the section 199 deduction with only a nominal amount of qualifying production activity performed by the taxpayer. For example, if compensation paid by others were included in both the numerator and the denominator, a taxpayer that spends only a nominal amount on compensation for services could be entitled to the deduction solely by reason of compensation paid by others with respect to the film, a result that the Treasury Department and IRS believe would be inconsistent with the statutory requirement that the film be "produced by the taxpayer."

Baucus Question 13

Finally, Treasury should revisit the many comments submitted that suggested alternatives to the Section 861 cost allocation method for taxpayers not otherwise subject to that method. The application of the section 861 cost allocation method is problematic because section 861 generally sources income based on the location of assets, while Section 199 is concerned with where production activities occur. Please comment on this and whether Treasury is considering any further guidance in this area.

Answer

The Treasury Department and the IRS responded to the many comments concerning the complexity of the section 861 cost allocation method by raising the threshold for the availability of that method from $25 million to $100 million of annual gross receipts. This threshold allows 99.5 percent of all corporate taxpayers to qualify for the simplified deduction cost allocation method or the small business simplified overall method. It is contemplated that some of the 0.5 percent of taxpayers that are not eligible for either of the simplified methods will work with the IRS to formulate other reasonable cost allocation methods through the pre-filing agreement (PFA) program. If the regulations were to adopt a method other than the section 861 cost allocation method, a complex new set of rules would have to be fashioned that would increase burden and complexity.

Confidentiality of Tax Return Information

The integrity of our voluntary self-assessment tax system depends on the government's commitment to protect sensitive financial information provided by taxpayers to the IRS.

Baucus Question 14

Can you provide assurance that the U.S. Department of Treasury, which reportedly used its powers of administrative subpoena to compel bank records to be opened, is not using the same tactic to secretly open databases of Americans' sensitive tax records?

Answer

I understand your question to relate to the Treasury Department's Terrorist Finance Tracking Program, under which certain financial transactions are reviewed as part of specific terrorism investigations. The Office of Tax Policy is not involved in such matters. I can assure you, however, that the Treasury Department takes very seriously the mandate of section 6103, which broadly prohibits the disclosure of tax returns and tax return information, subject to a number of specific exceptions. The Office of Tax Policy is not involved in any requests for disclosure of tax return information under these statutory provisions.

Baucus Question 15

Are you aware of any instance in which the privacy protections afforded by the Internal Revenue Code have been by-passed to gain access to private tax information?

Answer

Section 6103 contains numerous provisions that authorize the disclosure of otherwise confidential tax returns and return information in specifically defined contexts. In accordance with section 6103(p)(3)(C), the Treasury Department furnishes to the Joint Committee on Taxation an annual report on the number and nature of authorized disclosures of returns and return information. The Joint Committee makes a summary of this report public. A disclosure report covering the 2005 calendar year was released by the Joint Committee on June 29, 2006.

Civil and criminal sanctions may apply to unauthorized disclosures or inspection of tax returns or return information. The IRS thoroughly investigates reports of such unauthorized disclosures and inspections. The IRS has a vigorous program in place to ensure the integrity of confidential tax return information, recognizing the importance of confidentiality to our system of voluntary compliance. In recent years, the Office of Tax Policy has worked with the IRS on a number of guidance projects to ensure that appropriate administrative rules are in place to protect the confidentiality of tax returns and return information.

Corporate Governance Questions

Baucus Question 16

Executive Compensation – There has been growing concern regarding the excessive executive compensation packages that have been in the news recently. For example, Lee Raymond, a retiring chairman of Exxon, received a retirement package totaling nearly $400 million. A study by the Business Roundtable found that from 1995 to 2005, median CEO compensation at 350 major companies rose 151%, while the median pay increase for full-time, year-round workers ages 25 to 64 was only 32%. Do you think there should be a "clear" limit on the amount of executive compensation deductible under the tax code and what should that limit be?

Answer

I share your concern regarding the amounts involved in certain cases. I question, however, whether the Internal Revenue Code should set limits on deductible executive compensation. This has already been tried to some degree with the $1 million limit on deductible compensation under section 162(m), without much success. That provision was first effective for taxable years beginning on or after January 1, 1994, and has been

in effect for much of the period of concern. It has not noticeably curtailed the overall amounts of executive compensation.

The tax law is an imprecise and inefficient mechanism for managing the size of executive pay arrangements. Our experience with the golden parachute limitations under section 280G and the $1 million compensation deduction limit under section 162(m) indicates that using the tax law to influence contracting parties, in this case companies and their executives, generally serves to increase the costs of providing executive compensation but has not curtailed the overall amounts of executive compensation. The additional tax and compliance costs are absorbed by the company in order to facilitate the bargain reached between the company and the executive and ultimately may be passed on to shareholders or customers. For example, it is fairly common for corporations to "gross up" executives for any golden parachute excise taxes. Provisions limiting deductions for executive compensation also add significant complexity to the Internal Revenue Code and require lengthy and detailed regulations.

Tax rules are often by their nature "one size fits all" solutions that are difficult to tailor to varied businesses, customs and practices. A compensation deduction limit that is too restrictive can exact an inordinate economic price to accomplish its goal by shutting down incentives for growth and creativity. Rules that are loose or flexible enough to accommodate a variety of practices are unlikely to limit overall compensation, as has been our experience with section 162(m). What may be wrong with the system for setting executive pay levels has little to do with tax incentives. I am doubtful that an effective solution can be enacted through the Internal Revenue Code.

Baucus Question 17

Fines and Penalties – The GAO reported to the Finance Committee that a majority of companies it surveyed deducted their civil settlement payments when their settlement agreement did not label the payments as penalties. The Department of Justice recently proposed a settlement with Boeing for $615 million dollars, and it is unclear to what extent the tax ramifications of the settlement were considered – if Boeing deducts the payments, the out-of-pocket cost to the company will be significantly less than $615 million. Please comment on the findings of the GAO report. To what extent should companies that make payments to the government to resolve investigations into potential wrongdoing be allowed to deduct these settlements from their taxes? How would you clarify section 162(f) to make certain that payments in the nature of a fine or penalty are not deductible?

Answer

As discussed in the GAO report that you reference, the Commissioner has made progress in collecting information on tax issues that affect the deductibility of settlement amounts made to government agencies. In particular, the Department of Justice agreed to provide information about large False Claims Act settlements shortly after they are closed and

agreed to provide information to the IRS on all False Claims Act cases annually. In addition, in 2004, IRS introduced Schedule M-3, which is intended to help the IRS in identifying companies with civil settlements by capturing information on fines, penalties, and punitive damages from companies with total assets of $10 million or more.

As you know, section 162(f) provides that a taxpayer cannot deduct any fine or similar penalty paid to a government (or to an agency or instrumentality of a government) for the violation of any law. The Treasury regulations under section 162(f) regarding civil proceedings distinguish between punitive and compensatory payments paid to a government for the violation of any law (consistent with the legislative history to section 162(f)). Thus, while a deduction is not allowed for civil penalties paid to a government that are imposed for the purpose of enforcing the law through deterrence or punishing a violation of the law, a civil payment paid to a government may be deducted if it is imposed as a remedial measure to compensate the government or another party, even if it is labeled a penalty.

Whether a civil payment is a "fine or penalty" under section 162(f) depends on the origin of the liability giving rise to the payment. This is a facts and circumstances test, in which one must first analyze the purpose of the statute, regulation or other legal authority that forms the basis of claims that are settled (or for which there is an imposition of a penalty). The primary ongoing source of debate and uncertainty under section 162(f) involves an inherently difficult determination that often comes down to a situation-specific inquiry into governmental intent, taking all the facts and circumstances into account.

In general, I question the extent to which the federal income tax should be used as a sanction against wrongdoing. To measure net income accurately, the tax system should take into account all expenses associated with the production of income, regardless of moral or legal considerations. Furthermore, an expansion of the existing tax rules barring deductibility of certain fines and penalties would raise IRS administrative concerns by making an already difficult facts and circumstances determination more complex. For example, there are many governmental and regulatory agency regulations that taxpayers must comply with on a day-to-day basis for ordinary activities, including, for example, building construction regulations such as those imposed by the Occupational Safety and Health Administration (OSHA) and other state and local agencies. Recently proposed revisions to section 162(f) would increase complexity and IRS burden by forcing taxpayers and the IRS to make a determination as to whether any change made as a result of an investigation or inquiry by a regulatory entity regarding compliance with these types of regulations was performed to come into compliance with the law or whether the change was imposed as a substitute for a penalty for a potential violation of the law.

Baucus Question 18

Disclosure of Information on the Corporate Tax Return – Should portions of the corporate tax return – say the M-3 schedule that reconciles the book and tax difference – be made public to protect investors and discourage Enron-type abuses where artificial losses/profits are generated to boost share price?

Answer

In recent years the Treasury Department and the IRS have worked with Congress to expand disclosure to the IRS by corporations in ways that provide a deterrent to aggressive tax planning and that allow the IRS to target its audit resources more effectively. The Finance Committee has provided critical support for this effort by enacting statutory changes to the reportable transaction regime as part of the American Jobs Creation Act of 2004. The IRS has also taken administrative steps in this area, most notably through the development of the new Schedule M-3, which requires most large businesses to make a detailed disclosure to the IRS of transactions that result in differences between earnings reported on financial statements and taxable income ("book-tax differences").

Commentators have recently suggested that the government should move beyond broader disclosure to the IRS and consider whether the benefits of broader public disclosure of return information such as the Schedule M-3 might outweigh the potential detriments. In this context, it is important to note that book-tax differences are often not an indication of aggressive tax positions, but arise from intended treatment under financial accounting standards and the tax law. Moreover, consideration of increased public disclosure must take into account the fundamental importance of confidentiality of tax returns and return information in our self-assessment tax system. Furthermore, the IRS already has the information that would be disclosed, so public disclosure of the corporate tax return or portions thereof would not provide any direct benefit to the IRS.

The potential benefits of any proposed regime of public disclosure of corporate tax return information must be carefully considered in light of the potential detriments. Public disclosure could increase market confusion, particularly because most book-tax differences are not related to aggressive tax planning. In an area where even the most sophisticated practitioners in corporate taxation, financial accounting, and securities laws can have difficulty in understanding and reconciling complex corporate tax returns and financial statements, significant questions are raised as to how the general public might benefit from broader access to this information. In addition, public disclosure could provide competitors with access to a corporation's confidential financial information. Finally, public disclosure could encourage companies to withhold sensitive information from the IRS. The government long ago recognized that, under our self-assessment regime, taxpayers are more likely to provide full and frank disclosure of their financial information if they know that it will be kept confidential by the IRS.

Baucus Question 19

Deferred Compensation – Under present law, there is no limit on the amount of compensation that executives can defer under nonqualified deferred compensation arrangements. In order to defer income taxation of compensation through a nonqualified arrangement the deferred amounts must be subject to "substantial risk of forfeiture." Richard Grasso received almost $140 million in deferred compensation for his eight years as chairman of the NYSE. Should there be tighter rules regarding deferred compensation paid to corporate executives and what should they be? What would you recommend to address this issue?

