

EXPIRING TAX PROVISIONS: LIVE OR LET DIE?

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED NINTH CONGRESS
FIRST SESSION

—————
MARCH 16, 2005
—————



Printed for the use of the Committee on Finance

—————
U.S. GOVERNMENT PRINTING OFFICE

24-063—PDF

WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

COMMITTEE ON FINANCE

CHARLES E. GRASSLEY, Iowa, *Chairman*

ORRIN G. HATCH, Utah	MAX BAUCUS, Montana
TRENT LOTT, Mississippi	JOHN D. ROCKEFELLER IV, West Virginia
OLYMPIA J. SNOWE, Maine	KENT CONRAD, North Dakota
JON KYL, Arizona	JAMES M. JEFFORDS (I), Vermont
CRAIG THOMAS, Wyoming	JEFF BINGAMAN, New Mexico
RICK SANTORUM, Pennsylvania	JOHN F. KERRY, Massachusetts
BILL FRIST, Tennessee	BLANCHE L. LINCOLN, Arkansas
GORDON SMITH, Oregon	RON WYDEN, Oregon
JIM BUNNING, Kentucky	CHARLES E. SCHUMER, New York
MIKE CRAPO, Idaho	

KOLAN DAVIS, *Staff Director and Chief Counsel*
RUSSELL SULLIVAN, *Democratic Staff Director*

CONTENTS

OPENING STATEMENTS

	Page
Grassley, Hon. Charles E., a U.S. Senator from Iowa, chairman, Committee on Finance	1
Wyden, Hon. Ron, a U.S. Senator from Oregon	2

ADMINISTRATION WITNESS

Carroll, Hon. Robert, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, Washington, DC	4
--	---

PUBLIC WITNESSES

Alexander, Hon. Donald C., partner, Akin, Gump, Strauss, Hauer & Feld, LLP, Washington, DC	11
Hernandez, David, vice-president for tax policy, EDS, Plano, TX	13
Martin, Dr. David E., chief executive officer, M-CAM, Charlottesville, VA	15
Doctoroff, Daniel L., deputy mayor for economic development and rebuilding, City of New York, New York, NY	16
Giovengo, Dale, human resources director, Giant Eagle, Pittsburgh, PA	18
Dubowsky, Hy L., PhD, director, economic development services, New York State Department of Labor, Albany, NY	20

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Alexander, Hon. Donald C.:	
Testimony	11
Prepared statement	35
Response to a question from Senator Wyden	37
Baucus, Hon. Max:	
Prepared statement	37
Bingaman, Hon. Jeff:	
Prepared statement of the Electric Power Research Institute (EPRI)	39
Carroll, Hon. Robert:	
Testimony	4
Prepared statement	41
Doctoroff, Daniel L.:	
Testimony	16
Prepared statement	44
Dubowsky, Hy L., PhD:	
Testimony	20
Prepared statement	48
Responses to questions from Senators Grassley and Baucus	63
Giovengo, Dale:	
Testimony	18
Prepared statement	68
Responses to questions from Senators Grassley and Baucus	69
Grassley, Hon. Charles E.:	
Opening statement	1
Hernandez, David:	
Testimony	13
Prepared statement	71
Responses to questions from Senator Baucus	76

IV

	Page
Martin, Dr. David E.:	
Testimony	15
Prepared statement	77
Santorum, Hon. Rick:	
Prepared statement	84
Wyden, Hon. Ron:	
Opening statement	2

COMMUNICATIONS

The Active Financial Services Working Group	87
American Forest and Paper Association	91
Food Marketing Institute	94
Hotel Association of Washington, DC	96
National Employment Opportunities Network	97
National Retail Federation	100
Nellen, Prof. Annette	104
Norton, Hon. Eleanor Holmes	110
Puerto Rico, USA Foundation	115
The Real Estate Roundtable	117
Retail Industry Leaders Association	124
Washington, DC Association of Realtors	126
Work Opportunity Tax Credit Coalition	128

EXPIRING TAX PROVISIONS: LIVE OR LET DIE?

WEDNESDAY, MARCH 16, 2005

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

The hearing was convened, pursuant to notice, at 10:09 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Thomas, Santorum, Bingaman, Wyden, and Schumer.

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

The CHAIRMAN. Good morning, everybody. I thank you very much for joining us today on this very important issue, because we are here to have a thoughtful review of tax provisions that expire at the end of this year.

As an aside, we plan to hold a separate hearing, perhaps at the subcommittee level of this committee, on widely applicable expiring tax provisions. That hearing will look at the differing expiring dates that resulted from the 2001 and 2003 bipartisan tax relief bills. We hope to consider a rationalization of those dates. Today's focus is on the largely business-related provisions that expire annually.

Frequently, the tax writing committees in Congress are forced to make an all-or-nothing decision as to whether or not to extend all such provisions without any changes.

Last year was no exception. During the 108th Congress, the Senate was able to consider and to pass much-needed modifications to extend their proposals, like the Research and Development tax credit and the Work Opportunity tax credit.

Unfortunately, those improved provisions did not make it out of the conference committee, because the House believed that they lacked a basis for change.

One of the purposes of this hearing, then, is to create a record for these long-considered and broadly supported changes so that we may demonstrate their priority in the Senate, and to indicate that we intend to pursue these amendments in the course of this year's legislative business.

Additionally, the hearing will provide members an opportunity to examine the merits of other expiring provisions, to consider whether particular provisions should be made permanent or permitted to lapse, to consider whether proposed expansions are appropriate

and desirable, and also to consider whether reforms are needed to make provisions more administrable and more efficient.

Efficiency should be a key consideration of any tax incentive. For each expiring provision extended or made permanent, we need to be sure taxpayers' dollars are not being wasted. Sometimes we enact short-term provisions to provide temporary economic stimulus—for example, the temporary tax incentives enacted to aid in the revitalization of the New York Liberty Zone after 9/11.

Representatives from New York are here today to discuss a proposal for re-working a targeted post-9/11 tax relief. In fact, one of the reasons I am late getting this meeting started is because I just had a very short conversation, face-to-face, with the governor of New York on that issue.

Nevertheless, those incentives, even if we adopt changes, were intended as temporary economic stimulus for that area and will be permitted to lapse upon expiration.

Other temporary proposals were enacted as demonstration programs to allow Congress an amount of time to evaluate their efficacy. Periodically, this committee and Congress need to revisit those provisions and to determine whether they achieved their stated objectives, whether additional time is required for evaluation, and/or whether interim reforms are needed. This hearing will provide us an opportunity to make those evaluations.

In addition to the testimony that we will hear today regarding some of the larger expiring provisions, Senator Baucus and I asked the Joint Committee on Taxation to provide background and policy recommendations for all of the extender provisions.*

In response to the publication of that document, we have requested comments from interested parties on all remaining expiring provisions. Commentary provided by Joint Tax and outside parties will be of great assistance to us as we move forward in the future consideration of these provisions.

Now, Senator Baucus cannot be with us today because he is involved with the mark-up of a very important highway bill. I would turn now to Senator Wyden to speak for the Democratic members of the committee.

**OPENING STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON**

Senator WYDEN. Thank you, Mr. Chairman. Senator Baucus very much regrets not being able to come. We commend you for holding this important hearing.

Personally, I can say I am very much in favor of compassionate end-of-life programs, but I think some of these tax provisions ought to be allowed to die and are simply not a good use of scarce resources in a belt-tightening climate.

I would just like to mention very briefly, Mr. Chairman, the issue of energy and how it is treated under the Tax Code. There is hardly a bigger issue in our country right now than energy independence. Our Nation imports 10 million barrels a day. The country is

*For more information, *see also*, "Description and Analysis of Certain Federal Tax Provisions Expiring in 2005 and 2006," Joint Committee on Taxation staff report, March 11, 2005 (JCX-12-05).

just a few cents short of record energy prices. Yet, our tax laws subsidize wasteful practices every single day in the energy field.

The prime example is a part of the Tax Code that allows energy producers to deduct more from their taxes than they have invested in the wells that they try to develop. It is called "the suspension of 100 percent of net income limitation on percentage depletion." But what the provision really does is suspend the normal rules for what businesses can deduct.

It allows deductions greater than the amount oil and gas producers have actually spent on their wells. Even if this provision was justified way back when oil and gas prices were low, it certainly cannot be justified when oil prices have soared to around \$55 per barrel.

This is not just my opinion. Here is what the Joint Committee on Taxation said about this obsolete provision: "If the present law provision was intended as a temporary measure to assist taxpayers in times of depressed oil prices, further suspension of the limitation may not be warranted. Domestic crude oil prices are currently above \$50 per barrel. When the suspension was first put into place, domestic crude averaged \$10.87 per barrel."

Oil prices are five times what they were when this tax break was first instituted. It is time to give the American people a break from an outdated law.

Now, it was originally the position of this committee that this break would only be enforced when oil prices were low. In fact, the original Senate language limited the break to periods when the well-head price of crude was below \$14 per barrel.

The committee's report makes this clear when it stated, "The committee believes that a suspension of the net income property limitation for oil and gas production is appropriate if the price of oil falls to unexpectedly low levels." This provision was never intended to remain in force when oil prices skyrocket to the unexpectedly high levels our country is experiencing now.

With current prices at these levels, it is time to suspend the suspension of net income limits on deductions. Of all the expiring provisions the committee is considering whether to let live or die, I would just suggest, respectfully, Mr. Chairman, that this unjustified tax break should be among the first to get a thumbs down.

So, I thank you for your courtesy. As I say, Senator Baucus regrets that he cannot be here at this time. Of course, I will look forward to working with you in a bipartisan way.

Mr. Chairman, if we also could, could we have Senator Baucus's statement submitted for the record?

The CHAIRMAN. Yes. Without objection, it is received.

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

The CHAIRMAN. Now we go to Secretary Carroll, Deputy Secretary for Tax Analysis. Would you proceed with your testimony, please? Thank you for coming, too, to represent the administration's point of view on these tax provisions.

STATEMENT OF HON. ROBERT CARROLL, DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. CARROLL. Thank you, Chairman Grassley, Senator Wyden, and distinguished members of the committee. Thank you for inviting me to this important hearing to discuss the administration's proposals to extend expiring tax provisions.

Expiring provisions vary widely in scope and purpose. They are, nevertheless, important components to tax policy and deserve careful attention. The President has proposed extending many of these provisions in his fiscal year 2006 budget because they serve important policy objectives.

Whether to extend expiring provisions reflects a balance of fiscal discipline and Tax Code stability so households and businesses can make clear, well-informed decisions, and reevaluation of the effectiveness of certain tax provisions.

Consequently, whether to extend these provisions, and for how long, is multi-faceted and complex. The factors that were considered in determining the treatment of expiring provisions are essentially threefold. Is the provision central to the President's program for promoting economic growth and creating jobs? Should the provision be more broadly considered in the context of reform of the tax system, a key domestic priority of the President? Does the provision otherwise serve important policy objectives?

The President's 2001 and 2003 tax cuts were essential to the robust economic growth we now see. They reduce the tax burden on workers and small businesses and increase the after-tax reward from working and saving. Reductions in the cost of equity capital encourage more investment and innovation, leading to greater productivity and, ultimately, higher living standards.

Permanent extension of these tax cuts is a key component of the President's economic agenda to promote growth and to give households and businesses a predictable and stable Tax Code on which they can depend.

While not necessarily core elements of the President's policies to promote economic growth in the face of the economic difficulties and uncertainties over the past several years, certain expiring provisions are also important to the Nation's continued economic growth.

The Research and Experimentation credit provides a substantial incentive for businesses to invest in technology development. It is a source of innovation in the economy.

In order to make sound decisions, permanent extension of the R&E credit is important to provide businesses with a predictable and stable tax system to make R&D commitments that often can involve substantial lead times. The President's budget, once again, proposes permanent extension of this credit.

The President has also made reforming our tax system a key priority. The Tax Reform Advisory Panel, named by the President earlier this year, will of course develop tax reform options to make the Tax Code simpler, fairer, and more pro-growth.

In order to provide the Tax Panel with greater flexibility and latitude, a number of expiring provisions were excluded from the

budget. For example, the provision to increase the AMT exemption and allow all personal credits to be claimed against the AMT.

The so-called "AMT patch" will remain in effect through 2005. These provisions were excluded from the fiscal year 2006 budget in anticipation of the Tax Panel developing a long-term solution to the AMT problem.

Likewise, the administration does not propose to extend the low- and moderate-income saver's credit, nor the deduction for certain higher education expenses, in deference to the ongoing work of the Tax Panel.

The administration does propose a several-year extension of expiring provisions with certain policy objectives. This helps provide taxpayers a basis on which they can continue to plan and make decisions.

At the same time, it also provides Congress and the administration a continued opportunity to evaluate and monitor the effectiveness of these provisions on a periodic basis.

Thank you again, Mr. Chairman, Senator Wyden, members of the committee, for the opportunity to appear before you today. We look forward to working together with this committee, and others in the Congress, on this, and other issues.

I would be happy to answer any questions you might have.

The CHAIRMAN. Did you have a longer statement that you wanted to include in the record?

Mr. CARROLL. Yes.

The CHAIRMAN. All right. Then that will be done.

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

The CHAIRMAN. The Finance Committee has had discussions with IRS employees that raised concerns about the ability of the IRS to effectively administer the Research and Experimentation tax credit. We have a witness on the second panel that discusses these issues of administration, and also whether the R&E credit is meeting its stated purpose.

The administration has proposed making this credit permanent at the cost of \$76 billion. My question is, has the Treasury Department reviewed the issues of administration and effectiveness of the R&E credit, and if so, what is their response to these matters that have been raised by others?

Mr. CARROLL. The administration's view is that the R&E credit is a very important tax provision that provides a source of innovation in the economy. It encourages companies to invest.

The economic literature, particularly the more recent economic literature, supports the incentive effects of the R&E credit. I think there are some operational issues involving the definition of R&E that do need to be addressed.

The CHAIRMAN. Can I interrupt you just a second? I think your answer is in regard to the effectiveness and the necessity for the legislation. We are talking just about the administrability of it.

Mr. CARROLL. That is something that Treasury has been looking at. With respect to the administrability of the credit, one of the issues is how research is defined. Another issue is how the base period operates with the 20-percent credit. Those are structural issues that we have been working on at the Treasury Department with the IRS.

What the administration did is simply propose permanent extension of the R&E credit without, as you know, proposing any structural changes, to ensure that the basic incentive effects and structure of the credit are in place.

But we would also anticipate that the Tax Panel will take a very hard look at the R&E credit as it broadly considers investment incentives across the economy generally.