Answer

Code section 409A, as enacted under the American Jobs Creation act of 2004, made major changes with respect to the tax treatment of nonqualified deferred compensation. Section 409A substantially tightened the tax rules regarding deferred compensation. The Treasury Department and the IRS are currently developing and implementing regulations and other guidance under section 409A. Extensive proposed regulations were issued under section 409A on October 4, 2005. We expect to issue a substantial package of final regulations by the end of 2006.

Section 409A restricts the timing for elections to defer compensation as well as permissible times for payment of deferred amounts. The time for payment of deferred compensation under section 409A generally must be set at the time for deferral, and changes to the payment schedule are limited, with most accelerated payments of deferred compensation prohibited. There are significant tax effects of a failure to comply with section 409A, including immediate inclusion of the deferred amount in taxable income, an additional 20 percent tax on the included amount, and an interest charge that eliminates the tax benefit of the deferral. The section 409A rules impose significant new compliance obligations on a wide variety of compensatory arrangements and are widely regarded as the biggest change to employee compensation rules since the enactment of the Employee Income Retirement Security Act of 1974.

Guidance and Development of the Business Plan

There are many proposed and temporary regulations that date back 10, even 20 years. There are also final regulations that have not been revised to match changes in legislation. In some cases, the law has changed so drastically that these regulations are obsolete.

Baucus Question 20

Describe Treasury's process to develop the business plan, including the criteria that are considered.

Answer

Each year, the Treasury Department and IRS publish a priority guidance plan (PGP) identifying for the public those areas in which published guidance is under development. The guidance plan year currently runs from July 1 to June 30. The 2006-2007 PGP was released on August 15, 2006. During the course of the guidance plan year, the Treasury Department and the IRS publish periodic updates to the PGP.

Publication of the PGP is coordinated by the IRS' Office of Chief Counsel, in the office of the Associate Chief Counsel for Procedure and Administration, with input from other Associate Chief Counsel offices (Corporate, Income Tax & Accounting, Passthroughs & Special Industries, Tax-Exempt and Government Entities, International, Financial Institutions & Products) as well as IRS Division Counsel offices. The Treasury Department's Office of Tax Policy is actively involved in identifying items to include in the PGP.

Items considered for inclusion in the PGP come from a variety of internal and external sources, including taxpayer and practitioner comments and inquiries to the IRS or the Treasury Department, issues raised by IRS Division Counsel working with taxpayers and examination teams on audit, and Congressional inquiries. In addition, our work on current guidance projects often leads to new projects. Each year the Treasury Department and the IRS formally solicit input from the public on development of the PGP, and receive numerous comments in response to that solicitation. On March 26, 2006, the Treasury Department and the IRS issued Notice 2006-36, 2006-15 I.R.B. 756, soliciting input on the 2006-2007 PGP.

Enactment of new legislation often results in the addition of new projects to the PGP. For example, enactment of the American Jobs Creation Act of 2004 and the Energy Tax Incentives Act of 2005 caused the Treasury Department and the IRS to initiate dozens of new guidance projects, many of which had an accelerated timetable for completion. The pressing nature of projects resulting from newly enacted legislation often causes a reordering of existing guidance priorities. Examples of substantial guidance projects resulting from the American Jobs Creation Act include guidance on the repatriation deduction, the domestic manufacturing deduction, the deferred compensation rules, and the disclosure rules for potentially abusive transactions.

Criteria considered in determining whether to include guidance on the PGP include: (1) whether the guidance is timely, addressing an issue of immediate concern to taxpayers and the IRS; (2) whether the guidance is responsive to widespread issues; (3) whether the guidance will be simple and clear; (4) whether the guidance will be understandable and minimally burdensome to taxpayers; (5) whether the guidance will be administrable by the IRS; (6) whether the guidance will reflect good tax policy (i.e., be fair, neutral and transparent); and (7) whether the guidance will help to reduce return position uncertainty and audit uncertainty, thereby reducing audit risk and burden.

Baucus Question 21

What is Treasury's policy to ensure that regulations remain current and relevant? Is this policy adhered to?

Answer

The process described in my response to Question 20 to identify items for inclusion in the annual priority guidance plan (PGP), or in periodic updates to the PGP, ensures that regulations remain current and relevant. For example, a completed item on the 2005-2006 PGP was finalizing regulations reflecting the repeal of the individual estimated tax provisions under former Code section 6015, which are now contained in section 6654. An item on the 2006-2007 PGP is to finalize regulations updating the corporate estimated tax rules. There is a substantial need for guidance under new or amended Code provisions and, for that reason, publishing guidance in response to new legislation is a priority.

Baucus Question 22

Does Treasury have a systemic process to regularly review pending and final regulations to determine if they should be withdrawn, updated and/or finalized? Please describe the process.

Answer

Part of the process described in my response to Question 20 to identify items for inclusion on the priority guidance plan (PGP) includes continuous review of existing regulations to determine what needs to be withdrawn, updated or finalized. Within the Office of Tax Policy and the IRS Office of Chief Counsel, attorneys are assigned specific subject matters within the tax law. Part of their job responsibility is to identify outdated regulations, based on their own review and on input received from internal and external sources.

Baucus Question 23

Please identify regulations that Treasury considers outdated. When will these outdated regulations be reviewed and appropriate action taken?

Answer

The current priority guidance plan (PGP) is the best source for areas that the Treasury Department and the IRS have identified as needing an update or publication of new or additional guidance. Two important examples of current guidance projects that address outdated regulations include regulations dealing with the capitalization of tangible assets

under Code section 263(a) and regulations dealing with corporate estimated tax under Code section 6655.

Advance Pricing Agreements

Advance Pricing Agreements are designed to resolve transfer pricing disputes. There is a great deal of interest in using arbitration to resolve tax disputes. A pending protocol to the current United States-Germany income tax treaty provides for mandatory arbitration when the competent authorities are unable to resolve a case after two years. Factual issues can be submitted to arbitration, and possibly legal issues.

Baucus Question 24

To what extent should arbitration be used to resolve cases involving advance pricing agreements?

Answer

Although we consider arbitration provisions to be helpful in many instances, we do not generally support arbitration to resolve disputes between a taxpayer and the Internal Revenue Service (IRS) regarding the negotiation of an advance pricing agreement (APA). However, arbitration may be appropriate between countries where the dispute arises between the IRS and its counterpart in another country in the context of a bilateral or multilateral APA that will apply to prior taxable years. In such cases, what may have begun as an APA essentially becomes like any other dispute between competent authorities.

An APA is an agreement between a taxpayer and the IRS specifying transfer pricing methodologies to be used by the taxpayer in allocating items among two or more controlled persons. APAs are generally designed to address future years.

Arbitration is an "alternative dispute resolution" mechanism; that is, it is an alternative to the traditional adversarial process that can result in an administrative appeal, litigation, or competent authority proceedings under the mutual agreement procedures of our bilateral income tax treaties.

It is important to recognize that the APA Program is itself an alternative dispute resolution mechanism, designed (like arbitration) to be a quick and efficient, yet fair, alternative to the adversarial process. It is designed to be a flexible problem-solving process that is based on cooperative and principled negotiations between taxpayers and the IRS.

APAs must include "critical assumptions," including the objective business and economic criteria that form the basis of a taxpayer's proposed transfer pricing

methodology. APAs are generally designed to address future taxable years and a taxpayer always has the option to "terminate" an APA by breaching any of the critical assumptions (e.g., by changing its mode of conducting business operations, a particular business structure or strategy, etc.). Arbitration would be disruptive to the APA Program by effectively giving a taxpayer the right to invoke arbitration and comply with an arbitration result it considers favorable, yet walk away from an unfavorable arbitration decision by breaching a critical assumption.

With respect to resolution of disputes for prior taxable years, the pending protocol to the current United States-Germany income tax treaty provides for mandatory arbitration when the competent authorities are unable to resolve a case after two years, including mandatory arbitration with respect to prior taxable years where an APA is under negotiation and there are issues as to such prior taxable years. Importantly, tax returns must have been filed with at least one of the Contracting States with respect to the taxable years at issue in the case. Thus, arbitration under the pending protocol would only be available for APAs with respect to issues relating to prior taxable years.

Use of arbitration in this circumstance is limited to a determination regarding the amount of income, expense or tax reportable to the Contracting States. Thus, the arbitrator would not be deciding on the appropriate transfer pricing methodology. Thus, by definition any such resolution would not apply to future years. For this reason, the problems potentially rising from allowing arbitration with respect to negotiation of APAs for future taxable years (the disincentives for the taxpayer to reach a negotiated agreement and the one-sided nature of a result that allows a taxpayer to walk away from a bad result in arbitration by changing future business practices) are not present under the arbitration provision of the pending United States-Germany protocol.

Moreover, arbitration under the pending protocol is not available if both competent authorities agree that a particular case is not suitable for determination by arbitration. Thus, arbitration regarding the applicability of an APA to prior taxable years supplements, but does not supplant, the competent authority process, by encouraging the competent authorities to reach an agreement, but not forcing them to do so if they agree that a case is not appropriate for such resolution.

Baucus Question 25

Do you envision arbitration being used to resolve the most complex transfer pricing issues?

Answer

For the reasons discussed in my response to Question 24, we do not generally envision arbitration being used to resolve transfer pricing issues within the APA Program with respect to future taxable years.

Baucus Question 26

To what extent are legal issues suitable for determination by arbitration?

Answer

For the reasons discussed in my response to Question 24, I do not believe that any issues (legal or factual) would be suitable for determination by arbitration within the APA Program with respect to future taxable years. Even as to past taxable years, an arbitrator's decision only resolves a single factual issue – the amount of income, expense or tax reportable to the Contracting States.

Baucus Question 27

To what extent should information about arbitrations be included in Treasury's annual report on advance pricing agreements?

Answer

For the reasons discussed in my response to Question 24, I do not believe that arbitration should be used in the negotiation of APAs, and therefore no disclosure in the Treasury Department's annual report on advance pricing agreements would be required.

IRC Section 6103 Disclosure Issues

Section 6103 has become a prominent issue in the immigration debate. Current immigration legislation includes the sharing of taxpayer identity information, including the taxpayer's name, address, and taxpayer identification number. Some believe that such taxpayer identity information should not be protected by section 6103.

Baucus Question 28

Should taxpayer identity information continue to be protected by section 6103?

Answer

A critical element of ensuring voluntary compliance with our tax laws is protecting the confidentiality of tax returns and return information. Unless taxpayers know that information provided to the IRS will not be shared with others except in specifically defined circumstances, they may be reluctant to disclose the sensitive personal financial information that is necessary to report their federal tax liability accurately. With limited exceptions, current law protects "taxpayer identity" (defined under section 6103(b)(6) to mean "the name of a person with respect to whom a return is filed, his mailing address, his taxpayer identifying number . . . , or a combination thereof") to the same extent that it

protects both tax returns and tax return information. In limited situations relating to tax refunds, Federal claims, terrorist activities, and other circumstances, Congress has provided exceptions to the general rule prohibiting disclosure of taxpayer identity. Consideration of additional exceptions must carefully balance the need for such exceptions against the benefit that strict confidentiality provides for voluntary compliance.

Baucus Question 29

What type of information do you think section 6103 should protect?

Answer

Section 6103 should broadly protect information obtained or generated by the IRS in connection with a tax or related liability in order to maintain public confidence in our nation's voluntary assessment regime. If taxpayers become inhibited from supplying information to the IRS because of concern that the information will be improperly used, tax administration could be impaired. For this reason, section 6103(b)(2) broadly defines return information. At the same time, certain provisions of current law permit disclosure of particular items of return information in specified circumstances. Additional exceptions to these broad protections should, if justified, be narrowly drawn and specifically described.

Baucus Question 30

How would the proposed legislation change current IRS disclosure protection policy and practices?

Answer

Provisions included in the Senate-passed version of S. 2611, the Comprehensive Immigration Reform Bill of 2006, would amend section 6103 to permit the Social Security Administration (SSA), on a reimbursed basis, to disclose to the Department of Homeland Security (DHS) certain employee and employer return information derived from IRS Form W-2 (Wage and Tax Statement). Because SSA obtains certain taxpayer identity information under authorizing provisions of the Internal Revenue Code, this information is protected by section 6103 to the same extent that it would be protected in the hands of the IRS. Information disclosed to DHS under this new provision would be subject to existing safeguard requirements under section 6103(p)(4), which require an agency that receives return information to record requests for disclosure, maintain secure storage of the return information, restrict access to authorized personnel, report to the IRS on confidentiality safeguards, and destroy the return information or give it back to the IRS when finished. In addition, the bill would add a provision requiring DHS, in turn, to impose similar safeguards on any of its contractors that handle return information. DHS

would have to conduct a regular on-site review of contractors, report to the IRS on confidentiality safeguards by contractors, and certify annually that contractors are in compliance.

IRS Continuity of Operations Plan (Flood Damage)

Baucus Question 31

2400 employees who work in the IRS headquarters building are working in temporary quarters or at home because of flood damage. Commissioner Everson has stated, "we successfully implemented our Continuations of Operations (COOP) plan and all critical employees were back to work within two weeks." However, I am told that many workers do not have access to basic and necessary equipment, like telephones, laptop computers and data files, to be able to carry out their official duties.

a. If workers don't have computers, phones or access to their data, how can they operate normally or effectively? How many displaced workers still are unable to perform their official duties normally as a result of being displaced by the flood?

b. To what extent has the flood disrupted IRS operations? What is the impact of this disruption on tax administration? Are there delays in issuing Treasury or IRS guidance? Will taxpayers be adversely affected?

Answer

The flooding of the IRS headquarters building in late June caused the displacement of workers from the IRS headquarters building at 1111 Constitution Avenue. However, by July 5, 2006, all critical IRS employees were assigned workstations or were authorized to telecommute. While there was a short-term interruption in the ability of displaced IRS employees to perform their work fully, efforts to bring every worker up to full capacity, including providing them with computer and telephone access, are now almost complete.

I have been assured by Commissioner Everson and Chief Counsel Korb that the work of the IRS is continuing while the agency takes action to repair the damage and implements its business resumption plans for the headquarters building. The public should not notice any significant change in their interactions with the agency based on temporary closure of the headquarters building. Taxpayers should not be adversely affected in any way. The Treasury Department and the IRS have continued to publish guidance during the shutdown of the headquarters building and any impact on tax administration generally, or the guidance process in particular, will be nominal and short term.

Energy

Baucus Question 32

Refined Coal: The refined coal credit in Section 45(c)(7) requires that refined coal achieve a "20% reduction in NOx and either SOx or mercury" to be eligible for tax credit. Sulfur and mercury are contained in the coal and released during combustion. NOx can be adjusted in the combustion process – usually with an offset to boiler efficiency. Would you support providing taxpayers with guidance on complying with Section 45(c)(7) that would require that a nationally-recognized lab test the refined coal for all relevant emissions compared to emissions from the unrefined feedstock in a controlled environment where all boiler conditions are held constant to certify qualification for the Section 45 refined coal credit? How does the Department of Treasury plan to establish a uniform baseline to measure emissions reduction?

Answer

I have been closely involved in the development of guidance to implement the 2004 and 2005 changes to section 45. This is, however, the first occasion on which I have been advised that the new credit under section 45 for refined coal may require additional guidance. I look forward to learning more about the issue and working to ensure that all necessary guidance is issued.

Telephone Excise Tax

In Notice 2006-50, the IRS announced it would provide refunds, including interest, to consumers for the 3 percent federal excise tax on long-distance service collected between February 28, 2003 and August 1, 2006.

Baucus Question 33

In addition to Notice 2006-50, how will the IRS notify taxpayers during the 2007 filing season that they may be entitled to a telecommunications tax refund, especially those who do not normally file a tax return? Does the IRS intend to issue additional guidance on this process?

Answer

The IRS is working to develop a system under which it expects to make over 155 million refunds of the telecommunications excise tax. The IRS is still in the process of developing publicity and outreach efforts, including publicity and outreach aimed at those who do not normally file an income tax return. To accomplish this, the IRS plans to work with a variety of external partners with extensive networks in low-income communities to educate these taxpayers about the process for claiming a telephone excise tax refund.

Baucus Question 34

Notice 2006-50 provides that several forms (1040 series, 1041, 1065, 1120 series, and 990-T) will be revised to include a line to request the overpayment amount. Will the forms and instructions clearly indicate the purpose of the line? Will IRS employees be trained about the credit so they can assist taxpayers with questions?

Answer

The telecommunications excise tax refund system will include revisions to the forms to enable taxpayers to claim the refund and training for IRS employees. Although the specific form revisions and training programs are still under development, the IRS expects that the forms and instructions will clearly indicate the manner in which taxpayers may claim the credit and IRS employees will have training to enable them to assist taxpayers with questions.

Baucus Question 35

Notice 2006-50 provides that individuals who are otherwise not required to file a tax return must file Form 1040EZ-T to claim their refunds.

a. Since these individuals will be likely to use a paid preparer to file their claims for refund, how will the IRS ensure that tax preparers do not charge unreasonable fees that are not commensurate with the size of the refund?

b. Did the IRS consider a less burdensome format for nonfilers to claim their refunds, for example, a version of the Tele-File process that could be done over the phone?

c. Will Taxpayer Assistance Centers, Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites prepare the refund claims for individuals? If so, will this service be publicized?

Answer

Although the telecommunications excise tax refund system is still under development, the IRS expects that the system will include a very simple form nonfilers can use to claim the refund. Taxpayers will not have to use a paid preparer in order to claim the refund. IRS offices, as well as Taxpayer Assistance Centers, Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites will assist taxpayers in preparing their refund claims. In addition, the IRS anticipates that IRS Free File will be available to most taxpayers so that they may prepare and file their claims for free.

Baucus Question 36

Notice 2006-50 states that filers will be required to certify that (1) the taxpayer has not received from the collector a credit or refund of the tax paid on nontaxable service billed during the relevant period and (2) the taxpayer will not ask the collector for a credit or refund of that tax and has withdrawn any such request previously submitted.

a. Explain the certification process. How will the taxpayer obtain or declare certification that the taxpayer has not obtained a credit or refund of tax?

b. Will the certification be made on the revised tax forms?

Answer

Although the certification process is still under development, the IRS expects that the certification will be made on the tax form used to claim the refund.

Baucus Question 37

Notice 2006-50 gives individuals the choice of claiming a safe harbor amount or the actual taxes paid.

a. Has a safe harbor amount of credit been determined? If so, what is the amount and how was it determined? Does the safe harbor take the number of phone lines, phone, or types of service into account? When will the IRS issue additional information concerning the safe harbor amount?

b. How will the IRS determine whether actual claims are based only on the taxes covered in the notice and not other types of taxes that are paid through the phone bill?

c. What enforcement action will be taken to determine whether taxpayers claiming actual taxes are reporting the correct amount?

d. To what extent will phone companies be required to provide records to taxpayers or the IRS?

Answer

The IRS is still in the process of determining the safe harbor amount and appropriate verification and enforcement actions. Although the Code permits the IRS to require phone companies to provide records to the IRS relating to their customers, it also requires the IRS to reimburse the companies for the costs incurred in providing those records. I am not aware of any authority that would permit the IRS to require phone companies to provide records to taxpayers.

Baucus Question 38

Notice 2006-50 provides that entities other than individuals must file a claim based on actual taxes paid. Please explain the rationale for this decision and discuss why other types of taxpayers, especially small businesses, are precluded from using a safe harbor amount.

Answer

A safe harbor is being provided for individuals, in part, because they had no preexisting tax obligation to keep records of their nondeductible personal telephone expenses. Business taxpayers, on the other hand, are permitted to deduct telephone expenses and are required under the Code to maintain records to substantiate the deduction. In addition, whereas phone spending patterns enable the IRS to calculate a safe harbor amount for individuals, the wide variety of phone spending patters of businesses prevents use of a safe harbor for businesses.

Baucus Question 39

If a taxpayer has a balance due return, but is entitled to a telecommunications tax refund, will the refund be issued separately or used to offset the balance due?

Answer

The IRS is still in the process of developing the system to administer telecommunications excise tax refunds. The IRS plans to use the income tax return as the medium for claiming the refund in order to minimize paperwork burdens both for the IRS and taxpayers. In keeping with this goal, it is expected that excise tax refunds will be used to offset the balance due.

Baucus Question 40

How many refunds does the IRS expect will be issued, by individual or type of entity?

Answer

The IRS expects that as many as 145 million individuals and between 10 and 15 million business and nonprofit entities will submit refund claims.

Baucus Question 41

What is the dollar amount of the refunds expected to be issued, by individual or type of entity? What will be the cumulative dollar impact of taxpayers using the safe harbor instead of actual taxes paid?

Answer

The IRS is still in the process of determining the safe harbor amount. Until the safe harbor is determined, we are unable to provide an estimate of the amount of refunds expected to be issued or the cumulative impact of using the safe harbor amount instead of actual taxes paid. The IRS recognizes that it is not possible to design a safe harbor that all or substantially all taxpayers will use without incurring excessive revenue losses. The Service's objective is to design a safe harbor that will be used by a substantial majority of individuals who are eligible for refunds, while mitigating the payment of excess amounts that may result from use of a safe harbor.

Baucus Question 42

Notice 2006-50 provides that interest will be paid on refunds based on actual taxes paid. Will interest be paid on the safe harbor claims? If not, please explain.

Answer

Although the IRS is still in the process of determining the safe harbor amount, interest is being taken into account in determining the safe harbor amount and will be included in the safe harbor amount.

Baucus Question 43

What time period will interest on the refunds cover? If the taxpayer has a balance due return, but a telecommunications tax credit, will interest be paid on the credit amount?