The CHAIRMAN. All right.

The next question deals with tax-exempt bonds. For instance, the Qualified Zone Academy bonds. The administration has proposed to extend these.

Several issues. My understanding is, there are serious issues raised about the real value of the 10-percent contribution required from private entities. We are hearing reports, just as we do in charitable contributions of in-kind, that we are seeing very aggressive valuations being given for the charitable contributions.

Additionally, there is not a requirement that an information return be filed by the issuers of these Qualified Zone Academy bonds. Failure to have an information return raises serious administration questions.

We have seen in the commentary by the Taxpayer Advocate that the tax gap is particularly high in areas where there is no information reporting. Because there is no information reporting, my understanding is that this program is falling through the cracks and that there is no effective oversight of the program.

Finally, does Treasury have any knowledge that the money is being used as was intended, that is, directly rehabilitating and repairing facilities? Again, my understanding is that, because of significant arbitrage taking place, some of the funds are being used for other purposes. So, I have kind of laid out a proposition for you to respond to here.

Mr. CARROLL. All right. Certainly.

We do have operational concerns with this provision. I understand that the exam activity for the QZAB is not very great. It makes it very difficult to evaluate the effectiveness of the provision, and also makes it very difficult to, as well, evaluate the administrability of the provision.

We are also concerned with the fee structures and the arbitrage opportunities. We have been working with the IRS to better understand those issues. The Tax Code, as you know, does not apply the arbitrage limitations for QZABs. There is also no limit on the issuance costs related to QZABs. In contrast, there is a 2-percent limit applicable to private activity bonds, for example.

The administration proposal essentially does two things. First, it extends QZABs for 2 years, through 2007, so it is only a 2-year extension. A key part of the administration's proposal, the second part, is we have proposed a new reporting requirement to facilitate the program evaluation and assist in the administration.

The CHAIRMAN. On a follow-up point, but not just directly related to the purpose of this hearing, I would appreciate clarification on the administration's position on tax credit bonds, in general.

Although there have been many proposals for tax credit bonds, these Qualified Zone bonds are currently the only one in the Code. We know that the administration opposes tax credit bonds for high-

way construction, as an example, and that is an issue on the Hill right now.

I would like to understand the administration's view on tax credit bonds, in general, because it is an issue that often comes up before this committee.

Mr. CARROLL. That is something I think I would very much want to get back to you on.

The CHAIRMAN. In writing, you mean?

Mr. CARROLL. Yes.

The CHAIRMAN. All right.

The CHAIRMAN. Now, since the red light is on, Senator Hatch was here first, but we normally have deference to the Ranking Member.

Senator HATCH. I have no questions. Go right ahead.

The CHAIRMAN. All right. I would call on Senator Wyden, then Senator Bingaman, then Senator Thomas.

Go ahead.

Senator WYDEN. I thank you, Mr. Chairman, for your courtesy, and for Senator Hatch's as well.

I think you heard me discuss, particularly, Mr. Carroll, this suspension of 100 percent of net income limitation on percentage depletion.

What troubles me about this, it is a tax break in the energy sector. It is not tied to production. It is not tied to the producer's investment. It allows people in the energy sector to deduct more than they had invested in their business. Do you not think it is time to let this one die?

Mr. CARROLL. I think I really take your comments to heart. The suspension of the net income limit, with respect to marginal production, was originally intended, as you say, to encourage domestic oil production during periods of low oil prices when producers may not have the net income from a particular property. But, as you pointed out, of course, right now oil prices are at very, very high—historically high—levels.

Senator WYDEN. So you would not disagree with my analysis, that there are not any arguments for having it right now.

Mr. CARROLL. That is correct. This was originally intended to provide an incentive during periods of low oil prices, not during periods of very high oil prices that we are seeing right now.

Senator WYDEN. I appreciate your answer, and I want to work with the administration on re-doing this, if not eliminating this, because I want incentives for producers. We very much need more production in this country.

But what is going on now, as I have outlined, is we are wasting money with a very inefficient subsidy that could go for incentives that I am sure that folks in Wyoming, Louisiana, and other parts of the country would be very desirous to have.

At a time when we are importing 10 million barrels a day, we just cannot afford to waste these kinds of dollars. So, I appreciate your answer and your straightforwardness.

Now, the committee is very interested in examining this question of making permanent the provision in the Code to allow military service members to get the Earned Income Tax Credit while serv-

ing in combat. Under current law, combat pay is excluded from gross income for tax purposes.

An exception to the rule applies to taxpayers who claim the Earned Income Credit. A taxpayer can elect to treat combat pay that is otherwise excluded from gross income as earned income for purposes of the credit. This allows taxpayers who receive combat pay to claim the Earned Income Credit.

Now, this is a temporary provision. I, Senator Baucus, and others feel very strongly about looking at making this permanent because it is due to expire at the end of 2005. It is our understanding that the President's budget only suggests extending for 1 year the provision to allow the families—these are the families of those serving in a combat zone—to get the credit.

Could you tell us what the rationale is for not permanently ending the penalty here and permanently putting into our Tax Code some recognition for these families that make such a great sacrifice for our country?

Mr. CARROLL. Well, certainly, as you pointed out, the President's budget does include a 1-year extension for this provision. It recognizes the sacrifices made by members of our armed forces serving in combat zones.

Another point that you made is, failure to extend the provision will particularly hurt those who can least afford it, the lower-ranked personnel serving in the combat zones in Iraq and Afghanistan. I think it is the case that we would not oppose permanent extension of this provision.

That said, I would want to go on—

Senator WYDEN. I want to make sure that the record is clear on that point. So, if Senator Baucus, myself, and others seek to ensure that this tax break is permanently available for the families that are serving in combat, your position is, you would not oppose that.

Mr. CARROLL. Right. That is correct. I would also want to point out that we do also anticipate that the general issue of the Earned Income Tax Credit and its structure, and other provisions that are targeted to low-income individuals, is an issue that will generally be taken up by the Tax Panel.

Senator WYDEN. I understand that. I think we all would hope that combat action involving these courageous troops would end by 2006, but no one can count on that. I think it is a step forward that you would not oppose this effort, because I know that many Senators of both political parties are interested in it.

One last question. Is my light on, Mr. Chairman?

The CHAIRMAN. Go ahead with one more question.

Senator WYDEN. It is all right. I can wait. Senator Hatch has been waiting, Senator Thomas also. I will get another round.

Senator HATCH. I am going to pass anyway.

Senator WYDEN. Let Senator Thomas ask, then I will go with a second round.

The CHAIRMAN. All right.

Senator Thomas?

Senator THOMAS. Thank you. I am not sure I am ready. But just in general—and I am sorry I was not able to hear all of your comments—we are always talking about simplifying the Tax Code. Is this sort of thing necessary? What is your view of this? Are we

evaluating each one? What are we seeking to do? Are we seeking to simplify the Tax Code at all?

Mr. CARROLL. A lot of the expiring provisions focus on very narrow areas of the Tax Code and very narrow constituencies. They do raise issues of complexity in some areas, and I think there is a real balance, a continuing and periodic reevaluation that needs to take place for a lot of these provisions, to balance the policy objectives providing the benefits, however narrowly defined, with the complexity and the effectiveness of the provisions. Getting additional information on the provisions and their effectiveness through, let us say, additional information reporting, in the case of the QZAB provision, and in other areas, would be helpful.

Senator THOMAS. Medical savings account. Is this the only one that is available? Archer.

Mr. CARROLL. We have health savings accounts, which effectively replace medical savings accounts.

Senator THOMAS. Why do we have this one?

Mr. CARROLL. This one is in place. It expires. It is not something that we propose to extend. I think individuals, over a short period of time—certainly individuals putting new savings aside for their health needs—will, in effect, be using health savings accounts. That is essentially the vehicle that will be used on a forward-going basis.

Senator THOMAS. We are trying to simplify that, too.

Mr. CARROLL. That is right.

Senator THOMAS. Instead of having half a dozen different opportunities out there, we are trying to make it simpler.

Mr. CARROLL. Right.

Senator THOMAS. We seem to talk about it, but we do not seem to do it. Generally, on most of these things that we look at, is it what percentage of the potential involvement are people who are itemizing as opposed to just using the standard deductions?

Mr. CARROLL. Well, certainly.

Senator THOMAS. I would guess that in many cases these deductions are there for people who do not even itemize.

Mr. CARROLL. Well, a lot of the expiring provisions actually, of course, apply in the business area, and some of them apply in the individual area. Many of them do apply to individuals who do not itemize; some apply to those who do itemize.

Senator THOMAS. It just seems like we come up with ideas, someone needs something so we pass something, and then it piles up. Then the next thing we do is talk about simplifying the Tax Code and it is just kind of a mess, really.

Mr. CARROLL. Particularly on the individual side of the Tax Code, as you point out, it is extraordinarily complex. It imposes enormous compliance burdens on the economy. One of the major tasks of the Tax Reform Panel, and one of the major interests of the President, is to simplify the tax system.

One of the things that was done in the budget is, we did not propose to extend certain provisions, to give greater latitude to the panel and their work over the next 5 or 6 months.

We also, in the case of some of the expiring provisions where we did propose to extend, a lot of the extensions are only for 2 years. That does give the panel the opportunity to, as well, reevaluate.

Senator THOMAS. The Tax Panel is looking at all these things?

Mr. CARROLL. The Tax Panel is broadly looking at the Tax Code. It is looking at some of these specific provisions. Some of the points that you made, particularly with respect to, let us say, the fraction of taxpayers who itemize or do not itemize, really goes to the issue of base broadening and to what extent we want to achieve simplification by providing the benefits of some of these provisions more broadly across the taxpaying population.

That is an issue that, at the moment, we do not want to pre-judge where the panel is going to come out, but we want to let the panel do its work and kind of make a judgment.

Senator THOMAS. Obviously, there are situations in which we need to do something. But it just seems like, in general, we are better off to try to simplify the Code, maybe reduce the overall general taxes, and try to reduce to a minimum this idea of having special things for restaurants, for example. I am sure someone will argue that that is a good idea. Why restaurants as opposed to a bar?

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wyden and I have about a question apiece to ask.

Unlike in prior years, the President's budget for fiscal year 2006 did not extend the DC Enterprise Zone characterization and the related tax incentives that have been in effect since 1998. In the view of the administration, should these provisions be permitted to expire?

Mr. CARROLL. That is the position of the administration. As you know, the administration has put forward a new proposal for opportunity zones to especially help communities in transition. DC would be, certainly, eligible and able to apply for the benefits under the opportunity zone legislation. That is the administration's position.

The CHAIRMAN. Then, just in case we get to the end of 2005 and the new provision has not been enacted, does the administration have a position on whether or not the DC enterprise zone should be extended?

Mr. CARROLL. Currently, we would very much like to work with Congress to get the opportunity zone provision in place to avoid that situation.

The CHAIRMAN. So then I think you are saying to us that you do not want the DC enterprise zone extended if we do not get the new legislation?

Mr. CARROLL. Yes.

The CHAIRMAN. All right.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Carroll, I think it would also be helpful to get a sense of how the administration goes about deciding the periods of time that it assigns to various temporary provisions. You have got some that are 1-year, some that are 2-year, and you have this chart that illustrates some of this.

At the same time, it is not clear, at least to my way of thinking, how you reach these judgments with respect to various extension periods and why one would be one year and one would be another year.

Can you take us through the analysis that you apply in making these judgments about the various periods of time assigned for the tax provisions?

Mr. CARROLL. Sure. Several criteria were applied. In a sense, the broader provisions that affect a broad portion or segment of the population, the administration, by and large, chose not to extend so that those provisions could be considered more directly in the context of tax reform and the tax panel's work, to give the Tax Panel more flexibility and latitude.

With respect to the more narrowly defined expiring provisions, we generally, by and large, propose to extend most of those through the end of 2006. Essentially, in many cases, that was essentially a 2-year extension to give us the opportunity to reevaluate and to continue to consider the effectiveness of the provisions.

It also gives the opportunity for individuals and businesses to make plans over the next couple of years in anticipation of a potential reform of the tax system, where some of these areas as well might be affected.

There are a couple of provisions that we propose to extend permanently. The R&E credit is one example, where it is the administration's view that that particular provision provides a very substantial incentive for companies to invest in innovative technologies and as a source of innovation for the economy.

Because of that provision's potential effect on economic growth, innovation and job creation in the economy, which is a theme that runs through many of the President's tax policies, that is a provision that we felt ought to be extended on a permanent basis.

Senator WYDEN. Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Mr. Carroll.

Well, I should ask, does anybody have a second round? [No response].

The CHAIRMAN. Thank you, Secretary Carroll.

Now we will go to our panel of experts. We have one panel, but six people on the panel. We start with the former Commissioner of IRS, Donald C. Alexander, whom I consider a friend and a person that I talk to frequently. He is a partner at Akin, Gump.

We also have Mr. Daniel Doctoroff, Deputy Mayor for Economic Development and Rebuilding for the City of New York; Dr. David E. Martin, chief executive officer, M-CAM, Charlottesville, VA; Mr. David Hernandez, Vice-President for Tax Policy, EDS, Plano, TX; Mr. Dale Giovengo, Human Resources Director, Giant Eagle, Pittsburgh, PA; and Dr. Hy L. Dubowsky, director of Economic Development Services, New York State Department of Labor, in Albany, NY.

If I did not pronounce two or three of these names correctly, I will stand corrected by you.

We will go from Mr. Alexander over to Mr. Dubowsky.

Mr. Alexander?

**STATEMENT OF HON. DONALD C. ALEXANDER, PARTNER,
AKIN, GUMP, STRAUSS, HAUER & FELD, LLP, WASHINGTON, DC**

Mr. ALEXANDER. Thank you, Mr. Chairman. I have a statement which I would like to have introduced in the record. I do not propose to read any of it.

The CHAIRMAN. All right. And for all of you, if you have a longer statement than the 5 minutes that you have been given, it will be just automatically inserted in the record, at your request, without asking permission at this point.

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

The CHAIRMAN. Proceed, Mr. Alexander.

Mr. ALEXANDER. Mr. Chairman, I want to commend the committee for having this hearing. I think it is very important. I have gained much from the discussion thus far and the questions that have been raised, Mr. Chairman, particularly the concerns about administrability of the law, concerns that this committee and the other tax-writing committee ought to pay some very serious attention to, and I am delighted to see that you are doing exactly that.

Simplifying the law is equally significant. I hope you do not leave that to this panel, the panel that is supposed to report by July 31 and to take into account all kinds of ways to collect taxes, all ways of administering tax programs, and all ways of devising such programs.

Are we going to have a value-added tax? Are we going to have a flat tax? Are we going to continue to have an income tax? The administration is already saying that they want to protect home ownership and the charitable deduction. It sounds like an income tax to me, because it is hard to do that in a VAT.

But, I hope you do not leave that to them. I have served on too many commissions to take commissions very seriously, and I hope that this committee does not delegate any of its responsibilities to a commission appointed by the White House to carry out whatever its instructions are.

Let us go back to administrability. There are 21 expiring provisions in this group, in addition to a few that deal with Internal Revenue's ability to share information with other agencies.

Now, I like the words "let die" that are part of the title of this hearing. Many of these expiring provisions are candidates for consideration by committees other than the Finance Committee because they have nothing to do with the tax system, other than they are an excuse not to have to vote on an outlay, but instead to confer a benefit upon a particular group, whether or not they really need it, through the tax system.

That is what has made our law so complicated. That is why it is so difficult to administer. That is why it is far from simple. It is the most complex possible collection of some provisions that make sense, greatly outweighed by provisions that do not. Hopefully, you can do something about that.

One way is to simply let the undeserving expire, and that surely includes the District Enterprise Zone. One of the District Enterprise Zones, if I recall correctly, includes the Madison Hotel, where you can get a good room for \$350 a night and which deserves no special tax benefit.

It is a fine hotel and should be very profitable. Not to pick on the Madison particularly, but the District Enterprise Zone is in the Code right now and does not need to be there.

The R&D credit. You will hear a lot about that later. That has been extended 11 times. It expired once. The former Secretary of

the Treasury had something to say about it in his book, in his usual explicit way. The Treasury Department has come out in favor of making it permanent. Well, why not make it permanent, if you are going to extend it for a couple of years? The reason that things aren't made permanent is largely budgetary considerations. You can't afford to make them permanent, so you extend them.

That is fine, provided you have a chance to look at them to see if they are really doing what they were intended to do, and what they are expected to do; whether the outlay is worth the cost.

Thank you.

The CHAIRMAN. Thank you.

Now, Mr. Hernandez.

**STATEMENT OF DAVID HERNANDEZ, VICE-PRESIDENT
FOR TAX POLICY, EDS, PLANO, TX**

Mr. HERNANDEZ. Thank you. Good morning, Mr. Chairman, Senator Wyden, and other members of the committee. My name is David Hernandez, and I am the Vice-President of Taxes for EDS Corporation.

I hope my presence here today on the panel will serve to give a face and basis to corporate America in order to allow you and the rest of the Congress to hear first-hand exactly how important the research and development tax credit incentive is to us, and how much it has an impact on corporate America.

I think it is important to note whom I represent in order to put my thoughts in context this morning. My own company, EDS, helped found the information technology outsourcing industry, which is an industry created to use technology R&D to create economic value and efficiency for our clients. That industry has helped us create great jobs for over 120,000 employees in over 50 countries around the world.

I am honored to testify today on behalf of the R&D Credit Coalition, as well, which represents more than 1,000 small, medium, and large U.S. companies and 85 professional and trade associations, a rare and truly united front of industry in support of the R&D credit.

First, I want to express our appreciation for the Senate's long-standing commitment to a strong, vibrant, and permanent research and development tax credit. The coalition commends Senator Hatch, and in his absence, Senator Baucus, and all the members of this committee for your leadership in promoting U.S.-based research activities.

The coalition has worked with Senators Hatch, Baucus, and other members of the committee to make the current R&D credit permanent, enhance the alternative incremental credit, and add an alternative simplified credit option so that the R&D credit will encourage even more companies to increase their U.S.-based research activities.

We are extremely pleased that a new bill was introduced just yesterday that we can all support and rally behind in 2005, once again showing the leadership that is key on this important tax policy issue.

Since 1981, the R&D credit has been a proven and effective incentive for nearly 16,000 large-, small-, and medium-sized compa-

nies across all 50 States. Thousands of other companies that manufacture, distribute, market, and sell products and services made possible by credit-eligible research are indirect beneficiaries of the credit.

The credit has contributed to the development of new products and new industries, and the high-quality, high-wage jobs that are the product of technological innovation. As the leader of EDS's tax function, I am confident that you should think of the credit as a jobs credit, in many ways.

We fund more in R&D as a result of the cost savings created by the credit, which means we hire more people here in the U.S. to complete this high-end technology R&D. The positive effects of the R&D credit on my company's operation feed off each other and, if you will, spiral upward in a good way to create growth in our economy.

There are problems, however, that need to be addressed and we cannot lose sight of. The historical pattern of expiration and extension makes it difficult for companies to plan for projects that are long-term, high-cost, and high-risk.

Moreover, there are a significant number of research-intensive companies that, due to their business model or changes in the economy, receive little incentive to increase their research activity in the United States.

Economists agree that technological innovation has driven much of the productivity growth of the last decade. It is truly what makes our American economy so unique and great, and makes me proud to be a leader in a company like EDS that helps drive that technological innovation.

What you might not see, Senators, is that foreign jurisdictions recognize the value and importance of R&D investments and the high-quality jobs that flow from that investment.

Governments around the world are competing for corporate R&D investment to help create a better economic future for their citizens. I, as the leader of EDS's tax function, am often approached by foreign development authorities seeking EDS R&D investment dollars.

Just this week, the World Economic Forum released its annual global information technology report. The rankings which measured the propensity for countries to exploit the opportunities offered by information and communications technology revealed that Singapore had displaced the United States as the top economy in information technology competitiveness. As a leader of a U.S. technology company, I am personally united with you to make the U.S. number one again in that area.

There are 18 OECD countries employing tax incentives for R&D. Our Canadian neighbors tout the value of their R&D tax credit in the *Wall Street Journal* and on CNN.

I am a tax attorney and I try not to get, and often do not have the opportunity to be, melodramatic about the tax laws that I interpret and apply every day. But it is also very rarely that I get the opportunity to voice my opinions and the anecdotes associated with my life to policymakers like yourselves.

So, if you will forgive me, the bottom line for me and our coalition is that a stronger and more reliable R&D credit is a tax policy

that will create and drive a stronger and better tomorrow for me, for my company, for my kids, for you and your constituents as well. Thank you again for inviting me to speak, and I welcome your questions.

The CHAIRMAN. Thank you, Mr. Hernandez.

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

The CHAIRMAN. Now, Dr. Martin?

**STATEMENT OF DR. DAVID E. MARTIN, CHIEF EXECUTIVE
OFFICER, M-CAM, CHARLOTTESVILLE, VA**

Dr. MARTIN. Thank you, Mr. Chairman and committee members. It has been a delight working with you in the past on accountability and transparency in tax, particularly last year, working on the area of patent donations, which was an area where a great deal of economic gain was masquerading as economic incentive.

In fact, as this committee, and ultimately the Congress and the President, understood, it was, in fact, a masquerade far more than it was legitimate.

Most of my comments I would like to just include in the written component of the record. But job creation and economic development are frequently used to justify the existence, together with the recent calls for the extension, of the R&E credit and its expansion.

The Joint Committee on Taxation, in its recent report issued just a few days before this hearing, actually indicated that 84.94 percent of the credit is actually claimed by companies with assets greater than \$50 million.

Given the credit's use and its bias towards large companies and the available disclosed financial data from public companies in that sector, M-CAM undertook an independent investigation to assess the use of the R&D tax credit in publicly traded corporations in the United States.

This involved a survey of 5 years of every public financial disclosure of every publicly traded company in the United States. Out of that, it was helpful to understand that only 200 of the public companies explicitly reported use of the credit during that period of time.

Now, it is important to understand that "explicit use" and "actual use" are two different things, and I want to be clear on the fact that these are actually taken from the companies that actually self-report the use of the credit.

Twenty percent of the companies using the credit also receive the primary amount of their R&D funding through government contracts and government grants, which are coming from the support not only of the United States, but also from a number of other countries, not the least of which our neighbors to the north.

M-CAM decided to look at a question that, up until now, has not been looked at, which is whether or not the R&E tax credit actually has a demonstrable direct benefit in its users, which is something that, while it has been frequently touted, has never been measured.

In fact, up until now and including the Joint Committee on Taxation, the actual record states that the economic benefit is actually implied because there is a spill-over effect, because any time R&D happens, good things happen.

But no one has actually taken a disciplined look at the population that actually uses the credit to determine whether they, in fact, add to the economy. The following is helpful to understand. We measured the stock performance of companies using the tax credit compared against Standard & Poors.

Seventy-eight companies of the 200 that self-report, which is 39 percent of the population, actually outperformed the S&P, while 87, or 44 percent, a larger group, under-performed, filed for bankruptcy, or de-listed during that 5-year period from 1998 to 2003.

For the companies that remained operational through the 5 years of the study period, the average share price difference between a company's time of using the tax credit and the final reporting period during that period of time, was a positive 9.1 percent difference for companies that out-performed the S&P, and a 67.8 percent decrement for the companies that under-performed.

Now, just think about what I just said. There were more companies that under-performed, and their under-performance was much under-performing the over-performance of the beneficiaries, leading one to the question of whether or not the true beneficiaries of the research tax credit are, in fact, those who research—particularly in accounting firms—ways to look at historical tax statements and apply the credit retroactively, begging the question of whether or not the credit actually is used across the board and uniformly in its intended area.

Remember this: accountability is neither anti-business nor anti-American. We, the people, pride ourselves in holding truth self-evident, but if we have no visibility, we have no accountability.

While this country says that it is, in fact, supportive of research and development—and I, by the way, stand in unity with that position of being supportive of innovation and the public support of innovation—to imply, merely on an emotional argument that the R&D credit is actually doing its job, without any empirical basis for making the argument, is disingenuous.

We list some specific recommendations, but in the interest of time and the number of people on the panel, I will leave the recommendations for questions. Thank you very much.

The CHAIRMAN. Thank you, Dr. Martin.

[The prepared statement of Dr. Martin appears in the appendix.]

The CHAIRMAN. Now, Mr. Doctoroff?

STATEMENT OF DANIEL L. DOCTOROFF, DEPUTY MAYOR FOR ECONOMIC DEVELOPMENT AND REBUILDING, CITY OF NEW YORK, NEW YORK, NY

Mr. DOCTOROFF. Thank you very much. Good morning. I am Dan Doctoroff, Deputy Mayor for Economic Development and Rebuilding for the City of New York.

Mr. Chairman and members of the committee, thank you for the opportunity to testify in support of a proposal in the President's budget to restructure certain tax benefits for Lower Manhattan's recovery.

Mayor Bloomberg wanted to be here this morning, but he is now in Israel at the President's request to lead the American delegation for the dedication of the new Holocaust History Museum.

The mayor asked me to communicate, in the strongest possible terms, his belief that the restructuring of unused tax benefits for transportation infrastructure is essential to the redevelopment of Lower Manhattan.

On September 11, 2001, almost 3,000 innocent people were killed at the World Trade Center; 30 million square feet of commercial space was lost or damaged; 60,000 jobs were lost. Damages were in excess of \$80 billion.

Since that day, we have made tremendous progress, especially on the World Trade Center site itself. The site was cleared ahead of schedule and \$1 billion under budget.

We developed a master plan, including a memorial, that resolves perfectly the seemingly impossible task of remembering and rebuilding.

We selected tenants for cultural buildings, including a new International Freedom Center. We have already laid the cornerstone for the Freedom Tower. And, as a symbol of our progress, a new, 750-foot tall building, Number 7, World Trade Center, rises over the Lower Manhattan skyline.

Our success is, in large part, the result of Federal aid, thanks to President Bush and the Congress, including this committee. I especially want to thank the New York delegation, including Senators Schumer and Clinton.

After the attacks, the President and the Congress committed just over \$20 billion to New York City, about \$15 billion through appropriations, and another \$5 billion through two categories of tax provisions.

The first category is tax-exempt financing, including provisions that were to expire at the end of 2004, before this committee provided much-needed extensions. I want to thank you for that valuable assistance.

The other tax provisions were business-related, such as accelerated depreciation and employment credits. These provisions were expected to provide about \$3 billion toward the rebuilding.

The provisions were designed and analyzed in the rush of activity after 9/11, but it is now clear that they were not the right tools for New York. In part, as a result, Lower Manhattan has bounced back more slowly than we had hoped.

A report by State Assembly Speaker Shelvin Silver notes, 3 years after the attacks, private sector employment in Lower Manhattan was still 14 percent below pre-9/11 levels.

It is no surprise, therefore, that about \$2 billion of these tax provisions remain unused. That is \$2 billion of promised aid that New York has never received, and never will receive, unless you take action. Senators, we need your help to fulfill the original commitment.

The President has proposed to repeal some of the tax benefits and replace them with an expiring tax credit. The credit would help pay for a rail link from Lower Manhattan to Long Island and JFK Airport. This would address Lower Manhattan's most important need for better connections to the suburban labor pool and to visitors.

In fact, the new rail link will create as many as 80,000 new, permanent jobs to replace the jobs that were lost on 9/11. That was

our objective in the months following the attacks, and that is our objective today.

This proposal will complete the initial aid package. This proposal will help secure New York's place as a global financial capital in the face of competition from cities like London, Frankfurt, Hong Kong, and Tokyo. This proposal will enable Lower Manhattan to continue to generate economic activity and employment for the city, the State, and the Nation.

Thank you again for this opportunity.

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

The CHAIRMAN. Mr. Giovengo?

**STATEMENT OF DALE GIOVENGO, HUMAN RESOURCES
DIRECTOR, GIANT EAGLE, PITTSBURGH, PA**

Mr. GIOVENGO. Chairman Grassley, Senators Wyden, Hatch, Thomas, Santorum, and members of the committee, my name is Dale Giovengo and I am the director of Human Resources at Giant Eagle Markets in Pittsburgh, PA.

I have been with Giant Eagle for 35 years. I have served in both store operations and corporate human resource capacities.

I want to thank the committee for the opportunity to appear before you today to discuss the importance of the Work Opportunity and Welfare-to-Work tax credits to my company. These are very important and effective programs, and I am very pleased that this committee is considering legislation to permanently extend and improve them.

Giant Eagle has been in business for 75 years. Our corporate office is in Pittsburgh, where we opened our first store in 1930. We currently have 221 supermarkets located in Pennsylvania, Ohio, West Virginia, and Maryland, four distribution centers, and employ more than 35,000 people in those States.

Giant Eagle has been an active user of the WOTC and Welfare-to-Work credits since their first enactment by Congress. Our company makes a special effort to reach out into the local community to recruit new employees who are eligible for the credit.

In our community outreach effort, we work with a number of community organizations, including the Allegheny County Intermediate Unit, Goodwill, Pittsburgh Vision Services, Pittsburgh Public Schools, and the Cerebral Palsy Foundation.