Answer

Interest on the refund of taxes paid during a calendar quarter will cover the period between the last day of the month following the quarter in which the telecommunications tax was paid and the date of the refund (determined after the application of section 6611(b)(2) of the Code). Any income tax balance due on the return will have no effect on the interest computation. If the taxpayer has a balance due return, but a telecommunications tax credit, interest will be computed on the credit amount, but will offset the balance due.

Baucus Question 44

What will be the costs to administer this program, including the costs of form revisions, assistance, processing and enforcement? Please include all costs, including labor, fringes, other direct costs and overhead.

Answer

The IRS currently estimates the cost of the telephone excise tax refund effort to be approximately $49 million. This figure includes anticipated processing and systems costs as well as the impact of additional phone calls and support services the IRS will need to provide.

Baucus Question 45

Which operating division or function will be responsible for this program? Will this initiative take away from other work these employees would normally be doing? Please specify the affected programs and the impact on normal operations, including the effect on the tax gap.

Answer

The IRS approach to administering the telephone excise tax refund is to use existing processes as much as possible in order to minimize the potential for error and confusion. That is why taxpayers must use their tax returns to claim their refunds – something with which most people are familiar – rather than filing separate claims. This approach will help IRS manage the refund effort most effectively and will be easiest for most individual taxpayers.

Each IRS operating division or function is responsible for overseeing the portion of the excise tax process related to its core work. Overall management of this effort is under the direction of a team of IRS executives at very high levels within the agency. An executive steering committee meets regularly to review plans and progress, consider issues as they arise and provide direction to various working groups handling the different pieces of the refund effort.

The IRS anticipates more phone calls and walk-in inquiries as a result of telephone excise tax refunds. In addition, the IRS is developing a compliance strategy related to the excise tax which could have the potential of displacing some audits with ones related to the telephone excise tax refund. The IRS does not anticipate that these one-time changes will have a significant effect on the tax gap.

Baucus Question 46

When does the IRS expect to have the refund process designed and ready to receive claims? Do individuals who otherwise are not required to file need to wait until the 2007 filing season to file their claims for refund?

Answer

The IRS is working to develop a system under which it expects to make over 155 million refunds of the telecommunications excise tax. The IRS is still in the process of developing a system, but has concluded that a system using the 2006 income tax return is the only practicable method of processing this number of refund claims. Individuals who are not otherwise required to file a tax return will need to wait until the 2007 filing season to file their claims for refund. The IRS expects the system to be fully developed and ready to receive claims by the filing season for 2006 returns.

Baucus Question 47

What impact will the refund program have on local-only service providers?

Answer

I am unaware of any impact the refund program will have on local-only service providers. Until legislative action is taken, the telecommunications excise tax continues to apply to local-only service.

Baucus Question 48

Current law allows businesses a deduction as an ordinary and necessary business expense, tax payments that were collected and remitted to the Federal government. Are businesses claiming the entire amount of the collection as an expense or only the cost of collecting the tax? How is this cost quantified? How many businesses are not collecting and remitting the entire amount of the excise tax?

Answer

It is my understanding that telephone companies that collect excise taxes under an unequivocal statutory duty to remit those taxes do not hold the amounts collected under a claim of right. Thus, the taxes are neither gross income to the telephone companies when collected nor deductible by telephone companies when remitted to the government. I further understand that the costs of collecting the tax are an ordinary and necessary business expense and are deductible when paid or incurred. There is no requirement that telephone companies separately state the costs of collection on their income tax returns so the IRS has no basis for quantifying these costs.

Section 181 Regulations

In the 2004 Jobs Creation Act, I worked in support of enactment of an incentive program to keep film productions in the United States. This has been an important issue to me because of my interest in getting film productions to locate in Montana. I am concerned that Montana and other states have lost film production jobs to Canada as a result of the generous incentive program that country provides to attract U.S. film productions. In fact, the problem is not limited to Canada; most of the major industrialized nations have established film production incentive programs with the primary purpose of luring U.S. film productions to support domestic employment.

Unfortunately, the incentive program we enacted in section 181 of the Code in 2004 has been severely undermined by the failure of the IRS and Treasury to issue guidance. I am particularly concerned that Treasury clarifies the treatment of participations and residuals under the $15 million production cap in section 181. It is important that guidance be completed, but also that it be written correctly to exclude residuals and genuine participations from the cap. Otherwise, it will be impossible for film production companies to know at the time of the production whether the film will qualify for the incentives in section 181.

Baucus Question 49

Please tell me the status of Treasury's work on this matter and why it has taken so long to finish this project.

Answer

Section 181 was added to the Code by section 244 of the American Jobs Creation Act of 2004 and permits the producer of a qualified film or television production to elect to deduct certain production costs in the year the costs are paid or incurred, rather than capitalizing those costs and recovering them through depreciation allowances. On May 1, 2006, the Treasury Department and the IRS released Notice 2006-47, 2006-20 I.R.B. 1, which provided interim guidance on making elections under a number of provisions in the American Jobs Creation Act, including section 181. Publication of further guidance under section 181 is identified as an item on our current priority guidance plan. The Treasury Department and the IRS have met with taxpayers and practitioners regarding this provision, have reviewed a number of comment letters, and have identified a number of issues that need to be resolved through published guidance. Resolution of these issues and publication of the guidance has been complicated by the unique nature and structure of the film and television industry, in particular the use of participation arrangements with actors, directors and other talent, the use of residual payments under collective bargaining arrangements, and the manner in which many production costs are financed.

Baucus Question 50

When do you expect to get guidance out to the public?

Answer

The Treasury Department and the IRS recognize the need for additional published guidance in order for taxpayers to utilize the provision fully. We are also cognizant of the limited time frame in which the benefits of section 181 are available, and are working diligently to complete the pending guidance project.

Taxation of Escrow Accounts on Like-Kind Property

The Internal Revenue Service recently issued and held hearings on proposed regulations under section 468B and section 7872 (REG-113365-04 REG-209619-93) concerning qualified intermediaries.

Baucus Question 51

The Regulatory Flexibility Act requires that Federal agencies prepare a regulatory flexibility analysis for proposed rules to assess their impact on small businesses.

a. Has the Treasury prepared the regulatory flexibility analysis for this proposed regulation and if so, what were the findings of this analysis?

b. Based on these findings, does the Treasury believe that the proposed regulations will have a significant economic impact on a substantial number of the small business qualified intermediaries?

c. Will this proposed regulation have any significant economic impact on large business qualified intermediaries?

d. In what situations do you believe that proposed rulemaking is not a significant regulatory action and does not require a regulatory flexibility analysis?

Answer

The Special Analysis section of the proposed regulations notes that, before they were published, an Initial Regulatory Flexibility Analysis (IRFA) was performed by the IRS in accordance with the Regulatory Flexibility Act. The Special Analysis section also included a specific request for comments on the analysis. Although a significant amount of time and effort was put into developing the IRFA, following publication of the proposed regulations, commentators noted how aspects of the IRFA might be improved.

Accordingly, the IRS has committed to performing a new regulatory flexibility analysis with respect to the proposed regulations.

Tax Exempt Bonds for Indian Tribes

Tribes may not issue private activity bond, but Tribal governments may issue tax-exempt bonds for "essential governmental functions." The meaning of that term is unclear.

Baucus Question 52

1) Why have there been no regulations issued defining the term "essential government function?"

2) In the past 10 years, how many audits did the IRS conduct of tax-exempt bonds issued by Tribal governments and for what purpose were those bonds issued?

3) In the past 10 years, how many audits did the IRS conduct of tax-exempt bonds issued by municipalities and for what purpose were those bonds issued?

Answer

On August 9, 2006, the Treasury Department and the IRS released an advance notice of proposed rulemaking on the important topic of the definition of the term "essential governmental functions" under Section 7871 for purposes of tax-exempt bond financing eligibility for Indian tribal governments. Previously, in 1984, the Treasury Department did issue regulations in this area, but Congress later found that the regulations were based on an unduly broad interpretation of essential governmental functions. In 1987, Congress statutorily limited the definition of essential governmental function to provide that essential governmental functions do not include activities which are not customarily performed by State and local governments with general taxing powers. As your recent 2006 legislative proposal recognizes, it may be appropriate to consider statutory changes to address the eligibility of Indian tribal governments to use tax-exempt bonds for economic development needs and poverty conditions.

The IRS estimates that, in the past 10 years, it conducted approximately 13 audits of tax-exempt bond issues for Indian tribal governments. The purposes for which these tax-exempt bonds for Indian tribal governments were issued include approximately 10 facilities related to casino or resort complexes (including hotels, restaurants, recreational vehicle parks, water systems, and golf courses), one plastics manufacturing facility, one forest products facility, and one single-family housing facility.

The IRS estimates that, in the past 10 years, it conducted approximately 3,100 audits of tax-exempt bond issues for State and local governments. The purposes for which these tax-exempt bonds for State and local governments were issued include a broad spectrum

of activities including, for example, specific market segment initiatives for qualified small issue bonds for manufacturing facilities, exempt facility bonds for solid waste facilities, single-family and multifamily housing facilities, and various arbitrage investment.

These IRS estimates of audit activity are based on available data since the 2000 IRS reorganization that created a separate tax-exempt bond audit group and on estimates of previous audit activity. The IRS also has indicated that, based on data derived from IRS information reporting returns, the level of audit activity involving tax-exempt bonds for Indian tribal governments is within the same general statistical range as that for tax-exempt bonds for State and local governments generally.

Tax Administration

Foreign Source Information Reports

This Committee recently learned that the IRS has failed for years to use the foreign source information reports received from our treaty partners (similar to the Forms 1099 that we use here in the US) to determine whether income earned overseas by US taxpayers is being reported to the IRS. We learned the paper reports sat in boxes in Philadelphia without being reviewed. Now that the data is coming in electronic format, the IRS still is not using the information to find unreported income.

Baucus Question 53

1) With a $345 billion annual tax gap, and the use of offshore accounts to avoid taxes proliferating, why would the IRS let this valuable information just sit there and go to waste?

2) What do you intend to do to ensure that the IRS pursues unreported income from foreign sources?

Answer

I understand that the IRS is rethinking some of the traditional ways it has attempted to use this foreign source information and that it has expressed its commitment to evaluate the use of foreign-source income documents and determine their appropriate use in its compliance activities. The Office of Tax Policy will continue to work closely with the IRS to make sure that the IRS is making proper use of its tools in this area.

Tax Administration

Limited Issue Audits

To leverage its resources and to become more current in its examinations, the IRS uses several expedited or abbreviated audit techniques, including the limited scope audit and the LIFE (limited issue focused exam) audit. Agents examine only a few issues and generally do not have the time to look below the surface for tax shelters or other abusive transactions.

Baucus Question 54

Do you think that audits designed to pick the "low hanging fruit" are good policy? How effective are limited audits at finding Enron-type situations that are not apparent on the face of the tax return?