Our company incurs additional training and acclimation costs in order to work with this specific population. The WOTC/Welfare-to-Work credits support our outreach efforts by offsetting these additional costs to the company.

For example, it is not uncommon for us to pay outside job coaches and trainers to work with some of these hires. Our experience has shown us that our spending on special training for this population is a good investment. We have found that many of our WOTC/Welfare-to-Work hires become loyal, well-trained employees, with a turnover rate comparable to, or better, than our overall workforce.

We encourage our store managers to hire WOTC/Welfare-to-Work eligible employees. All credits earned by Giant Eagle are credited back to store level, which contributes to that store's profitability

and, ultimately, to the manager's compensation, so they have some personal motivation to maximize the hires that would qualify.

Allow me to share with you our WOTC/Welfare-to-Work hiring experience for 2003. Ninety-four percent of our applicants were pre-screened for tax credit eligibility, either as a referral from a community-based organization or in conjunction with our employment application.

IRS 8850 forms were submitted for 1,386 of those individuals we hired. So, WOTC/Welfare-to-Work hires made up almost 14 percent of our new employees in 2003.

Our company treats our WOTC/Welfare-to-Work hires the same as traditional hires. They are entitled to the same benefits, including health insurance, dental, vision coverage, life insurance, sick pay, and vacation pay. This includes part-time employees, as well as full-time. In addition, all of our full-time employees receive medical coverage for their dependents as well.

Mr. Chairman, we strongly support S. 595 because, first, a permanent program will end the harmful uncertainty that results from temporary extensions, or, worse, the disruptions that occur when the programs expire.

Second, merging the Welfare-to-Work tax credit into the Work Opportunity tax credit will simply program administration.

Third, the proposed expansion of the age eligibility for the high-risk youth in food stamp groups will help companies like ours move more unemployed men, who are often fathers of children on welfare, into the workforce.

To date, the program has been very helpful in encouraging us to hire women on welfare, but as currently structured, we receive no incentive to hire absentee fathers, who also face significant, if not greater, barriers to work than welfare moms.

Finally, we also support the proposal to remove the income test for the ex-felon category. Since I have a second, I just wanted to describe one program that we have put in place that has been somewhat underwritten by the tax credits.

We have, in two of our inner city stores, what we call Project Advantage. It is our store in East Liberty and our store in Waterfront, where we employ about 400 employees. A lot of them, because it is inner city, qualify under the Welfare-to-Work tax credit and the WOTC credit.

We have hired three specific counselors to act as an EAP program for those two stores and counsel our employees on things like child care, transportation, legal issues, housing, and it has been very successful in those two stores in reducing the turnover and maintaining the employment for those at-risk employees. So, this credit has helped us offset the cost of doing that. We employed a United Way nonprofit organization to run that program for us.

I thank the committee again for the opportunity to appear today, and urge members to support the Santorum-Baucus bill to permanently extend and improve the Work Opportunity and Welfare-to-Work credits. Thank you.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Now, Dr. Dubowsky?

STATEMENT OF HY L. DUBOWSKY, PhD, DIRECTOR, ECONOMIC DEVELOPMENT SERVICES, NEW YORK STATE DEPARTMENT OF LABOR, ALBANY, NY

Dr. DUBOWSKY. My name is Hy Dubowsky and I direct economic development services through the New York State Department of Labor.

Mr. Chairman, Senator Wyden, members of the committee, on behalf of New York State Governor George E. Pataki and the New York State Department of Labor Commissioner Linda Angello, I want to thank you for providing this opportunity to submit testimony regarding a review of tax extenders. My testimony will be limited to the Work Opportunity and Welfare-to-Work tax credits.

New York State is proud of our efforts to administer tax credit programs. By applying uniform, constant standards, we have earned the appreciation of the companies and providers that work with us. This, combined with our excellent customer service, encourages participation and has enabled our State to maximize the usage of all tax credits.

Under Governor Pataki, the WOTC program has certified more than 155,000 individuals with barriers to employment. Those individuals were assisted in finding private sector jobs, the first step of transitioning from dependence to independence.

According to the New York State Department of Labor, more than 65 percent of these individuals were former public assistance or food stamp recipients. The remaining third were vocational rehabilitation consumers, ex-offenders, supplemental security income recipients, low-income veterans, and youth living in federally designated empowerment zones or renewal communities.

These statistics mirror those of the Nation; as these people transition into jobs, they start on a new road. They contribute to the economic well-being of their communities and of the Nation.

The benefits of the WOTC program exceed the costs. In a 2003 report submitted to former U.S. Representative Amo Hoden, the New York State Department of Labor concluded that WOTC benefits surpassed costs by more than \$200 million.

Public spending was reduced as hard-to-employ individuals transitioned into private sector jobs, earned wages, and lessened their reliance on government-supported programs. Such budgetary savings generate reoccurring economic benefits.

Tax credits are also used extensively by the not-for-profit workforce development community. The credits offer job developers and counselors, working in everything from small neighborhood centers to sophisticated training facilities, a carrot to enhance their chances of placing hard-to-employ individuals.

Our ability to build a network of business and not-for-profit partners was weakened by the gap between the program's expiration on December 31, 2003 and reauthorization in October of 2004.

In New York, as in other States, the uncertainty surrounding program reauthorization virtually brought our efforts to a halt. Acceptance of government programs depends on trust and a degree of certainty to justify integrating the programs into long-term organizational development and marketing plans. The lack of certainty that the credits will be extended beyond the December 31, 2005 expiration date may have negative consequences.

It may discourage businesses, service providers, and State tax credit operations from investing in application and processing system improvements, computer and database upgrades, staff development and field structures.

More importantly, it may constrain our joint efforts to persuade businesses to commit to behavioral changes when hiring workers and to include individuals with barriers to employment in their workforce.

Funding for the WOTC and WTW programs has remained constant for a number of years. The original Federal support level of approximately \$20 million that has supported the 53 State workforce agency operations has shrunk to \$17.3 million this year. According to U.S. DOL, nearly a quarter of State operations receive less than \$65,000 for direct support of the tax credit programs.

New York State has learned to do more with less. We were the first State in the Nation to offer electronic filing in addition to paper forms. We give large businesses and consultants certification data on CD-roms and a database that is easy for them to use. New York has also promoted the tax credit programs through the State's Economic Development Team.

We have found that presenting employment tax credits as part of a full package of incentives makes them more attractive to employers and more effective in the long run.

Our customers also appreciate the availability of a toll-free number, 1-800-HIRE-992, which serves as a single point of entry for a number of agency services. We are able to offer our customers excellent service and personal attention, and still keep our administrative costs low.

It is possible, next year, that funding will be allocated to support WOTC and WTW in lower amounts than this year. Without adequate support, State agencies may not be able to process applications that serve their business provider and local government partners in an effective and efficient manner.

Backlogs will grow, exacerbated by an anticipated response to the provisions of the IRS TANF Revenue Ruling, which will effectively require State agencies to postpone reviewing current applications while staffers are assigned to re-review applications denied in error.

New York State was proud to chair a joint Federal/State workgroup which provided a framework for EWOTC, to guide the States and U.S. DOL in developing a paperless process. EWOTC addresses the evolving human resource needs of the business community, and it enhances the ability of State agencies to strengthen their internal controls and system capabilities.

There are many, many, many low-income, hard-to-employ individuals who are currently out of reach of the WOTC/WTW program. Legislation introduced by Senator Santorum and Senator Baucus, which cuts red tape by combining the WOTC and WTW credits, raises the age limit for the food stamp and high-risk youth categories from 24 to 39, and eliminates the onerous burden of verifying income for recently released felons, is the next logical step for this program. WOTC and WTW are often lost in the shadows above the larger, well-funded workforce development or employment programs. It merits your attention.

We support reauthorization, the program enhancements offered by Senators Santorum and Baucus, and assurances that adequate funding will be made available for tax credit operations at the State level.

Again, on behalf of Governor George E. Pataki and Commissioner Linda Angello, thank you for this opportunity to provide testimony in support of these valuable programs.

[The prepared statement of Dr. Dubowsky appears in the appendix.]

The CHAIRMAN. Well, we thank you all very much. We will take 5-minute rounds in the order of: Grassley, Wyden, Hatch, Bingaman, Thomas, and Santorum.

Mr. Giovengo, I will start with you. There is considerable support and evidence of the success of both the Work Opportunity tax credit and the Welfare-to-Work tax credit.

Everyone seems to agree that the programs should be merged, and though not included in the President's budget, a provision was included in last year's JOBS bill to make the provision permanent.

We are also here today, though, to consider ways to improve administration of each of these provisions. The IRS and practitioners tell us that the untimely certification process creates considerable uncertainty and complexity for corporate taxpayers and creates difficulty for the IRS to review and do the administration.

We understand that taxpayers are inconsistent in how they deal with the problem of certification that failed to materialize. For example, Mr. Giovengo, you indicate that your company expected that 14 percent of its workforce would render tax credits, but realize only about half of that amount. Because it takes some time to get State certification, Giant Eagle has to take a position on its current returns with respect to recent hires.

Can you please tell the committee how Giant Eagle addresses this issue? That is, do you make an estimate on your current return and then amend the future years when certifications are obtained? If so, do you make an amendment each year for credits that did not materialize over a period of years?

Mr. GIOVENGO. Yes.

The CHAIRMAN. You do all that?

Mr. GIOVENGO. We do.

The CHAIRMAN. As I have described it?

Mr. GIOVENGO. We get credits in an untimely manner.

The CHAIRMAN. Yes. Do I describe what is the situation for your company?

Mr. GIOVENGO. Yes.

The CHAIRMAN. All right.

Then let me follow up with this. I would like you and Dr. Dubowsky to offer recommendations on ways that the certification process can be improved. States are obviously incentivized to promote employment using the credit so as to reduce welfare and encourage productivity.

Nevertheless, they fail to get the certification done in a timely manner, and the suggestion seems to be that these offices are under-funded by the Department of Labor or that the program's potential expiration is the problem. I would appreciate any rec-

ommendations that you have on ways to streamline the process and make the credit more effective.

Mr. GIOVENGO. We would be happy to do that.

The CHAIRMAN. Do you want to do that in writing then?

Mr. GIOVENGO. Yes.

[The information appears in the appendix.]

The CHAIRMAN. Dr. Dubowsky?

Dr. DUBOWSKY. We will be glad to submit further suggestions in writing, sir.

[The information appears in the appendix.]

Dr. DUBOWSKY. But, just very briefly, funding is obviously an issue in States that support a maximum of one full-time equivalent worker. Obviously, there needs to be an equitable distribution of funding to support staff.

States need to strengthen their agreements with other State agencies to be able to verify targeted status. New York has excellent agreements with our various verification groups and has direct access to those databases; other States do not.

We believe that moving to a paperless process will streamline not just the application process, sir, but in our submitted testimony we allude to the fact that EWOTC will also provide management tools for States both to interact with their own agencies and staff, but as well with their employer-customers.

Finally, the issue of permanence of a long-term extension, certainly, in any organization, uncertainty dissuades folks from development and from long-term planning.

So, as to the extension, in fact, we would love to see this program made permanent. It would allow us to go back to our budget folks and say, we need to put some systems in place to address this important program in a timely manner.

The CHAIRMAN. All right.

Mr. Alexander, with your experience and background, both in practice as well as running the IRS, you give us a lot of helpful perspectives. I would like to have your thoughts on an issue that concerns me, the extent of Treasury's consultation with the IRS about the administration of specific Code provisions prior to proposing them to Congress.

I would ask you to give us, as best you can, the history of consultations between the IRS and Treasury and any sense you have of the current practice. In addition, I know that Congress has gone back and forth on having the IRS play a greater advisory role in its deliberations, and so your thoughts on that as well.

Mr. ALEXANDER. Thank you, Mr. Chairman. It varies. It varies depending on who is in the Commissioner's office, who is in the Assistant Secretary for Tax Policy's office, how well they get along, and how well the Assistant Secretary for Tax Policy is willing to let the IRS have its say at the Hill.

I can strongly recommend to you having oversight hearings, because then you can listen to IRS and you can ask them questions about whether a particular provision that the White House might like, Treasury might like, both might like, can actually be administered, whether taxpayers can get the benefit they are supposed to get from it and whether the IRS can actually make sure that those who would fudge a little bit are prevented from doing so.

Treasury likes to have the Hill to itself. Now, my distinguished colleagues from Treasury are fine people. They have left, but they are fine people, anyway. [Laughter.] But what you need to do, is try to get by a barrier that 15th Street is going to erect, and has erected for years, against going directly to 1111 Constitution Avenue.

The only way I know how you can do that is to use your oversight responsibilities, as well as your general responsibilities, otherwise, IRS is not going to be at this table talking to you about whether some highly worthwhile thing—we just heard how wonderful all these credits are—actually is administrable.

The CHAIRMAN. I thank you very much.
Now, Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Dr. Martin, let me start with you. Thank you for your very interesting comments and suggestions on the research credit. As a long-time proponent of the credit, and especially of making it permanent, I am interested in trying to improve it in any way we reasonably can.

Now, some of your comments raised some questions in my mind, however. First, I am a little unclear as to why you began studying the credit. You mentioned that you were doing some work for the IRS in the area of patent donations when you discovered some problems with the research credit. Am I correct in that?

Dr. MARTIN. Yes, that is correct. We actually were reviewing tax behavior generally among the donation companies, and we found an alarming number of cross-overs between donating companies who were over-valuing donations and people applying, particularly the credit, in retrospect.

Senator HATCH. Did someone commission you to undertake this study?

Dr. MARTIN. No. As a matter of fact, similar to our work on the patent donation situation, that was information we surfaced both to this committee and to the Treasury.

Senator HATCH. So it was part of your work at the IRS.

Dr. MARTIN. No, no, no. We do that prior to. We have surfaced this information in advance, because this was information that was not available prior.

Senator HATCH. Now, you stated in your testimony that there is no mechanism in existence today to ensure that the U.S. taxpayer receives any of the intended benefit from the research credit.

What about the mechanism of an audit from the Internal Revenue Service? Are you saying that IRS is powerless in policing the research credit? Let me just ask one last question on this. Is the situation of the research credit not basically the same as with most other credits or deductions claimed by taxpayers?

Dr. MARTIN. Well, there are a number of unique challenges that the R&E credit affords both to the Service, from an enforcement standpoint, and actually for the company trying to use the credit. There are three layers of a response that I would want to provide.

The first layer is that the IRS is stymied equally, as is industry, to define what qualified research is. That is something that has been before this committee and before Congress since 1981.

The definition of qualified research remains ambiguous, and it continues to have problems in that area, so what constitutes qualified research is problematic. But a broader issue, and this is the same thing that we encountered in patent donations, which is the case also in the research exemption, the problem that you wind up with is the documentation that can be surfaced by a company is commensurate with their documentation systems internally.

On many, many occasions, we have found, on the enforcement of other matters, the IRS will actually submit information disclosure requests to a taxpayer, and that information is neither surfaced, nor surfaceable.

Given the absence of the documentation to justify what particular research was applicable against the credit, what is typically done is, in fact, the large- and medium-sized business compliance office within the IRS specifically has guidance that says that the best they can do is statistically sample reports, because they cannot go through the record.

In this situation, what the IRS is confronted with is the absence of documentation to verify the credit's use and has no ability to effectively enforce it against either legitimate use or illegitimate use of the credit; therefore, there is no transparency afforded, and the absence of IDR and the absence of IDR response, unfortunately, has also surfaced in an application of the fast-track settlement approach within IRS, where people failing to disclose under IDR requests are still being afforded the opportunity for fast-track settlement, which is absolutely ludicrous.

Senator HATCH. Let me ask Mr. Hernandez, do you agree with Dr. Martin's conclusion that there is no mechanism available today to ensure that the research credit is not being widely abused? If you have any other comments about Dr. Martin's comments, I would appreciate that.

Mr. HERNANDEZ. Thank you, Senator Hatch. A couple of reasons on my part, in my function of managing the corporate tax function for EDS.

The IRS is very vigorously pursuing enforcement, and tight enforcement, of the application of the Research and Development tax credits. The documentation that Dr. Martin refers to is something that the taxpayer has an obligation to produce and maintain in order to back up the position that it takes on its tax return.

That documentation, in my case—and anecdotally, what I would like to share with you—on audit is then backed up with specific interviews behind the basis of our projects that we have claimed a credit for. I do not think anyone on my IRS exam team would indicate to you that there is a lack of information available to assess the applicability of the credit on our fact pattern.

The other thing I guess I would react to is a general criticism of using statistical sampling in the audit process. It is potentially a bit of an overstatement. There are so many individual line items that flow through a corporate tax return these days that, in many cases, many deductions—going back to your original question, Senator Hatch—the only way to possibly audit those results is through statistical sampling, which is intended to reach an aggregate result that would approach looking at each individual project that you

would look at with respect to the research credit that I have claimed.

The other thing that I would react to, in general, to Dr. Martin's findings that he discussed, a bit unfortunately, but perhaps a bit fortunately for us here today, I fall into Dr. Martin's unfortunate fact pattern. My company has not performed from a stock price perspective to what we would have expected over the last 3 to 5 years.

But what I will tell you, Senators, is that the existence of the research credit has reduced our cost base and has given my company an opportunity to reinvest in the technology associated with our business, to reinvest in our strategic direction, in order to give the company a chance to resurrect itself and, again, grow our stock and our stock price based on our economic performance.

Senator HATCH. Well, thank you. The Chairman has allowed me to just ask two more questions, one for you and one for Mr. Alexander.

In your experience, does the research credit make a difference when a company is making its spending and hiring decisions? Does it really encourage a company to do more than it otherwise would in terms of R&D spending?

Mr. HERNANDEZ. I think there are two aspects to answering that question. I am constantly in dialogues with our senior financial executives, as well as our senior strategic and operational executives, in the decision making process associated with investments that we are going to make in our business. The biggest part of the dialogue that I contribute to is the cost reduction associated with the Research and Development tax credit.

There is also an incentive effect, even if those decisions are not made at the front end of those processes and strategic decisions, in the following manner: the research credit serves as a reduction of our overall cost base from an operational perspective.

The result is that we have more dollars in total to reinvest in the company and the business. Therefore, you have a continued, positive effect to the existence of the credit, even absent a fact situation where it was not at the front end of the decision-making process.

Senator HATCH. Well, thank you.

Mr. Alexander, I share the Chairman's high opinion of you. You have been very helpful to this committee for years and years.

Mr. ALEXANDER. Thank you, sir.

Senator HATCH. In your experience, does the administration of the research credit present huge problems above and beyond those presented by other credits or deductions? In other words, do we need to institute new compliance requirements to ensure massive fraud is not occurring with the research credit?

Mr. ALEXANDER. Senator Hatch, the research credit has presented many administrative problems for years because, as pointed out by the witnesses, it is very hard to define what it is, what is research and what is not, where it stops.

Congress has contributed a little bit to the problems of the research credit by not making it permanent. It extended it 11 times, 1 year left out. If you are going to have a research credit, let us have one that is either in the Internal Revenue Code, or if not, somewhere else.

The research credit is sort of a substitute for an ancient problem that we had with research expenses way back in the 1970s, when people did not know whether research expenditures could actually be deducted at all. Now we have gone not only toward a full deduction, we have gone toward a credit, which is a lot better than a deduction, as we all know.

But people need to know whether you are going to keep it in effect or whether you are not. That would solve one problem. The other problem of trying to define it and trying to seek it out, trying to get good answers to IDRs—which I hope you can get—and trying to deal with the people that refuse to answer, but still claim the credit—which I find is as impermissible as Dr. Martin—you can improve the utilization of the credit. You can improve the administrability of the credit. But let us get rid of the uncertainty, if you can, or whether the credit is going to continue to exist.

Senator HATCH. Well, I appreciate it. I want to thank Senator Bingaman and Senator Grassley for allowing me to ask these two questions, since I have to leave. But I appreciate all of you, and appreciate your testimony.

The CHAIRMAN. Thank you, Senator Hatch.

Now, Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman. Thank you all for testifying.

I wanted to just focus also on this R&E tax credit. I was going to ask you, Mr. Hernandez. One of the efforts I have been making around here for the last several years, along with Senator Domenici, and Senator Baucus has joined us in this, has been to work on a proposed change in the R&E tax credit to deal with a couple of weaknesses that we have identified.

The first part of the proposal that we made provides participants in a research consortium with a flat 20-percent research tax credit. The consortium would be defined as a group of five or more unrelated companies working together on a specific type of mutually beneficial research, our thought being that we should try to be encouraging this kind of cooperative effort by companies, and that the current tax credit does not do that.

The second part of our proposal would get rid of a restriction in the current law that allows companies to only consider 65 percent of their research expenses for purposes of calculating their credit when the funds are paid to a Federal laboratory, a university, or a small business that they have been working with.

Again, it seems to me that there is a good public policy reason to want to encourage the expenditure of funds at our universities, at our laboratories in this way. For that reason, we would eliminate that provision.

Mr. Chairman, there is a statement that I have by the president and chief executive officer of EPRI, which is the Electric Power Research Institute, generally supporting this. I would ask if we could make this a part of the record today.

The CHAIRMAN. Yes.

[The prepared statement of the Electric Power Research Institute appears in the appendix.]

The CHAIRMAN. Also, I wanted to alert you to the fact that I heard your statement about the bill that you have with Senator

Domenici. I would assure you that I will work with you on that and be supportive of it, I believe.

Senator BINGAMAN. Thank you. That would be a big help. We appreciate that. Thank you very much.

Let me ask Mr. Hernandez if he has had a chance to look at the bill that we introduced in the last Congress. We have not reintroduced it yet. But let me ask if he is aware of this provision, and if he has any views on it.

Mr. HERNANDEZ. Senator Bingaman, again, as a representative of the R&D Credit Coalition, we supported the bill that was introduced in the Senate last year. The consortia changes that you specifically discussed are not part of the coalition's objectives, but we applaud you for trying to make the research credit a stronger incentive vehicle for encouraging research in this country. We applaud those efforts and we support you in them. Thank you.

Senator BINGAMAN. Well, thank you very much, Mr. Chairman. I also have to go to another hearing. But I appreciate your having this hearing, and I appreciate the testimony.

The CHAIRMAN. Yes. I am going to call on Senator Schumer, but before I do that, I want to say to all members that the record would be open for 48 hours for questions to be answered in writing from any members of this committee, and in like mind then, hopefully a quick written response from whomever those questions might be directed to.

Anticipating what Senator Schumer might bring up, I would tell him that I had a chance to visit with Governor Pataki just prior to this meeting about some of the issues that New York City is interested in. You have already been complimented by the witnesses for your work on this, as well as Senator Clinton.

Now, while you are asking questions, I am going to step out just for a minute. But if you get done quickly, would the panel wait, because I have one more question I would like to ask.

Senator SCHUMER. Mr. Chairman, would you like to ask it first?

The CHAIRMAN. No, you go ahead. Then I will come back.

Senator SCHUMER. Well, thank you. There is still a Chuck here at the hearing, I guess, so we are all right. [Laughter.] We used to have four Chucks, but Chuck Robb lost, or left, so now we have three.

Anyway, I want to thank Chairman Grassley and Ranking Member Baucus for this hearing. I know its importance. I am going to cut right to the chase here, but I do have to say I am a new member of the Finance Committee, as everyone knows, and I was amazed at how many provisions are set to expire and how many are just regularly renewed every year. I do not know why that is, but I am glad we are having this hearing ahead of time. It makes a good deal of sense.

One issue that I am very concerned with that is not the subject of this hearing, of course, is the proposal that Senator Snowe and I had, which is a law now making tuition tax-deductible. That is a vital provision for middle-class families that does expire before next year, so I hope we will pay some attention to that.

But I want to talk today and I want to welcome our two New York witnesses, Daniel Doctoroff, the Deputy Mayor for Economic

Development and Rebuilding, someone I have known for close to 2 decades.

And Dr. Dubowsky, I want to thank you for being here, someone I have known for about a minute and a half, now.

Dr. DUBOWSKY. We went to the same high school.

Senator SCHUMER. Oh. A Madison High School graduate. Wow.

Dr. DUBOWSKY. We have a lot of common ground.

Senator SCHUMER. You graduated in the class of 1967?

Dr. DUBOWSKY. 1968.

Senator SCHUMER. Oh. I was 1967.

Dr. DUBOWSKY. I also went to your first employer. That is how I got into college. I was not working at the Stanley Kaplan Print Shop.

Senator SCHUMER. He knows a lot about me. My first job was to run the mimeograph machine at a Madison High School teacher's office, who was starting a new company. He had this brand-new idea. He was going to tutor students to prepare for the SATs. [Laughter.]

I ran the mimeograph machine. We had an electric one. So as the machine went around and around and around in this little 3 foot by 3 foot room, and I had to work weekends, after school, and sometimes in the summer, I read the preparatory materials over and over again, and I got 800s on my tests. [Laughter.]

Which disproves what the College Boards were saying, that it was aptitude; it was really achievement. If you study for the test, it works. I then had a fight with Kaplan. When I got those 800s, he wanted to hang them up on the wall.

Dr. DUBOWSKY. Let me assure you, I did not get 800s. [Laughter.]

Senator SCHUMER. All right. But, anyway, he wanted to hang them up on the wall and I said no, and my employment was terminated. He went on to sell the business to the Washington Post for \$50 million, and look what happened to me! [Laughter.]

So, anyway, getting back to my long association with both Mr. Doctoroff and Dr. Dubowsky, I am glad both of you are here, and you are able witnesses for the great city that we all love, New York.

Now, we are here to talk about some of the provisions, the tax initiatives, that were enacted to help rebuild Lower Manhattan after 9/11. I worked with, in fact, Deputy Mayor Doctoroff on those. They have been very successful.

Downtown is not a wasteland: people are moving back; Goldman Sachs plans to build a headquarters there; commercial companies are beginning to look at moving back there, and a few have already decided to do it; residentially, it is booming.

So, this is all a success story. I think, without the assurance that America, this Congress, and this Senate gave the Nation, we would not have been able to do it. So, I thank you.

But not every provision was fully utilized. We do have remaining tax incentives, which were not fully used. We thought more of them would be used than were. With the help of Mayor Bloomberg and Governor Pataki, Senator Clinton, and the House delegation, Republicans and Democrats alike, we were able to persuade the Bush administration to make these funds a little more fungible.

In fact, I had a good relationship with Mitch Daniels. When we did the initial agreement about the \$20 billion which he and I negotiated, there was a codicil that said if we did not use all these funds, we could use them for transportation, in particular.

So, the \$2 billion to connect downtown to the Kennedy Airport is in keeping with the spirit of the \$20 billion because we want to see downtown stay vibrant, and its great missing rail link is to Kennedy Airport and to Long Island.

Anyone who lives on Long Island, which is one of the main places for New York City's workforce, has to really go a convoluted way to get to Lower Manhattan. It is one of the reasons Lower Manhattan has not grown as quickly as midtown. So, it makes a great deal of sense.

The point I want to underline over and over again is, this is not new money. This was money we did not spend. It was money promised to New York. Without this, we would not be getting the \$20 billion in change that we were promised over and over again.

And I want to salute the President for stepping up to the plate and admitting that. We have had our disagreements, but on the \$20 billion he has been true blue. He has stuck by his commitments through thick and thin and deserves a great deal of credit for that.

From the day he made the promise to me 2 days after 9/11 that he would support the \$20 billion, in the Oval Office, through this very moment, he has really been true to his word. So, this is an important thing to do.

I want to ask Mr. Doctoroff a question. At a Finance Committee hearing a few weeks back, I asked Treasury Secretary Snow whether the President was committed to fighting for the new provision.

Secretary Snow was not quite on point. He said the President supports the provision. I have the feeling he was not fully up to date on it.

Now, you and I know that fighting for something is different than just supporting it. We are going to need to do that, given the budget vagaries here.

What has been your communication with the Bush administration? Have they committed to the degree of support as opposed to the actual support? Will they be fighting for this throughout?

Mr. DOCTOROFF. Thank you, Senator. I would concur with your view about President Bush and his commitment to New York and fulfilling the commitments that were made immediately after 9/11. We have had extensive conversations with the White House.

We can submit into the record a letter from OMB Director Josh Bolton. We have seen absolutely no evidence that, from the President on down, they are not prepared to live up to the commitments that they made after 9/11.

Senator SCHUMER. And that includes this \$2 billion?

Mr. DOCTOROFF. Especially this \$2 billion, because this is really the last amount of money that really needs to be resolved. Everything else has either been spent or is largely accounted for. So, this is the final piece of the puzzle.

Senator SCHUMER. And the one other worry I have, and I would want to share this with the Chairman, as well as with you, Mr. Deputy Mayor, is if this is added into the transportation bill, which

it may be, there is some talk about that, I would not want it to come out of other things that New York would be entitled to in the transit bill, because this is not new money, but an old commitment.