Answer

The decision whether to pursue a Limited Issue Focused Examination (LIFE) is based on the historical compliance behavior of the taxpayer and a rigorous risk analysis of the tax return using established materiality thresholds. Both the traditional limited scope and LIFE examinations are employed only where the IRS examiner's assessment of the return indicates that a few distinct areas represent substantial compliance risk, and that the balance of the return being examined represents relatively low risk. This determination is made only after the examiner has conducted a risk analysis that encompasses a review of the return and publicly available information, and may include a limited review of taxpayer records. Because the initial determination to pursue a limited scope examination is based on the taxpayer's compliance history and the relative risk of noncompliance presented by an assessment of the taxpayer's return, there are limited risks associated with a limited scope examination.

Baucus Question 55

What impact do you think limited audits have on the tax gap? Has quality been sacrificed so the IRS can get caught up on its audits?

Answer

Limited scope and LIFE examinations should have a positive impact on the tax gap. Given the initial determination whether to pursue a limited scope examination is based on the taxpayer's compliance history and the relative risk of noncompliance presented by an assessment of the taxpayer's return, a reduction of the resources devoted to that examination can be realized.

The resource savings from limited examinations can be deployed in the conduct of other, more productive examinations that would not otherwise have been conducted. Effective use of resources in this way should result in an expansion of coverage and should serve to foster compliance. Data collected from the Large and Mid-Size Business Division indicates that there is no diminution in the quality of LIFE examinations as compared to regular examinations.

Baucus Question 56

Are there alternative ways the IRS could conduct fast, efficient audits that would not sacrifice quality?

Answer

As noted in the response to Question 54 and 55, the IRS is confident that, in the circumstances in which they are used, limited examinations do not result in a decrease in audit quality.

The Compliance Assurance Process (CAP) is an initiative designed to allow some of the nation's largest companies to resolve audit issues before they file their returns. Under the program, large companies can participate in "real-time" audits in which a variety of issues are resolved in advance of filing deadlines. There are benefits to both taxpayers and the IRS. CAP cases will close within a few months of being filed, as opposed to three to five years under the traditional examination program. This program greatly reduces taxpayers' compliance burdens and their need for contingent book-tax reserves, while increasing currency and allowing for more efficient use of IRS resources. Additionally, the IRS is hoping to identify emerging issues more quickly and issue guidance to non-CAP taxpayers on the proper treatment of these issues.

Tax Shelters

Baucus Question 57

In the American Jobs Creation Act, Congress enacted a $10,000 penalty ($100,000 for a listed transaction) on individuals who file incomplete tax shelter disclosure forms (Form 8886). Many disclosures received by the IRS are not complete. They contain phrases such as: "Details available upon request," "N/A" or "See attached" (and then don't attach).

a. Is a tax shelter disclosure form complete if it contains the phrase "details available upon request?"

b. When will the IRS begin asserting the disclosure penalties?

Answer

The IRS does not consider a Form 8886 complete if it contains the phrase "details available upon request" or similar non-responsive language. The Treasury Department and the IRS have an open guidance project involving the disclosure provisions of Treas. Reg. § 1.6011 and anticipate addressing this issue in more detail in the context of that project.

Section 6707A is effective for returns and statements due after the date of its enactment (October 22, 2004), which were not filed before that date. The first extended due dates for the vast majority of returns that might be subject to the penalty were September 15, 2005 (for corporations) and October 15, 2005 (for other taxpayers). While the number of disclosure forms has increased significantly since enactment of section 6707A, the penalty generally applies only to taxpayers who fail to file those forms, which typically is not discovered by the IRS until an examination of the underlying tax return. Generally, few underlying returns for taxable years subject to the penalty have reached the audit stream. Accordingly, to date, the IRS has not assessed any section 6707A penalties. It is also important to note that the IRS will only assess section 6707A penalties in appropriate, fully-developed cases. Moreover, perhaps the most effective aspect of the penalty is its deterrent effect, which ensures that taxpayers adhere to the disclosure requirements of Treas. Reg. § 1.6011. That effect has already been seen, even without assessment of any penalties under section 6707A. As returns subject to the section 6707A penalty continue to enter the audit stream, I expect to see increased audit activity with respect to the section 6707A penalty.

Baucus Question 58

Commissioner Everson's June 12, 2006 letter to this Committee reported that 236,000 disclosures were sent to the IRS Office of Tax Shelter Analysis, but that only 25,427 of them had been transferred into the database. I understand the database is outdated and that the IRS has been working on a new one for over two years.

a. Why has it taken over two years to build a new database to help the IRS process information quickly and to cross-match information coming in from different sources?

b. How many shelters go undetected because the IRS lacks the ability to quickly and accurately cross-match data?

Answer

I share the Committee's concern that the IRS be able to identify shelter participants and promoters and follow up on such identifications with assertion of the enhanced penalties created by the American Jobs Creation Act of 2004 (AJCA). A part of this strategy involves the IRS' continued work toward implementation of a new database. One cause of the delay in this implementation is that, following enactment of the AJCA, the volume

of disclosures received far exceeded expectations. The IRS is currently in the process of modifying its systems based on the current volume and known needs.

Since the Commissioner's June 12 letter was sent, the IRS has made significant strides in processing and reviewing the information received. The IRS has implemented a process that manually screens the forms. The disclosures are scanned, run through an Optical Character Recognition (OCR) process, verified and then loaded on the existing database. Since the Commissioner's June 12, 2006 letter, the IRS has completed processing of the data for the 2005 file year and loaded it into the database (a small number of processing and scanning errors are still being resolved). This information is being searched for "key words." With this and other functions, the IRS is in the process of conducting the following analysis, which includes cross-checking information on the Forms 8886 (taxpayer disclosure) and 8264 (material advisor registration):

- Manually comparing the two existing data bases to compare information on Forms 8886 and Forms 8264. It is anticipated that this step will potentially identify material advisors who have failed to meet the registration requirements.

- Comparing investor lists received from material advisors to Forms 8886 for possible failures by taxpayers to comply with the disclosure requirements.

- Sorting disclosures and registrations by transaction type and referring certain ones to technical experts for review and analysis. Reviewers are forwarding various disclosures to IRS agents for further investigation. New issues will be considered for listing notices or other appropriate follow-up.

- Identifying all Forms 8886 disclosing transactions and sending them to the field for examination.

A significant part of the challenge associated with capturing and analyzing this data is that the information received by the IRS is in the form of paper filings, rather than electronic filings. Information filed electronically would be more easily manipulated and readily utilized.

The IRS is committed to making continual improvements in its data analysis. To address challenges in this area, the IRS has formed a Shelter Data Management Team to aggressively identify ways to improve the processing and evaluation of all shelter data. The IRS is exploring the possibility of improving its text search capabilities; creating systems to compare data electronically from multiple sources and following up with those taxpayers who have provided incomplete information. Looking to the future, the IRS is considering revisions to the forms to require taxpayers to provide more complete and descriptive information.

The Office of Tax Policy intends to monitor this situation closely to ensure the effective implementation of the shelter provisions enacted as part of the AJCA.

Baucus Question 59

Two years is too long to wait for IRS to implement the new tax shelter laws and to install a computer database to track these disclosures. Within the next 30 days, I am requesting a report from you that includes,

a. An implementation plan, including timelines, identifying everything that still needs to be done to put the new tax shelter laws to work (and regular updates on your progress).

b. A timetable for the completion and implementation for the tax shelter database.

c. An IRS tax shelter organization chart that includes every function that works on tax shelters and describes what role they serve.

Answer

I have raised your concerns with the IRS and asked them to prepare a detailed response as quickly as possible. The IRS's Office of Tax Shelter Analysis, which maintains the computer database that is used to track disclosures of potentially abusive tax transactions, is taking the lead on this issue.

Guidance Process

Recently, Commissioner Everson sent a letter to the Committee identifying the "most significant" corporate tax compliance issues. Many of these issues have been under consideration for years, including cost sharing, transfer pricing and the universal service fund.

Baucus Question 60

What prevents the Treasury and IRS publishing prompt guidance on important compliance issues?

Answer

Each year, the Treasury Department and the IRS include on the priority guidance plan (PGP) more than 250 separate items, with the goal of completing all of them before the end of the plan year. Because of the increasing complexity of the tax law, many difficult issues are presented for resolution. In addition, progress on items is often delayed as unanticipated events lead to a reordering of guidance priorities. For example, in the aftermath of last year's Gulf coast hurricanes, the Treasury Department and the IRS published numerous administrative guidance items in order to provide immediate and necessary relief to affected taxpayers and to implement the relief and rebuilding

provisions included in the Katrina Emergency Relief Act and the Gulf Opportunity Zone Act. Notwithstanding such unanticipated events, hundreds of guidance items are published each year. In addition, we continue to make progress on important compliance issues. For example, in the last few months, we have issued extensive guidance on transfer pricing issues, including proposed regulations on cost sharing and final regulations on services.

Baucus Question 61

What can Treasury and the IRS do to expedite the issuance of guidance to address compliance problems?

Answer

The pace at which guidance is issued is driven by competing demands on the resources available to the Treasury Department and the IRS. Modifications to the process of drafting and developing guidance have helped to increase the pace at which guidance is issued. The Treasury Department and the IRS are currently working to determine whether additional modifications to the guidance process can be made to further expedite the process of issuing guidance.

Baucus Question 62

What impact does the lack of guidance have on compliance and the tax gap?

Answer

A significant reason for the tax gap is that the complexity of the tax law prevents even well-meaning taxpayers from understanding and complying with their tax obligations. Complexity also creates opportunities for those who seek to avoid their tax obligations or those inclined to take aggressive positions on their tax returns. The guidance process is an important element in addressing complexity as a root cause of the tax gap. Where guidance is issued interpreting ambiguous provisions in the law, taxpayers are less likely to take aggressive return positions and more likely to have their aggressive positions ultimately disallowed by the IRS and the courts.

Data Warehousing

States are creating databases of publicly available data, for example, business licenses granted, that can be compared to tax return information in order to detect unreported income or unwarranted deductions. The states report they are collecting hundreds of millions of dollars in tax revenues as a result of this tool.

Baucus Question 63

To what extent is IRS/State coordination of data warehousing viable?

Answer

The IRS currently shares tax information with state tax authorities as authorized by Code section 6103. The states in turn use this information to improve tax compliance by matching it against information they have on file and identifying potential non-filers and taxpayers who have underreported income. The IRS is testing a pilot initiative under which the states provide data back to the IRS based on certain criteria. Four states (Arkansas, Iowa, Massachusetts, and New Jersey) are participating in Phase I of this pilot. For this phase, the states matched various IRS extracts against their systems to identify individuals and businesses where a state return had been filed but no federal return was filed as well as where amounts reported on a state return were greater than amounts reported on the federal return.

The IRS is testing this pilot to determine its effectiveness. If the pilot is successful, the IRS expects to expand the project to include additional states.

Baucus Question 64

What impact would the use of data warehousing to detect noncompliance have on the tax gap?

Answer

A major portion of the tax gap arises from underreporting of income. Receiving data warehousing information from the states would provide additional information for the IRS to identify those individuals and businesses that have potentially underreported their income. The IRS can, in turn, use this information and contact the taxpayers to determine whether additional federal income tax is due. Furthermore, information sharing with the states will identify potential non-filers, who are also a component of the tax gap.