I would prefer to have it stay in the extenders bill for that reason. But if for some reason we were going to put it in the transit bill, I would want it made sure, with that caveat. What do you think of that?

Mr. DOCTOROFF. We think that is absolutely correct. The provisions were initially tax provisions, and we think it is most appropriate for them to remain tax provisions. So, we do not think it has a place in the transportation bill, and we share your concern that it could reduce other funding for New York. This is really 9/11-specific.

As I indicated in my testimony, despite what I think has been a remarkable recovery, we are still way behind where we were on 9/10/2001. We are still down 60,000 jobs in Lower Manhattan.

I think, with everybody involved, there is absolute unanimity among our Congressional delegation, and Senator Schumer really has been the true champion of this project, among the Governor, the mayor, the local business community, community groups. This is the single most important project in order to bring Lower Manhattan back, not just for New York City, but for the Nation.

Senator SCHUMER. Thank you, Mr. Chairman.

The CHAIRMAN. Let me have some reaction to what you asked me to pay special attention to. It probably would be better if this were not in the highway bill, not for the reasons that you give, but because this committee has a very heavy lift on additional money to offset.

But then that would also give me an opportunity to challenge you. The issue of certain taxes and reconciliation is still out. In the case of reconciliation, it only takes 51 votes. Then that leaves two propositions about any tax legislation.

One, regular order with offsets would only take 51 votes. If we could find offsets, that is always our druthers. But then for your help, if we cannot find offsets, then it would be very helpful for you to help us get the 60 votes that it might take to get a bill otherwise passed. Particularly, if this were included in it, I would expect that we would get that help.

Senator SCHUMER. If this were included, it would make it much easier to get those 60 votes, as far as I am concerned.

The CHAIRMAN. All right. Thank you. Thank you for listening to me, because I am sharing with you some of the problems that I have down the road.

Senator SCHUMER. I understand, Mr. Chairman.

The CHAIRMAN. I am sure you are very familiar with them, but as time goes on, as a member of this committee, you will become even more familiar with them.

Senator SCHUMER. Yes, Mr. Chairman.

In all seriousness, Chairman Grassley, when we brought this issue to him last year, both Chairman Grassley and Ranking Member Baucus understood the problems of New York, understood the commitment, and really worked hard. As you know, it was in the Senate proposal. It just was not in the House's. I want to thank you for that, Mr. Chairman.

The CHAIRMAN. Yes. Thank you.

Now, I think my last question is directed just to Dr. Martin, but if anybody else wants to respond, I would welcome it.

I appreciate your testimony regarding the R&D tax credit. While I am a supporter of the R&D tax credit, we need to make certain it is targeted to achieve the intended results and that it can be effectively administered by the Internal Revenue Service.

I want you to discuss, further, a few points raised in your testimony. First, I would like you to expand on your experiences with the IRS in terms of examination by the IRS of R&D tax credit issues. In addition, please comment on any particular abuses you may have seen, as well as IRS's response to resolving or settling exam questions on these issues.

Dr. MARTIN. Thanks, Mr. Chairman. I have already commented to Senator Hatch on the issue with respect to allowing settlement in the face of non-response to IDR, which is a very material and very real problem, because as the Service tries to audit, if there is obfuscation on the part of a taxpayer, it makes their job very difficult.

In the pressure that they have to do revenue recognition, obviously, they have to make a very difficult decision of trying to force the issue or moving to settlement. That is probably the over-arching concern.

So, I think the first issue is that, anecdotally and in practice that we have seen ourselves involved in from time to time, the absence of transparency with respect to the flow of information between the taxpayer and the IRS is probably the single largest enforcement problem.

The biggest problem, ultimately, is then the court's interpretation of what has been defined, all the way up to appellate court, as "willful practice of ignorance."

Willful practice of ignorance is a very interesting standard to be trying to debate, whether you are trying to enforce or comply with the regulation. What we need to do is, we need to make sure that we have a vehicle whereby the taxpayer can clearly and transparently indicate the research for which the credit is being applied, and, second, have the Service looking at the same data.

The fact of the matter is, in retrospect of application—which is where the predominant use of this credit is afforded, not in prospective research planning but in retrospective application—it is absolutely imperative that there be a clear picture that, at the time that the research was being undertaken, that research, in fact, met the requirement, because it is a stimulator in its construction, not a retrospective revenue smoother.

Now, I am not opposed to retrospective revenue smoothing, but let us not call it a research credit in that case, let us call it a revenue smoothing credit, and let us use it as an economic incentive that way.

The CHAIRMAN. Then, second, I would like to have you expand on your statement about companies having the affirmative duty to disclose to the IRS certain issues related to the credit. I would ask that you compare this to the company's opposite position not to disclose because of patent and trade secrets.

Dr. MARTIN. Certainly. There is a tension, particularly in the area of patentable innovation, where the Patent Office standard—and this has been supported under Rule 56 of the Patent Statute—actually allows the applicant not to disclose, and has no duty to disclose any due diligence verifying the uniqueness of their work.

Under the “qualified research” definition, the work must be considered unique to be qualified, and it has to be done for the first time to be qualified. There is no qualification requirement and no qualification statutory standard in any part of the law that actually allows for the enforcement of this kind of dynamic challenge that we face.

On the IP side, there is no duty to disclose. On the part of the tax side, there is an inference to disclose under audit, but there is no duty there as well. An active and affirmative duty to disclose the conditions that met the requirement as a part of a stimulation plan that would be a priori in its definition, meaning that prior to the application of the credit a company would attest that they are engaging in research that is qualified and agree to documentation standards, does not place an onerous burden on industry, but would clarify the audit requirements for the IRS.

The CHAIRMAN. Then, finally—and if you would like to respond in writing on this you could do that, but if you want to respond now I have time—I would ask for your specific recommendations to the committee as we consider the administration’s proposal to make the R&D credit permanent.

In particular, I would like your thoughts on what could be done to achieve the results intended by Congress, encourage transparency, improve disclosures, and ensure effective enforcement.

Dr. MARTIN. I have five specific recommendations in my written comments. I would merely want to reinforce, and actually applaud Mr. Hernandez for his comments with respect to the fact that there are a number of people who diligently try to use the credit appropriately. But I think that if we make this permanent, as a condition of making it permanent, that the statute defining its permanence should also define regular oversight requirements that would measure economic output numbers to verify that the country is actually benefitting from the use of the credit, because, at this point in time, in the history of the credit, since 1981, there is not a single study performed in any federally sponsored research, IRS-sponsored research, or any economic research that actually verifies that the credit itself and its application directly leads to the creation of jobs or economic gain.

Every study that has been cited in the Joint Committee on Taxation report infers just that, based on an inference that has not been substantiated, and we need to have that written into the statute, otherwise the abuse levels are upping the ante.

The CHAIRMAN. I will take note of your five specific points that you made in your extended statement.

I thank this panel. I think it has been very, very useful, and I think has given us a real eye-opener on review of extenders. Today’s hearing, I think, informs our committee very much as it considers these extenders, and obviously they will be considered.

Thank you all very much.

[Whereupon, at 11:57 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. DONALD C. ALEXANDER

My name is Donald C. Alexander, and I am appearing today at the Committee's invitation as a former tax collector and a long-time tax practitioner with an interest in sound tax administration.

That expiring provisions are now commonly called "extenders" indicates that most of the time they don't expire on schedule; instead they are extended, usually for short periods of time. Much of this is a consequence of budgetary restraints since the adoption of the "pay-go" rules. From the standpoint of trying to keep the nation solvent, budgetary rules are a good idea. From the standpoint of producing sound, administrable, tax legislation, they are not.

As the Joint Committee on Taxation staff wrote in 2001:¹

The practice of extending temporary provisions for another "temporary" period creates significant uncertainty for taxpayers. It invites speculation as to whether every temporary provision will be extended. For example, the exclusion from income for employer-provided group legal assistance was enacted on a temporary basis in 1976, was extended seven times, and was allowed to expire after June 30, 1992. Similarly, the exclusion from income for employer-provided educational assistance has been extended ten times since its original enactment in the Tax Reform Act of 1978, was allowed to expire after 1994 and then retroactively was reinstated in 1996, and has at times applied to undergraduate education only, and at other times to graduate education and undergraduate education.

This practice of numerous short extenders may well be good for tax lobbyists, but I doubt that improving their livelihood is an appropriate national goal.

So long as the "pay-go" rules continue to foster short-term extenders, it is imperative that Congress somehow find the time to evaluate each candidate for extension to see how it has performed. Does the extender's benefit justify the extender's cost?

The R&D credit is the poster child extender. According to my limited research, it has been extended eleven times, and allowed to expire for a year.² I don't know whether research in

¹ Staff of Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, at 63 (Comm. Print 2001).

the United States ceased when the credit expired in 1995, to resume in mid-1996. The recently-departed Secretary of the Treasury, Paul O'Neill, would have been skeptical. According to Ron Suskind in *The Price of Loyalty*, Mr. O'Neill stated:

“Go talk to people who make practical business decisions about how much [research and development] tax credits influence the level of R&D that they invest in. You find somebody who says, ‘I do more R&D because I get a tax credit for it,’ you’ll find a fool.”

Ron Suskind, *The Price of Loyalty* 90 (2004).

Joint Committee on Taxation’s current list of twenty-one extenders (excluding those relating to tax administration) is quite instructive. Most of them confer narrow benefits to remedy a perceived social or economic problem, unrelated to what most rational people would consider to be an appropriate income tax base. They are simply tax expenditures: a substitution of an income tax benefit for an outlay. In these days where anything with a “tax increase” label attached to it is anathema to many, these tax expenditures are “two-fers”: (1) a tax cut and (2) a government outlay to the lucky recipients.

Some stem from the oldest and largest of these tax expenditures, the earned income credit. Of course, this is not an extender and, of course, it has a laudable goal.³ It is an income supplement to encourage the poor to work rather than to remain on welfare. I thought this fine idea should be administered by the then Department of Health, Education and Welfare, but Milton Friedman, who favored a negative income tax, thought otherwise, and he persuaded the then Administration to adopt the EITC in 1975. I argued that it would be very difficult to administer and that the Internal Revenue Service was not the right agency to engage in social work. Obviously, I lost, and it doesn’t help to say that the predicted problems have occurred.

² The R&D tax credit has been extended 11 times since it was enacted in 1981.

1981 - *Economic Recovery Tax Act* - Credit enacted from July 1981 - December 1985
 1986 - *Tax Reform Act* - Credit was extended for 3 years (January 1986 - December 1988)
 1988 - *Technical and Miscellaneous Revenue Act* - Extended 1 year (January 1989 - December 1989)
 1989 - *Omnibus Budget Reconciliation Act* - Credit prorated to be extended for 1 year (Jan. 1990 – Dec. 1990)
 1990 - *Omnibus Budget Reconciliation Act* - Extended 1 year (January 1991 - December 1991)
 1991 - *Tax Extension Act* - Extended 6 months (January 1992 - June 1992)
 1993 - *Omnibus Budget Reconciliation Act* - Extended for 3 years (July 1992 - June 1995)
 There was no credit from July 1995 - June 1996
 1996 - *Small Business Job Protection Act* - Extended for 11 months (July 1996 - May 1997)
 1997 - *Taxpayer Relief Act* - Extended for 13 months (June 1997 - June 1998)
 1998 - *Tax and Trade Relief Extension Act* - Extended for 1 year (July 1998 - June 1999)
 1999 - *Ticket to Work Incentive Improvement Act* - Extended for 5 years (July 1999 - June 2004)
 2004 - *Working Families Tax Relief Act* - Extended for 18 months (July 2004 - December 2005)

³ “The earned income tax credit, administered through the federal income tax system, is the largest cash assistance program for low-income families. The EITC provides up to \$4,200 a year for working families with two or more children—less for families with fewer children. The EITC is refundable so the credit is not limited to the amount of taxes a family owes. In 2002 the EITC lifted around 4.9 million people out of poverty (Llobrera and Zahradnik, 2004).” Elaine Maag, *Disparities in Knowledge of the EITC*, TAX NOTES 1323 (March 14, 2005) [footnote omitted].

Although the Internal Revenue Code had been used long before the 1970s to favor certain activities⁴ we have now developed targeted tax expenditures into an art form. In addition to the enormous welfare program that the IRS must administer, it also administers major segments of our housing incentives, our education incentives, our health incentives, our child care needs and all sorts of narrowly-focused economic incentives. Many of these are in the extender category.

Satisfying an economic or social need through an outlay gives the Congress a chance through the exercise of its oversight responsibilities to see whether the outlay is working, to determine whether the benefit justifies the cost, and to see what corrections and changes should be made in the national interest. Extenders should get the same scrutiny. Before extension, each expiring provision should be subject to questions like the following:

1. What does it cost? (If possible, compare dollars of tax cost with dollars of benefit produced.)
2. To what extent has it met its predicted goal?
3. Are there more effective or less costly ways of accomplishing its goal?
4. Does it overlap another provision to the same or similar effect? If so, why shouldn't the two (or more) be combined?
5. Have changing conditions made it obsolete or unnecessary?
6. What administrative problems has it created for taxpayers and the Internal Revenue Service?

Unfortunately, such a review rarely happens.

Finally, Congress should not extend expiring provisions retroactively and should leave sufficient time for the Internal Revenue Service to provide forms and guidance to taxpayers.

⁴ And even particular individuals.

RESPONSE TO A QUESTION FROM SENATOR WYDEN

Question: Mr. Alexander, according to the Congressional Research Service, two of the largest tax breaks for oil and gas production are not economically efficient: (1) Expensing of Oil and Gas Exploration and Development Cost; and (2) Excess of Percentage Over Cost Depletion. That is the analysis of the Congressional Research Service (CRS) in the Tax Expenditures Compendium that CRS recently prepared for the Senate Budget Committee (S. Prt. 108-54). Please provide your views on CRS's conclusion that these tax incentives are economically inefficient and, if you agree with their analysis, what you would recommend Congress do to improve these inefficient tax incentives.

Answer: As I understand it, neither the Expensing of Oil and Gas Exploration and Development Cost nor the Excess of Percentage Over Cost Depletion are expiring provisions. Moreover, since I have not studied either of them in recent years, I am not in a position at this time to conclude that these tax incentives, as now in effect, are economically inefficient. I continue to believe, however, that Congress should conduct regular hearings on both social incentives and economic incentives in the Internal Revenue Code to see whether they should be revised or removed.

PREPARED STATEMENT OF HON. MAX BAUCUS

Thank you, Chairman Grassley.

This hearing is aptly titled, "Expiring Tax Provisions: Live or Let Die." Back in the early 70s, there was a popular song by a similar name. That song spoke about the "ever-changing world in which we're living" and said that "when you've got a job to do, you got to do it well." That's a good description of why we're here today:

to consider what to do about several temporary tax provisions that are about to run out, some of which have been renewed many times over, and even allowed to expire on occasion.

This leaves America's taxpayers in an "ever-changing world" of uncertain tax laws that makes it difficult for them to plan and make decisions about their future.

Congress needs to do its job, and not wait until the last minute when these laws are ready to expire and then simply re-extend them. We should decide if they should be made permanent or not; whether they live or are let die.

To put this hearing in context, there are 43 tax provisions that are due to expire on December 31, 2005. Some were made temporary to provide a short-term economic stimulus, while others are temporary either to limit or to test the effect they would have on the economy, jobs, our businesses and our citizens. Now, it's time for us to check in on these laws and decide their fate.

Many of these provisions have proven themselves worthy of staying, because they have improved the U.S. economy, business performance and the quality of life for our citizens.

Just last week, Senator Santorum and I introduced legislation to combine and permanently extend the Work Opportunity Tax Credit and the Welfare-to-Work tax credit, creating a win-win situation both for employers and low-income individuals who are looking for a job.

Recently, in my home State of Montana, more than 1,000 people were certified as eligible under the WOTC program over an 18-month period, including 476 Food Stamp recipients, 475 AFDC/TANF recipients, and 52 veterans. Knowing that the credits are permanent will give employers the certainty that they need to continue and expand their participation, and reduce the administrative burden and complexity associated with a credit that comes and goes.

Since 1996, these credits have helped more than 2 million individuals on public assistance to enter the workforce, giving them hope and a future. A credit that so strongly assists employers to provide jobs and the unemployed to get jobs, building up the U.S. economy in the process, is one that must be kept on a permanent basis.

We will hear from two witnesses today that this credit is working for employers and employees, and I look forward to their testimony.

Another win-win for everyone is the Research and Development Tax Credit. It benefits employers by providing financial incentives to take risks to develop new and innovative technology and products, keeping U.S. companies competitive in today's global economy. Plus, the credit keeps research here in the U.S. instead of allowing it to be out-sourced to foreign countries. It is true that companies must conduct research to stay competitive. The big question is, "Where will this be done?"

The R&D tax credit is critical to our economy by keeping and creating high quality, good-paying jobs here in the U.S. Vigorous research and development is vital to the growth and well-being of our economy and to improvements in our current and future standards of living.

We will hear testimony today in support of permanent extension of this important credit for innovative research.

We also want to remember our responsibility to continue to support the recovery of New York City after September 11, 2001.

Several New York Liberty Zone provisions to stimulate the resurgence of the economy and way of life in New York City are set to expire next year. We do not want that recovery, coming along so well, to slow down because folks are uncertain whether these economic incentives will continue.

We need to make sure that we continue to provide the tools to that area to continue the rebuilding and rebirth. We will hear expert testimony from the city itself about how these incentives have helped recovery.

I welcome also two respected tax experts testifying today, one from the Treasury Department, Bob Carroll, and the other from private practice but formerly in charge of the IRS, Don Alexander, who will advise the committee on a broad range of expiring tax provisions. Since the President did not include a number of these provisions in his budget, we hope Secretary Carroll can explain why.

And, I look forward to Don Alexander's testimony about the problems as a former tax administrator with tax provisions that come and go.

So, again, I thank my friend and Chairman, Chuck Grassley, for calling this important hearing. We have a job to do today—to take a serious look at several of these expiring provisions and consider whether they should live or die. Many of these temporary tax incentives make America a better place for jobs, individuals, business and the economy and should be extended or made permanent. Let's do our job and do it well.

STATEMENT OF THE ELECTRIC POWER RESEARCH INSTITUTE (EPRI)
SUBMITTED BY HON. JEFF BINGAMAN

Written Statement

Dr. Steven Specker

President and Chief Executive Officer

Electric Power Research Institute (EPRI)

3412 Hillview Avenue; Palo Alto, CA 94304

Before the

United States Senate

Committee on Finance

Hearing on "Expiring Tax Provisions: Live or Let Die"

March 16, 2005

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present this written statement in conjunction with your hearing on the expiration and proposed expansion of various tax provisions. The Electric Power Research Institute (EPRI) is a non-profit, collaborative organization that conducts electricity-related research and development in the public interest. EPRI has been supported voluntarily since our founding in 1973. Our members, private and public, account for more than 90% of the kilowatt-hours sold in the U.S. EPRI now serves more than 1000 energy and governmental organizations in over 40 countries.

Our testimony today is also endorsed by three other non-profit organizations:

- National Center for Manufacturing Sciences (NCMS), which supports all sectors of the manufacturing industry, and whose 2004 collaborative R&D dollar amount was approximately \$21 million involving small and medium sized businesses.
- National Council for Advanced Manufacturing (NACFAM), which serves all sectors of US-based manufacturing.
- Semiconductor Industry Association (SIA).

We have all previously indicated our support for the sponsorship of Section 2651, the Expansion of Research Credit, in a September 24, 2004 letter to you and House Ways and Means Committee Chairman Thomas. At that time, the Expansion of Research Credit was being considered during the Senate/House conference on S. 1637, the Foreign Sales Corporation/Extraterritorial Income Act. We are grateful for your past sponsorship of that provision, Section 2651, as well as the sponsorship of Senators Bingaman, Domenici, and Baucus.

The Expansion of Research Credit provision would provide a tax credit for expenses attributable to certain collaborative research consortia and would repeal the limitation on contract research expenses paid to small businesses, universities and federal laboratories. Specifically, the provision would provide a 20% “flat” (non-incremental) tax credit for amounts paid to support certain 501(c)(3) and 501(c)(6) research consortia which operate primarily to conduct research in the public interest and would allow 100 percent of contract research expenses paid to small businesses, universities, and Federal laboratories to be eligible for the credit rather than only 65 percent.

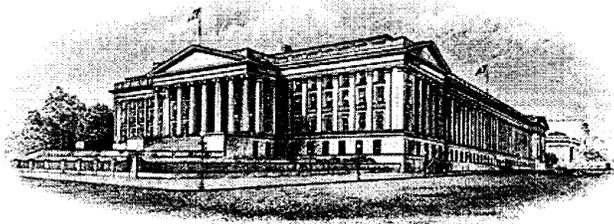
The public benefit research activities of many consortia have been constricted in recent years by a number of factors, including reduced federal funding for physical sciences, engineering and energy research, and the cost pressures on private industry resulting from energy and utility deregulation. The collaborative research tax credit would help to rebuild research funding by encouraging private sector investment in R&D conducted in the public interest and would at the same time stimulate U.S. economic growth.

For example, manufacturers provide two-thirds of all private sector R&D. With manufacturing constituting approximately 16% of GDP, it leads all other sectors in productivity growth. The Expansion of Research Credit would be especially timely now as industry continues outsourcing its R&D at a rapidly growing rate.

The Expansion of Research Credit would strengthen the innovation, productivity and competitiveness of the U.S. economy. It is vital to America’s leadership in technological innovation and global competitiveness in the 21st century. Furthermore, the cost of this tax provision is extremely low, especially when compared to the private sector research investment it would create.

Your continuing leadership in including the Expansion of Research Credit in this year’s tax bill would be a valuable investment in scientific research and the U.S. economy.

Thank you for your consideration and for the opportunity to address the Committee.



**DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS**

**Testimony of Robert J. Carroll
Deputy Assistant Secretary (Tax Analysis)
United States Department of the Treasury
Before the Senate Finance Committee
United States Senate**

Mr. Chairman, Senator Baucus, and distinguished members of the Committee.

Thank you for the opportunity to discuss the Administration's proposals to extend expiring tax provisions.

Expiring provisions vary widely in intent and purpose from the higher expensing limits for small businesses and the research and experimentation credit to the work opportunity and welfare-to-work tax credits to the higher exemption for AMT taxpayers. As you know, many of the expiring provisions were extended through the end of 2005 by Congressional action last fall as part of the Working Families Tax Relief Act of 2004 and the American Jobs Creation Act of 2004.

The choices made with respect to expiring provisions inevitably reflect a balancing of the various and sometimes competing goals of fiscal discipline, providing a stable tax code on which households and businesses can make clear and well-informed decisions, and reevaluation of the effectiveness of special tax provisions. The President has proposed to extend many of these expiring provisions in his FY 2006 Budget.

Whether to extend these provisions and for how long is a multi-faceted and complex decision. Some of these provisions involve substantial revenue cost. Others are relatively new provisions whose temporary nature is by design to give policy makers an opportunity to evaluate their effectiveness. Still others are fully intended to be

temporary, such as the provision providing 50 percent bonus depreciation, to allow the economic recovery to strengthen and provide the needed incentive for new corporate investment at just the right time.

I would like to spend a few moments providing some insights on how the Administration approached the choices with respect to expiring provisions for the FY 2006 Budget. Three factors were considered in making decisions about expiring provisions, as well as some of the other budget proposals:

1. Is the provision central to the President's program for promoting economic growth and creating jobs?
2. Should the provision be more broadly considered with reform of the tax system, a key domestic priority of the President?
3. Does the provision otherwise serve an important policy objective?

Although not the subject of this hearing, the 2001 and 2003 tax cuts were essential to the robust economic growth that we now enjoy. The tax cuts increased after-tax rewards from working and reduced taxes paid by entrepreneurs thereby increasing their rewards to innovation and risk-taking. The cost of equity capital and investing were reduced. More risk-taking, investment and innovation mean higher productivity, greater capital formation, and, ultimately, higher living standards.

Permanent extension of these tax cuts is a key component of the President's economic agenda to ensure that taxes do not increase for millions of Americans. Households and businesses also need a predictable and stable tax code on which they can rely to make sound decisions.

There are several other provisions that fall into the first category of expiring provisions, although not necessarily core elements of the 2001 and 2003 tax cuts which are also important to achieving the nation's full potential for economic growth. The research and experimentation (R&E) tax credit provides a substantial incentive for businesses to invest in technology development and encourages innovation in the economy. The Congress acted this past fall in the Working Families Tax Relief Act to extend the R&E credit through 2005. However, businesses need the certainty and assurance of this credits' availability over the long-term to make R&D plans and commitments that can involve significant lead times. The President's FY 2006 Budget once again proposes permanent extension.

The President has made reforming our tax system a key priority. The tax code is extremely complex is perceived by many as unfair, and the compliance costs place a huge drag on our economy. Complexity arises from the myriad provisions with income phase-ins and phase-outs, numerous definitions and overlapping and duplicative purposes. This complexity translates to total compliance costs of the tax system of what experts estimate to be roughly \$125 billion per year and 3.5 billion hours spent by individuals to maintain records and understand and comply with the tax system. The economic costs are even

greater, with some estimates suggesting that fundamental reform could ultimately add \$200 billion to \$400 billion in output to our economy annually.

The President's Advisory Panel on Federal Tax Reform, named by the President earlier this year, will develop options to reform our tax system to make it simpler, fairer and more pro-growth. A number of provisions were excluded from the Budget in anticipation of this panel's work and to provide the panel with greater flexibility and latitude.

Examples of tax provisions that fall into this second category are the provisions to increase the AMT exemption and allow all personal credits to be claimed against the AMT – the so-called “AMT patch” – both of which remain in effect through 2005. These provisions were excluded from the FY 2006 Budget in anticipation of the tax panel developing a long-term solution to the AMT problem.

Similarly, extensions of the low- and moderate-income savers credit and the deduction for higher education expenses were not included as in deference to the panel's work. In last year's Budget submission, the Administration included a simplification proposal to collapse the four existing education provisions into the HOPE Scholarship and Lifetime Learning Credits. These duplicative and overlapping provisions require taxpayers to understand all four provisions to determine which they should claim. The Administration anticipates that all of these education provisions will be considered by the panel as it considers option for how the tax code can best provide appropriate incentives for individuals to invest in education.

The tax code also includes numerous provisions that allow individuals to save through tax-preferred accounts. The FY 2006 Budget again includes a proposal to consolidate many of these savings vehicles into the Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs). Similar to the education provisions, the Administration anticipates that the tax panel will broadly consider options that promote savings.

The third category of expiring provisions are those with certain policy objectives that need to be extended at least for several years to provide taxpayers a basis for planning, but that also need to remain temporary, to allow the Congress and the Administration to continue to reevaluate and monitor their effectiveness on a periodic basis. The Administration has proposed to extend many of these provisions, which are varied in their purposes, through 2007 (see Table below). One consideration in determining whether to extend these and other provisions permanently is whether the benefits they provide exceed the costs associated with their complexity.

Thank you again, Mr. Chairman, Senator Baucus, and members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on this and other issues.

Tax Provisions That Expire Through FY 2006 Proposed to be Extended			
<u>Tax Provision</u>	<u>Expiration Date</u>	<u>Proposed Expiration Date</u>	<u>Revenue Estimate, 2006-2015 (in millions)</u>
Leaking Underground Storage Tank Trust Fund excise tax	03/31/2005	03/31/2007	229
Various Vehicle Tax Provisions	09/30/2005	09/30/2011	65
IRS Authority for Undercover Operations	12/31/2005	12/31/2010	—
Credit for research and experimentation	12/31/2005	permanent	-76,225
Deduction for Elementary and Secondary School Teachers	12/31/2005	permanent	-2,630
Corporate Contributions of Computers to Schools Donations	12/31/2005	12/31/2006	-122
Brownfields Remediation	12/31/2005	permanent	-1,743
Credit for Electricity Production from Renewable Sources	12/31/2005	12/31/2007	-1,779
Combat Pay Included as Income for EITC Purposes	12/31/2005	12/31/2006	—
Work Opportunity and Welfare-to-Work Tax Credits	12/31/2005	12/31/2006	-383
Qualified Zone Academy Bonds	12/31/2005	12/31/2007	-162
Tax credit for first-time DC homebuyers	12/31/2005	12/31/2006	-19
Tax information for Employment Tax Reporting and to Inform Officials of Terrorist Activity	12/31/2005	12/31/2006	—
Disclosure of tax return information for student loans	12/31/2005	—	—

PREPARED STATEMENT OF DANIEL L. DOCTOROFF

Mr. Chairman, Senator Baucus and members of the committee, thank you for this opportunity to come before you on behalf of Mayor Bloomberg to support a proposal contained in the President's budget. This proposal would restructure some of the tax benefits that were provided to help in the rebuilding of Lower Manhattan after the terrorist attacks of September 11, 2001. The Mayor very much wanted to testify in person this morning, but at the President's request he is now in Israel to attend the dedication of the new Holocaust History Museum in Jerusalem. In his absence, the Mayor asked me to communicate, in the strongest possible terms, his belief that enabling the restructuring of previously-promised tax benefits for transportation infrastructure is an essential part of the long-term redevelopment of Lower Manhattan, and will have substantial benefits for the national economy. I urge you to enact that restructuring at the first opportunity.