Offers in Compromise

Baucus Question 65

The IRS recently announced interim offers in compromise guidance pursuant to recently enacted legislation requiring a 20% good-faith down payment. The guidance includes exceptions for low-income taxpayers and offers in connection with doubt as to liability.

1. To what extent does the IRS have the authority to create significant exceptions to the law?

2. To what extent will these exceptions create additional burden for taxpayers to make offers and for the IRS to process them?

3. To what extent do you anticipate that taxpayers will characterize their tax liabilities as "doubt to liability" to avoid the 20% down payment?

Answer

The Treasury Department and IRS recently published Notice 2006-68, 2006-31 I.R.B. 105, providing guidance on amendments to section 7122 enacted as part of Tax Increase Prevention and Reconciliation Act of 2005. The amendments generally require a taxpayer to submit a partial payment with an offer in compromise.

Section 7122(c)(1) generally requires a taxpayer to submit an offer in compromise with a 20 percent down payment. The statute provides authority to waive the requirement of a partial payment in certain circumstances. Under section 7122(c)(2)(C), a waiver of the partial payment requirement is available in circumstances involving offers-in-compromise submitted by low-income taxpayers and offers submitted by other taxpayers based on doubt as to liability. In addition, as amended, section 7122(d)(3)(C) provides that the IRS may return the taxpayer's offer as unprocessable if the taxpayer submits an offer without the partial payment required by section 7122(c)(1). Under this permissive statutory authority, the Treasury Department and the IRS are considering whether there are circumstances in which offers-in-compromise that do not meet the technical requirements imposed by 7122(c)(1) at the time of submission should be processed.

The statutory amendments to section 7122 apply to offers-in-compromise submitted on or after July 16, 2006. Notice 2006-68 was published in order to provide prompt guidance to taxpayers submitting offers-in-compromise on or after that date. The Treasury Department and the IRS anticipate issuing further guidance regarding these amendments.

From Senator Rockefeller

Rockefeller Question 1

I am concerned about the implementation of Section 11161 of SAFETEA (P.L. 109-59). I would like some information about progress implementing this law in order to judge whether it is working as Congress envisioned.

a) How many IRS Form 637 applications have you received from aviation fuel providers seeking to register as an "Ultimate Registered Vendor" since October 1, 2005?

b) How many Ultimate Registered Vendor applications (for aviation fuel providers) has the IRS approved since October 1, 2005?

c) What was the average time for final approval for these Ultimate Registered Vendor applications?

d) Approximately how much money has the Secretary transferred from the Highway Trust Fund to the Airport and Airway Trust Fund under the terms of the new law?

e) Has the Department of the Treasury or the Internal Revenue Service assessed the internal administrative costs of transferring such large sums of money from one trust fund to another, including the analysis to determine how much to transfer? If so, what is this estimated cost?

Answer

The IRS has issued guidance (Notice 2005-80, 2005-46 I.R.B. 953) to implement the SAFETEA provisions relating to the treatment of kerosene used in aviation. In addition, the IRS has conducted outreach sessions with the Petroleum Marketers Association of America, Aerial Applicators Association, National Business Aviation Association (NBAA) and National Air Transportation Association. The IRS also plans to participate in the NBAA conference in October 2006.

Since October 1, 2005, the IRS has received 816 applications for registration for Ultimate Vendor that Sells Kerosene for Use in Aviation (UA). As of July 19, 2006, 707 applicants were approved and registered, 31 were denied, and 3 registrations were revoked. A total of 29 applicants withdrew their registration requests, and 46 are under review. The average time for final approval of UA reviews is 75 days.

The IRS received and processed 174 UA claims for refund during the period October 1, 2005 to April 30, 2006, paying out $3.5 million in refund claims. IRS records indicate that 88 percent of these claims were processed within 45 days or less.

Upon enactment of SAFETEA, the Treasury Department estimated that pursuant to Section 11161, $55 million would be transferred from the Highway Trust Fund to the

Airport and Airway Trust Fund. Based upon this estimate, the Secretary has transferred $43 million to the Airport and Airway Trust Fund through June 2006. All amounts transferred during the fiscal year will be subject to correcting adjustments made upon certification by the IRS.

The transfer of these amounts from the Highway Trust Fund to the Airport and Airway Trust Fund is made by the Secretary as part of the routine process of allocating and certifying dedicated excise taxes to the various trust funds that have been created by Congress. While no attempt has been made to assess the incremental impact of this particular provision on internal administrative costs, we believe that it is negligible.

Rockefeller Question 2

I have been a strong supporter of the reauthorization of the New Markets Tax Credit, which expires at the end of 2007. I have introduced bipartisan legislation with Senator Snowe to extend the Credit through 2012, and we also have worked together to secure a one-year extension of the Credit in the Senate-passed tax reconciliation measure. I remain hopeful that if Congress agrees to a tax extender package this year, the New Markets Tax Credit extension will be included.

Reports from the CDFI Fund and the New Markets Tax Credit Coalition indicate that the Credit has been very successful in spurring private sector investments in low income communities. In fact, the Credit is being deployed into low income neighborhoods at an extremely fast rate. Allocatees are even targeting poorer communities than required by law or regulation. Competition for the Credit also has been keen in the four allocation rounds as community development organizations submitted requests for $107 billion when only $12.1 billion in Credit authority was available.

a) While I am pleased about the work of the West Virginia Community Development Loan Fund in rural parts of the state, I am concerned about the lack of Credit allocations and activity in rural areas across the country. What is your view about the lack of rural participation? How can we improve it?

b) How would you rate the efficiency of the New Markets Tax Credit in terms of, the percentage of Qualified Equity Investments going to finance businesses, the time frame for deploying capital raised with the Credit, and the level of economic distress of communities in which businesses are financed by the Credit?

Answer

Community Development Entities (CDEs) compete for awards of New Markets Tax Credits (NMTCs). A CDE that is awarded NMTCs provides those credits to investors who make Qualified Equity Investments (QEIs) in the CDE. At the time of submitting an application, CDEs are asked to estimate the percentage of activities that will be undertaken in rural areas. Through the first three allocation rounds, awardees have

estimated that approximately 17 percent of their transactions would be undertaken in rural areas, which is consistent with the percentage of the U.S. population that resides in rural areas (17.4 percent, according to 2000 census data).

In addition, the CDFI Fund has completed an analysis of transactions undertaken by awardees as of fiscal year end 2004, and has determined that approximately 19 percent of the investments closed that year were undertaken in rural communities. The CDFI Fund has also analyzed the application trends in the 2005 application round, and determined that there is no selection bias against applications submitted by organizations serving rural areas. In other words, CDEs focusing activities primarily in rural markets received awards in a rate consistent with their application rate.

That being said, the CDFI Fund will continue its efforts to provide more outreach in markets that do not appear to be benefiting from NMTC investments. Additionally, the Treasury Department recently released Notice 2006-60, which provides guidance regarding the designation of certain targeted populations. The Notice announces that the IRS will amend Treas. Reg. § 1.45D-1 to grant flexibility to permit CDEs to invest in certain businesses located in moderate-income census tracts, provided that the businesses are owned by low-income persons, hire significant numbers of low-income persons, or predominantly serve low-income persons. The Treasury Department anticipates that the new designation will allow CDEs more flexibility to invest in rural areas that would not otherwise qualify as low-income communities without the targeted population designation.

The NMTC Program, in general, has proven to be a very efficient model for attracting private investment capital to low-income communities. Awardees, by statute, have up to five years to receive QEIs from investors. However, in less than three years since the first allocation agreements were signed by awardees, awardees have issued $4.57 billion in QEIs – or over 57 percent of the total allocation authority issued in the first three rounds. Third-round awardees, just nine months since receiving their allocation agreements, have already issued over $714 million, or 35 percent of the $2 billion in QEIs allocated that round. This reflects not only the investor interest in these credits, but also the competitiveness of the NMTC program -- since applicants that can demonstrate an ability to raise QEIs and deploy capital quickly are more likely to receive an allocation from the CDFI Fund.

NMTC awardees intend to serve communities that are more economically distressed than are minimally required under program regulations. The regulations require awardees to invest substantially all of their QEIs in "low-income communities," which are generally defined as census tracts with a poverty rate of at least 20 percent and/or a median family income at or below 80 percent of the area median family income. As part of the application process, the CDFI Fund asks applicants whether they will commit to serving areas of higher distress (e.g., poverty rates of 30 percent or higher; median family incomes at or below 60 percent of the area median family income) or areas that have otherwise been targeted for redevelopment through other programs, such as brownfields, Renewal Communities, and Empowerment Zones. In the most recent allocation round,

56 of the 63 allocatees indicated that at least 90 percent of their activities would be targeted to such communities, and 42 of the 63 allocatees indicated that 100 percent of their activities would be targeted to such communities. The CDFI Fund will require these awardees to meet these benchmarks as a condition of their allocation agreements.

NMTC awardees have also committed to investing more than is minimally required under the regulations. The regulations generally require that 85 percent of the QEIs be invested in low-income communities. In the most recent allocation round, all 63 of the awardees indicated that they would invest more than the minimally required 85 percent of QEI dollars into qualified low-income community investments, and 58 of the 63 allocatees indicated that at least 95 percent of their QEI dollars would be invested into qualified low-income community investments. In real dollars, based on commitments made by awardees, this means at least $477 million above and beyond what is minimally required by the NMTC Program will be invested in low-income communities. The CDFI Fund will require these awardees to meet these benchmarks as a condition of their allocation agreements.

The products that NMTC awardees intend to offer are also more advantageous to borrowers than those offered in the conventional financial markets. All 63 of the awardees in the most recent allocation round indicated that 100 percent of their investment dollars would be made either in the form of equity or in the form of debt that is at least 25 percent below market interest rates and/or is characterized by multiple concessionary features. The features of the debt include, among other things, equity-equivalent terms and conditions, subordination, reduced origination fees, and higher than standard loan-to-value ratios.

Finally, preliminary data would seem to suggest that there is a preference for using NMTCs to support real estate development activities in low-income communities. Of the approximately $1.2 billion of NTMCs that was invested in low-income communities in 2004, 25 percent was invested in support of operating businesses (e.g., fixed asset and working capital loans or equity investments), and 75 percent was invested in support of real estate development (including retail, mixed-use, manufacturing, and community facilities). It is important to note, however, that the investments in real estate provide direct benefits to the underlying operating businesses – including, for example, investments in manufacturing facilities, childcare centers and charter schools.

From Senator Bingaman

Bingaman Question 1

During your testimony today, you laid out six principles that will guide you as Treasury considers tax reform. One of those principles is keeping a focus on tax reform in its entirety rather than getting bogged down with specific aspects of the current tax system. How does this principle fit with the Administration's desire to make the 2001 tax cuts permanent?

Answer

I believe that tax reform is one of our highest priorities. As I said in my formal statement, "If confirmed, I look forward to working together with Secretary Paulson, the Administration, this Committee and the Congress to address the challenging issue of tax reform."

Investors, businessmen, workers, retirees, and all other taxpayers make their economic decisions on the basis of what they expect tax rates to be in the future. Until tax reform has actually been enacted, taxpayers will base those decisions on the current tax code. Economic decisions based on the assurance that the tax relief enacted in 2001 and 2003 will be extended permanently would result in more investment, more economic activity, faster economic growth, and more jobs that would benefit all of our citizens. In order to preserve the benefits of the tax relief passed in 2001 and 2003, it is essential to make those tax reductions permanent so that individuals and businesses can be certain of lower tax rates and act accordingly when they make their economic decisions.

From Senator Kerry

Kerry Question 1

The previous Treasury Secretary did not have a real role in shaping tax policy; rather he was a cheerleader for the Administration's economic policies. Do you believe that you and Secretary Paulson will have a more active role and that you will be consulted?

Answer

In his remarks at Secretary Paulson's swearing in ceremony on July 10, 2006, President Bush affirmed the key role that the Secretary will continue to play as the principal spokesman for the Administration's economic policies. In the short time Secretary Paulson has been on the job, I have met with him a number of times to begin discussions on the challenges facing our tax system, including the need for fundamental tax reform, a solution to the growing problem of the alternative minimum tax, and the challenge of addressing the $290 billion annual net tax gap. If confirmed, I look forward to continuing these important discussions and am confident of the key role the Secretary will continue to play on tax policy issues within the Administration.

Kerry Question 2

The National Taxpayer Advocate, Nina Olson, has stated that the alternative minimum tax (AMT) punishes taxpayers for having children and living in certain states. The Administration only proposes temporary fixes to the AMT. Each year these temporary fixes become more expensive. Outright repeal has a cost of over $600 billion. Without action, the AMT will become our de facto tax system. You mentioned addressing AMT as your third priority and noted that it cannot be addressed in isolation. I think it should be your first priority, especially since the President's budget does not address it for 2007. What are your recommendations for addressing the AMT? I agree than it cannot be fixed in isolation. Are you willing to consider adjusting the rates to pay for AMT reform or relief?

Answer

The alternative minimum tax (AMT) was created to ensure that a very few high-income individuals would pay at least some taxes. Now, it has expanded far beyond its original intent. The AMT affects an ever-growing number of middle-income earners, has become a major source of tax system complexity, and creates significant frustration among taxpayers who have to calculate their taxes twice and pay the higher amount.

There is no easy solution. Because of the complexity of our income tax system and the interrelationships between many of its provisions, the long-term AMT problem should not be dealt with in isolation. Rather, solutions to the problem associated with the AMT

over the long-term should be developed in the context of broader reform of the tax system.

Kerry Question 3

Last month, the House passed a so-called compromise on estate tax repeal. The Senate may vote on it later this week. The House bill does not reflect a true compromise, because it loses most of the revenue collected by the estate tax. It lowers the rates on the wealthiest estates. Do you support outright repeal of the estate tax? How do justify the loss in revenue?

Answer

The estate tax is much more than just a tax on the wealth of individuals at the time of death. It penalizes savings and risk-taking and reduces capital formation in the economy. Further, the significant costs associated with the need to plan for liquidity in order to pay the estate tax deprives businesses of funds they could more productively devote to expansion, employment, and innovation.

Unfortunately, the provision of the 2001 Act that repeals the estate tax expires at the end of 2010, creating significant uncertainty for family estate planning. Making repeal of the estate tax permanent will ensure that Americans can save for their children's education, undertake new business ventures, budget for charitable contributions, and plan for retirement and the transfer of family businesses.

I understand that the Committee and others are working on this issue to develop a compromise on the estate tax. The Administration has supported recent efforts toward full repeal, including House passage of H.R. 5638, which would provide significant relief from the estate tax. These efforts are constructive steps toward full and permanent repeal of the estate tax, which remains the ultimate goal.

Kerry Question 4

Last November, the President's Advisory Panel on Federal Tax Reform issued a report. I do not agree with many of the recommendations, but it took a hard look at our current system. I am primarily concerned with the baseline used by the panel that assumed the 2001 and 2003 tax cuts would be made permanent. Do you believe the current tax system raises an adequate amount of revenue?

Answer

As you know, making the 2001 and 2003 tax relief permanent is a high priority for the Administration. The tax relief clearly has been good for the economy. Our country has experienced healthy economic growth and growth in jobs since the tax relief was enacted.

We also are experiencing very healthy growth in federal tax receipts. The Mid-Session Review released by the Office of Management and Budget in mid-July revised our estimate of federal receipts for fiscal year 2006 upward by $115 over our estimate in the January budget. Receipts are up nearly 13 percent over last year. In terms of a percentage of GDP, Federal receipts are currently at about their post-war historical average of approximately 18 percent. Under current law, receipts as a percentage of GDP will rise considerably above this historical average. Hence, it is difficult to make a case that the current tax system does not raise an adequate amount of revenue. Moreover, it is important that we leave in place the conditions for a thriving economy so that we can deal with the long-term fiscal problems – Social Security, Medicare, and Medicaid – from a position of economic strength.

Kerry Question 5

I am concerned that outsourcing continues to be a problem. Some firms even outsource the preparation of tax returns. Our current tax system encourages U.S. multinationals to increase offshore investment. We need to substantially change our international tax system. Have you given any thought to this issue? Have you considered recommendations made by the Joint Committee on Taxation in their January 2005 publication, Options to Improve Tax Compliance and Reform Tax Expenditures on this issue?

Answer

We are monitoring this issue. Investment works in both directions – outbound and inbound – and the United States has an overall trade surplus in services. One of our priorities is to ensure that the U.S. economy remains competitive, attracts investment, and continues to create jobs. This is an important issue to consider as we evaluate options to reform our tax system. We are currently studying international tax reform in the context of broad reform of our overall tax system. Both the Joint Committee on Taxation report and the Tax Panel's report provides options for international reform that are currently under review at the Treasury Department.

Kerry Question 6

I have been in contact with the IRS about its Questionable Refund Program (QRP). It appears that the Service had made substantive progress in the QRP by informing taxpayers that their refunds are being frozen and in trying to speed-up resolution of refund freeze cases. What steps had the IRS been taking to ensure that low-income families receiving the earned income tax credit (EITC) are not unfairly targeted by QRP?

Answer

The IRS is constantly working to improve its fraud detection systems. The IRS recognizes the impact its fraud detection activities can have on compliant low-income taxpayers whose refunds may be temporarily suspended by its systems. The IRS is continually striving to eliminate the burden on compliant taxpayers through strategic approaches involving systemic and procedural improvements designed to detect erroneous returns with minimal impact on legitimate refund returns.

Currently, the IRS is implementing improvements to the questionable refund program (QRP). An Executive Steering Committee comprised of numerous functions within the Service is studying workflow processes to determine what efficiencies and potential workload migration changes can be made in the QRP. This is being accomplished through refining and streamlining the processing of questionable returns, and modifying existing technology and utilizing sophisticated analytical tools to assist in the identification of false claims and improvement of the filtering systems.

One such improvement is the timely movement of work between functions in the IRS. In particular, issues identified through the QRP that are determined to be civil in nature are now moved in a more timely fashion through the process. This improvement helps ensure that low-income taxpayers are not unfairly affected by the QRP process.

To improve its filtering system, the IRS has recently contracted with the Department of Health and Human Services (HHS) to verify wages for taxpayers who claim the EITC. This HHS database, which contains salary data updated quarterly, was not available until this year. This filter will help the IRS release legitimate refunds with the EITC faster because it automatically verifies wages and withholding credits. This will greatly reduce the number of initial freezes on questionable refund requests that have an EITC component because the IRS will not need to contact employers to verify income.

Kerry Question 7

I share your concerns about the tax gap. However, I am concerned that there is too much of a focus on auditing EITC taxpayers. In fiscal year 2004, the IRS conducted 48 percent of its audits on EITC taxpayers. EITC error represents a very small portion of the overall tax gap. Will the IRS continue to concentrate on EITC taxpayers?

Answer

The IRS is continuing to build a balanced compliance program to address the tax gap. The IRS' EITC efforts are just one component of this program but they have roots in previous Congressional guidance. For five years, the IRS received special funding for EITC compliance initiatives aimed at reducing the credit's error rate. Since that separate funding ended, IRS spending on EITC audits has been virtually flat and, for the past two years, the number of EITC audits has remained constant. As the IRS continues to

increase compliance activities in a variety of other areas, the EITC audits as a percent of total audits will fall.

It is also worth noting that IRS' EITC program has adopted a balanced approach to administering the credit – one that seeks to maximize participation among eligible taxpayers even as it takes steps to combat noncompliance. As a result, in addition to EITC compliance activities, the IRS actively provides outreach through its stakeholder relationship management organization – working with hundreds of community-based organizations across the country to educate taxpayers about the availability of the credit and its requirements.

Kerry Question 8

According to the 2005 National Taxpayer Advocate Report, the most serious problem facing taxpayers is trends in taxpayer service. Recently, the IRS has proposed decreasing service to taxpayers and increasing enforcement. I am all for enforcing our tax laws, but wouldn't tax collection improve if taxpayer's had access to the appropriate services to help them with their taxes?

Answer

I appreciate the concern about taxpayer service. Commissioner Everson has stated that his working equation is "Service + Enforcement = Compliance." I agree that taxpayer service is important. The IRS has established a Taxpayer Assistance Blueprint (TAB) team to analyze taxpayer needs, preferences, and behaviors to determine the optimal delivery of service. In April 2006, TAB's Phase 1 report was delivered to Congress, discussing initial findings, including an inventory of current services. In October 2006, delivery of TAB's Phase 2 report to Congress is expected. The Phase 2 report will address empirical data on taxpayer demographics and geography and will recommend expanded service delivery options. The Phase 2 report also will address the development of an implementation plan for recommendations, integration of recommendations into the budgeting process, and integration of the blueprint into the IRS Strategic Plan. The IRS' goal is to maintain a balanced service portfolio that meets the needs of the greatest number of taxpayers.

From Senator Lincoln

Lincoln Question 1

As you may be aware, in 2004 Congress enacted a new program to deal with the problem of runaway film production that has reduced film industry employment in this country. This is an issue that I worked on in 2004 and one that I continue to be concerned about. The incentive program under section 181 of the Internal Revenue Code was only enacted for a four year period. Unfortunately, it has been a year and a half and the Treasury Department has not issued necessary guidance on some key issues.

Are you aware of this new law and can you tell me what has taken so long for the Treasury Department to put guidance out? When do you expect this project to be completed? I hope this is something that will get your attention so that guidance can be put out promptly.

Answer

Section 181 was added to the Code by section 244 of the American Jobs Creation Act of 2004 and permits the producer of a qualified film or television production to elect to deduct certain production costs in the year the costs are paid or incurred, rather than capitalizing those costs and recovering them through depreciation allowances. Under section 181, additional benefits are available when a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress. On May 1, 2006, the Treasury Department and the IRS released Notice 2006-47, 2006-20 I.R.B. 1, which provided interim guidance on making elections under a number of provisions in the American Jobs Creation Act, including section 181. Publication of further guidance under section 181 is identified as an item on our current priority guidance plan. The Treasury Department and the IRS have met with taxpayers and practitioners regarding this provision, have reviewed a number of comment letters, and have identified a number of issues that need to be resolved through published guidance. Resolution of these issues and publication of the guidance has been complicated by the unique nature and structure of the film and television industry, in particular the use of participation arrangements with actors, directors and other talent, the use of residual payments under collective bargaining arrangements, and the manner in which many production costs are financed.

From Senator Wyden

Wyden Question 1

If you are confirmed as Assistant Secretary of the Treasury for Tax Policy, what will you do this year to help Tax Reform efforts move forward? For example, will you provide options to the Committee for how to simplify the Tax Code and brief Senators on what the Administration is considering?

Answer

We are currently working with Secretary Paulson to consider practical and viable tax reform options. As you know, the current tax system is complex and creates economic distortions. It needs to be reformed. Once the Administration decides how to proceed on tax reform, we will work with the tax-writing committees of the Congress to move forward. Rather than addressing simplification of the tax code separately, we believe that it would preferable to address simplification in the context of the changes in the tax code that will result from our joint tax reform efforts.

I look forward to working with you and other members of Congress to consider tax reform legislation that will be simple and fair, and that will promote economic growth.

Wyden Question 2

What do you consider to be the most complicated provisions of the Tax Code for individual taxpayers? How would you propose to simplify them?

Answer

Unfortunately, complexity pervades the U.S. individual income tax system. For example, choosing between the myriad tax incentives for saving challenges taxpayers. Moreover, complicated and subtly different eligibility rules for two refundable tax credits – the earned income tax credit (EITC) and the refundable child tax credit – confuses many working parents who are eligible for one, both, or neither credit. The alternative minimum tax (AMT) imposes substantial compliance burdens. These are just a few examples of the many complicated provisions that individual taxpayers face. Duplicative and overlapping provisions are a significant source of complexity. Consolidation and streamlining such provisions can provide real simplification.

The Administration's Fiscal Year 2007 budget includes several proposals that address these issues.

- The Fiscal Year 2007 budget includes a proposal to consolidate the three types of Individual Retirement Accounts (IRAs) under current law into one account dedicated solely to retirement (Retirement Savings Account), and includes a

proposal to create a new account (Lifetime Savings Account) that could be used to save for any reason. These proposals would simplify taxpayers' investment choices while further encouraging savings.

- The Fiscal Year 2007 budget includes a proposal to consolidate many defined contribution accounts into an Employer Retirement Savings Account (ERSA), which would be available to all employers and have simplified qualification requirements.

- The Fiscal Year 2007 budget includes a proposal to clarify the uniform definition of a child. This clarification would increase consistency among the child-related tax benefits, including the EITC and child tax credit.

- The Fiscal Year 2007 budget includes a proposal to simplify some of the EITC eligibility criteria, which would reduce compliance burdens among low-income taxpayers with children.

- The Fiscal Year 2007 budget also includes a proposal that would make the eligibility criteria for the EITC and refundable child tax credit more similar. The proposal also would reduce the computational complexity of the refundable child tax credit.

We are also currently evaluating the recommendations of the President's Advisory Panel on Federal Tax Reform. These recommendations include the elimination of the AMT and consolidation of many provisions as part of a comprehensive tax reform plan. As I discussed in the response to your first question, we are currently working with Secretary Paulson to consider practical and viable tax reform options.

Wyden Question 3

What are the least effective tax breaks? How would you recommend reforming these tax breaks or should they be repealed?

Answer

Before evaluating and ranking tax benefits, I would need to identify and clarify their goals. Was the tax benefit created to improve equity or efficiency or a social policy goal or some combination of these objectives? Should the benefit be provided through the tax system or through other means? A second consideration is the context. Was the tax benefit created to address a short-term or long-term problem? Does the tax benefit address a national or regional problem? A third consideration is simplicity. Does the tax benefit place undue compliance burdens on taxpayers? Can the IRS administer the provision? Does the provision raise concerns about compliance and enforcement? Does the provision raise concerns about the tax gap by reducing the rate of compliance? A

fourth consideration is the budgetary cost of the tax benefit. In making a judgment about the effectiveness of a tax benefit, it is necessary to weigh each of these considerations.

As we develop a tax reform plan, we are continuing to evaluate the effectiveness of various tax benefits using these criteria.

Wyden Question 4

Which of changes to the Tax Code that my Fair Flat Tax Act would make do you think should be included in any tax reform legislation enacted by Congress? Which of recommendations of the President's Reform Panel are the most important to include in comprehensive tax reform?

Answer

As you know, some of the proposals included in your Fair Flat Tax Act are similar to proposals included in the Report of the President's Advisory Panel on Tax Reform. These include reducing the number of tax brackets, eliminating many deductions and exclusions, and eliminating the AMT. However, at this time I am not in a position, to identify which of these common proposals, or which proposals unique to your plan or the Advisory Panel's plan, should be included in an Administration tax reform plan.

As the Treasury Department considers tax reform options, we will keep your proposals in mind. We appreciate your leadership and interest in tax reform and particularly in tax simplification. I look forward to sharing ideas and working with you in pursuit of a simpler, fairer, pro-growth tax system.

Wyden Question 5

If confirmed, will you commit to work with me and other members of the Committee to develop proposals for ways to simplify the Tax Code that could gain bipartisan support?

Answer

Yes. Secretary Paulson and I both strongly believe that we need a simpler tax system. We believe that simplification is best pursued as part of broader tax reform that also makes the tax system fairer and more pro-growth. We view the pursuit of tax reform as a bipartisan matter in which we can and should all work together to develop a constituency in support of simplification and other goals of tax reform. If confirmed, I look forward to working with you, the tax-writing committees, and all other interested stakeholders to reform and simplify the tax code.

From Senator Schumer

Schumer Question 1

We have all seen the statistics about how almost all families with children and incomes over $75,000 will get hit by the AMT by the end of the decade if Congress fails to act. I know that the President's top priority is to make his tax cuts permanent, at a cost of more than $150 billion a year – and that's a conservative estimate. As part of your testimony, you even stated that this will be one of your top priorities. Yet the AMT problem surfaces *before* the current tax cuts are set to expire.

Isn't it wrong to expect the middle class to receive these tax cuts in one hand, and then pay them back with the other hand? What kind of message does it send the middle class to say, "Our most important priority is a tax cut that will take effect *five years from now*, yet the AMT is something that we will address on a piecemeal basis, year by year?"

Answer

I am very concerned about the impact of the alternative minimum tax (AMT) on an ever-growing number of middle-income earners. In addition to the increased taxes on middle-income taxpayers, the AMT has become a major source of tax system complexity, and creates significant frustration among taxpayers who have to calculate their taxes twice and pay the higher amount.

There is no easy solution to the AMT problem. Because of the complexity of our income tax system and the interrelationships between many of its provisions, the long-term AMT problem should not be dealt within isolation. Rather, solutions to the problem associated with the AMT over the long-term should be developed in the context of broader reform of the tax system.

Even though most of the tax relief enacted in 2001 and 2003 does not expire several years, investors, business owners, and all other taxpayers make their economic decisions based on the tax rates they expect to apply in the future. Until tax reform has actually been enacted, taxpayers will base those decisions on the currently tax code. Economic decisions based on the assurance that the tax relief enacted in 2001 and 2003 will be extended permanently would result in more investment, more economic activity, faster economic growth, and more jobs that would benefit all of our citizens. If confirmed, I look forward to working with the Congress on fundamental tax reform and on addressing the AMT problem in that context.

Schumer Question 2

I appreciate the effort the Administration is taking to close the "tax gap," and I have told Commissioner Everson that I think he is doing a good job despite not being given all of the tools he needs to do his job.

I'd like your opinion on what appears to be the House of Representatives' problem with tax offsets. Here in the Senate, we often pass bills that close tax loopholes, or address problems with tax compliance, only to have these offsets rejected by the House. In the mind of the House Republicans, any tax provision with a positive number is a "tax increase," even if it is closing the most abusive tax shelter. This difference between the House and the Senate prevents a lot of good tax legislation from getting done, particularly when many of us are concerned with the size of the deficit.

What is your view on whether closing a tax shelter or loophole is indeed a "tax increase"?

Answer

In the recent update to its estimate of the tax gap, the IRS focused on a baseline of taxes due and owing under current law. As the Office of Tax Policy continues to work with the IRS to address the tax gap, I think it is appropriate that we stay focused on the baseline used by the IRS, rather than an increase in revenue that would result from substantive changes in the tax law. Nonetheless, the Administration has supported a number of legislative changes that close loopholes in current law, and improve compliance and tax administration. I would not characterize these changes as tax increases, although they are changes in substantive law.

Schumer Question 3

To combat the tax gap effectively, the IRS Oversight Board recommended in April that the IRS budget should be more than $700 million more than the Bush Administration requested. If the Administration takes tax enforcement and the budget deficit seriously, why would Treasury not follow the Board's recommendations? Which of their recommendations do you believe are NOT worth implementing?

Answer

The input of all stakeholders, particularly the IRS Oversight Board, is important in developing the Administration's budget recommendations. In developing those recommendations, however, the Administration (unlike the Oversight Board and others) is limited by the need to meet overall budgetary constraints for domestic discretionary spending. Therefore, the budget recommendations of the Oversight Board are weighed against other government budget priorities. The Administration's request for the IRS represents a balanced approach that allows the IRS to accomplish its mission, taking into consideration other discretionary domestic spending demands.

Schumer Question 4

If you look back on the Tax Reform Act of 1986, twenty years ago, Congress really succeeded in lowering rates and broadening the base – exactly what we ought to be trying to do today. What stands out to me is that the debate back then was not as ideologically driven as tax policy is today.

Just as one example, many of us forget that one of the key parts of that Act was the elimination of any preferences for capital gains. After 1986, gains were taxed as regular income. Yet one of the key tenets of conservative tax policy today is that the rate on capital income should be low, even zero, despite the effects that might have on the perceived fairness of the system.

Many of the people pushing most strongly for so-called "tax reform" today believe sincerely that we ought to have a system that taxes *only* wage income, where all inherited wealth and income from savings and investments is completely tax free. I'd like for you to comment on whether you think such a tax system – one that taxed only labor income – would indeed be fair.

Answer

In considering tax reform, commentators and policymakers usually focus on variants of two basic models, income taxes and consumption taxes. The primary difference between an income tax and a consumption tax is the treatment of the return on investment. An income tax taxes the return on investment, whereas a consumption tax does not. Our current tax system is a hybrid between an income tax and a consumption tax. The current system taxes the return on some investments, but exempts or gives preferential treatment to the return on others. In deciding how to reform our current tax system, policymakers would need to decide whether to adopt a model that has more, fewer, or similar income tax and consumption tax attributes. Regardless of the relative mix of income tax and consumption tax attributes selected, an important factor that needs to be considered is progressivity. A consumption tax, an income tax, or a hybrid system can achieve an appropriate level of progressivity. As the Treasury Department considers options for tax reform, one of the important issues we will address is progressivity.

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