On September 11, 2001, 2,749 people were killed at the World Trade Center. Seven buildings were destroyed and 30 million square feet of commercial space was lost or damaged, leaving 1.6 million tons of debris on the Trade Center site alone. Sixty thousand jobs were lost. The PATH rail station below the Trade Center was destroyed, as were portions of five subway lines and 12 subway stations. There was widespread damage to the communications and utility infrastructure of Lower Manhattan—the nerve center of the Nation's and the world's financial markets. Estimates of the damage range from \$80 billion to over \$100 billion.

We have made tremendous progress since that dark day, under the leadership of Mayor Bloomberg and Governor Pataki, and with the tireless efforts of the Lower Manhattan Development Corporation. The Trade Center site was cleared ahead of schedule and under budget, thanks in large part to New York's construction firms and unions. Residential life has returned to Lower Manhattan. Rail and subway service has been restored, and we will begin construction this summer of the first of two new stations for local and regional transportation. Perhaps most importantly,

plans are moving forward for rebuilding on the Trade Center site itself. We have already laid the cornerstone for the Freedom Tower and selected a design for the memorial to the victims. We have selected tenants for the cultural buildings, including a new International Freedom Center. And as a symbol of our progress a new 750-foot building—Number 7 World Trade Center—rises over the Lower Manhattan skyline.

Our success to date is in large part the result of the assistance we received from the Federal Government, thanks to the commitment of President Bush and the help of those of you in Congress, including this committee. I especially want to thank the New York delegation, Senator Clinton, and of course Senator Schumer, who has joined you on the Finance Committee.

In the months following the attacks, the President and the Congress committed to providing \$20.577 billion to help with the rebuilding of Lower Manhattan. About \$15 billion of that assistance was provided through various appropriations and about \$5 billion was provided through several tax provisions that were enacted in the spring of 2002.

There were a total of seven tax provisions that fell into two broad categories. One category involved tax-exempt financing and the other involved a variety of business-related provisions. All of the provisions had sunset dates. However, the estimate that they would contribute \$5 billion to the rebuilding of Lower Manhattan was based on projected levels of usage that have not materialized, due to the design of the provisions and lower-than-expected economic activity.

Last year, this committee extended the two tax-exempt financing provisions that would have expired at the end of 2004 and which have proved very helpful in assisting in the rebuilding of Lower Manhattan: tax-exempt Liberty Bonds and the ability of the city and State of New York to take advantage of lower interest rates in their bond financings. I want to take this opportunity to thank you for those critically needed extensions.

However, there remains the question of the other, business-related provisions—including accelerated depreciation and employment credits. In total, they were estimated to provide about \$3 billion toward the rebuilding of Lower Manhattan. We heard from the business community, however, that those provisions were not being used as expected—largely because the level of economic activity had not rebounded as fast as Congress had projected. For example, a recent report by New York State Assembly Speaker Sheldon Silver notes that 3 years after the attacks, private sector employment in Lower Manhattan was 14 percent below its pre-911 level. Speaker Silver's report provides a thoughtful and sobering reminder that despite our collective efforts and the passage of more than 3 years, the Lower Manhattan economy continues to suffer from the events of September 11th.

This has significant implications for the actual value of the tax incentives promised. For example, consider the incentive that provides accelerated depreciation for leasehold improvements in Lower Manhattan. Congress estimated the value of this benefit at \$595 million, based on their projections of leasing activity. The New York City Economic Development Corporation tracks new leases signed, as well as typical leasehold improvement costs per square foot. Based on that data, we were able to estimate with a high degree of confidence that just \$218 million of these benefits had actually been realized, leaving an unused benefit of \$377 million. This illustrates why we—and the administration—believe that the initial commitment will not be realized.

Moreover, as the rebuilding plans have moved forward, it has become apparent that the mix of benefits originally enacted is not what is really needed to rebuild Lower Manhattan and solidify its place as the world's financial center. The city, the State and the downtown business community all agree that what is needed is better transportation links, specifically to the pool of workers who live on Long Island and to the visitors arriving at John F. Kennedy Airport.

The proposed Long Island and JFK rail service would materially address this deficiency and help re-attract lost jobs, by dramatically cutting travel times to the area. Indeed, the new rail link will help to create as many as 80,000 new permanent jobs—jobs that will be accessible to the metropolitan area and will contribute mightily to the Nation's economy. An estimated \$9 to 12 billion worth of economic output will be generated by the rail link annually—an amount, each year, more than the project's total construction cost.

This transit investment will make Lower Manhattan a more attractive financial center, particularly for international businesses heavily dependent on air travel that would locate downtown and create jobs. In so doing, the rail link will help preserve New York's place as a global financial capital in the face of competition from cities such as London, Frankfurt, Hong Kong, and Tokyo. It will also provide efficient ac-

cess for the millions of people from around the globe who are expected to visit the World Trade Center memorial each year.

In surveys of major downtown employers, this rail link is consistently rated as the most important unrealized transportation infrastructure project. We are grateful for the strong support of New York's business and civic communities, including especially the Downtown Alliance, the Association for a Better New York, the Real Estate Board of New York, and the New York City Partnership.

After extensive discussions, the administration agreed that the tax benefits were not being used as expected and the full amount of assistance promised would not materialize. The White House estimated that \$2 billion of the original amount would not be realized. They also recognized that the best way to secure Lower Manhattan's pre-eminence in global finance and to ensure that the Federal Government gets the best return on the funds already invested in rebuilding Lower Manhattan would be to restructure the tax package.

That restructuring takes the form of repealing some of the tax benefits, with appropriate protections for those few who have made investments in reliance on them. In their place would be an expiring tax credit for the expenses of building the rail link to Long Island and Kennedy Airport. The credit would be limited to \$200 million a year for 10 years, split evenly between the city and State of New York, for a total of \$2 billion.

I want to emphasize that we are not asking for a new commitment of assistance over and above the initial Federal commitment of \$20 billion. Rather, we are asking for the fulfillment of that commitment through a restructuring of benefits that were expected to stimulate economic recovery, but that have not proved successful. It is our judgment that a restructuring of these incentives will complete the promised benefits package, and play a major role in fulfilling the initial purpose of the assistance: rebuilding Lower Manhattan.

This is an important project and one that will provide national benefits by securing Lower Manhattan's, and through it the United States' place in the world's financial markets. New York City is an economic engine that benefits the entire country. As one small example of that, in a typical year New York City sends to the Federal Government \$64 billion dollars and only gets back \$51 billion. The difference, \$13 billion, is what New Yorkers send every year to Washington to help finance what the Federal Government does elsewhere in the country and around the world. A good deal of that \$13 billion comes from the Lower Manhattan business community. This community generates critically needed economic activity, tax revenues, and employment for the city, the State, the region, and the Nation. We would all benefit by not only protecting, but also growing, the economic engine that is Lower Manhattan.



THE DIRECTOR

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D. C. 20503

October 4, 2004

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington DC 20510

Dear Mr. Chairman:

I am writing to highlight the Administration's proposal to restructure the tax benefits for New York recovery that were enacted in 2002. This restructuring was developed in concert with Governor Pataki, Mayor Bloomberg, and other New York business and community leaders.

In the aftermath of the terrible attacks of September 11, 2001, the President and the Congress pledged \$20 billion in assistance to New York to help those who live there and to ensure Lower Manhattan's continued role as an economic engine for the region and the nation. The efforts to stem a further short-term exodus of jobs from Lower Manhattan have met with great success. Much has already been accomplished and the rebuilding is well underway.

It is now apparent that a portion of the assistance will likely not be usable in the form in which it was originally provided. Approximately one-quarter of the assistance was in the form of tax benefits. Some of those tax benefits have proved valuable, such as the Liberty Bonds. Other tax benefits that were provided may not be fully utilized – largely because their use was predicated on a level of activity that has not, as yet, materialized. The Administration estimates that \$2 billion of the tax benefits will likely not be used.

At the same time, it has become apparent that further improvements to Lower Manhattan's transportation infrastructure are a critical component for ensuring long-term economic recovery. With the support of New York officials, the Administration proposed in the Mid-Session Review of the 2005 Budget to sunset certain of the existing New York Liberty Zone tax benefits and in their place provide tax incentives for transportation infrastructure in and connecting to the Liberty Zone in Lower Manhattan. The proposal would provide tax incentives in the amount of \$200 million per year for 10 years in the form of tax credits equally distributed to the Governor of New York and the Mayor of New York City.

The Administration looks forward to working with you to ensure that the Federal government continues to play an appropriate role in New York's recovery.

Sincerely,

A handwritten signature in black ink, appearing to read "JB", with a long, sweeping flourish extending to the right.

Joshua B. Bolten
Director

PREPARED STATEMENT OF HY L. DUBOWSKY, PhD

My name is Dr. Hy L. Dubowsky and I direct economic development services for the New York State Department of Labor. Mr. Chairman and members of the committee, on behalf of New York State Governor George E. Pataki and New York State Department of Labor Commissioner Linda Angello, I want to thank you for providing this opportunity to submit testimony regarding a "Review of Tax Extenders." My testimony will be limited to the Work Opportunity and Welfare-to-Work tax credits (WOTC/WTW).

Since their inception, the Work Opportunity and Welfare-to-Work tax credit programs have been an integral part of New York's workforce development strategy. They are widely used to encourage the hiring of individuals with barriers to employment by providing an employment-based tax incentive that effectively lowers the cost of labor. The credits enable employers to partially offset the personnel transaction costs typically associated with recruiting, hiring and training a new employee. The credits, over the long-term, actually help employers to overcome their anxieties about hiring people with barriers to employment, and help to modify the stereotypical images associated with such individuals.

In tight labor markets, employers may be apt to ease their hiring standards. However, when the market is flush with workers, they will not—and those most in need of a job will be unable to compete in the marketplace. By using the credits to reduce the costs of labor, employers are more likely to continue to hire from these applicant pools, gaining comfort with each successful hire of an individual with barriers to employment.

New York State is proud of our efforts to administer the tax credit programs with a high degree of customer service. Our knowledgeable staff and quick responsiveness benefits both businesses and providers.

Another characteristic of our program is our consistency in making determinations. By applying uniform, constant standards we have earned the appreciation of the companies and providers that work with us. This, combined with our excellent customer service, encourages participation and has enabled our State to maximize the usage of all the tax credit programs.

Under Governor Pataki, the WOTC program has certified more than 155,000 individuals with barriers to employment. Those individuals were assisted in finding private sector jobs, the first step towards transitioning from dependence to independence.

According to the NYS Department of Labor, more than 65 percent of those individuals were public assistance or food stamp recipients, a statistic which mirrors that of the Nation's. According to the U.S. Department of Labor (USDOL), approximately 2,523,000 individuals have been certified nationwide, the majority of which, 66 percent, are former TANF and food stamp recipients. The remaining third are vocational rehabilitation consumers, ex-offenders, Supplemental Security Income (SSI) recipients, low-income veterans and youth living in federally-designated empowerment zones or renewal communities. As these people transition into jobs, they start on a new road, contributing to the economic well-being of their communities and the Nation.

The benefits of the WOTC program exceed the costs. In a 2003 report, submitted to former Representative Houghton, the NYS Department of Labor concluded that WOTC benefits surpassed costs by more than \$200 million. Public spending was reduced, as hard-to-employ individuals transitioned into private-sector jobs, earned wages and lessened their reliance on government-supported programs. Such budgetary savings, whether they are due to TANF case closings or reduced recidivism rates, generate recurring economic benefits. Moreover, economic gains also are derived from the inclusion of the new payroll, which, unlike entitlement transfer payments, is included in calculations of gross domestic product.

Tax credits are also used extensively by the not-for-profit workforce development community. This community is charged with developing and placing a population that is hardest to serve. This population requires the development of training and family support systems before job placement efforts can even start. Many tax-credit-eligible individuals have never worked before or have been out of the workforce for a long time. The credits offer job developers and counselors, working in everything from small neighborhood centers to sophisticated training facilities, a "carrot" to enhance their chances of placing these hard-to-employ individuals.

Within the last month, I conducted several training workshops in New York City on *Using Employment Tax Credits*. Approximately 200 people attended, including representatives from the United Way, Council of Jewish Organizations, St. Nicholas Neighborhood Preservation Corporation, Federation Employment and Guidance Services, Goodwill Industries, and Center for Employment Opportunities. Their

staffs serve people across the entire range of job seekers with barriers to employment, including TANF and food stamp recipients, the hearing-impaired, physically challenged, blind, mentally impaired and economically disadvantaged. These partners use these programs everyday.

For example, the Center for Employment Opportunities (CEO) in New York City serves more than 2,000 parolees a year and makes approximately 800 placements each year. They work with more than 150 private sector companies, and use the WOTC as a major incentive in attracting companies to work with them.

Trine Rolled Moulding Corporation, which produces moldings for high-end department stores, has enjoyed a working relationship with CEO for 18 years. In the last 2 years alone, the firm has hired 20 CEO participants. James M. Lange, the company's director of operations, stated, "Trine has benefited from the tax credits and payments to pay for hourly wages for employees. These credits have saved our company many thousands of dollars, and helped to provide us with some great employees."

Our ability to build a network of business and not-for-profit provider partners was greatly weakened by the gap between the WOTC/WTW programs' expiration on December 31, 2003 and reauthorization in October 2004. In New York, as in other States, the uncertainty surrounding program re-authorization virtually brought our efforts to a halt. During the 9-month hiatus, New York's certification activity dropped by 54 percent from the prior year, an experience that was mirrored nationwide. Acceptance of government programs depends on trust and a degree of certainty to justify integrating the programs into long-term organizational development and marketing plans. The lack of certainty that the credits will be extended beyond the December 31, 2005 expiration date may have negative consequences. It may discourage businesses, providers and State tax credit operations from investing in application and processing system improvements, computer and database upgrades, staff development and field structures. More importantly, it may constrain our joint efforts to persuade businesses to commit to behavioral changes when hiring workers, and to include individuals with barriers to employment into their workforce.

Funding for the WOTC/WTW programs has remained constant for a number of years. The original Federal support level of approximately \$20 million, for support of 53 State Workforce Agency operations, has shrunk to \$17.3 million this year. According to USDOL, nearly a quarter of State operations receive less than \$65,000 for direct support of WOTC/WTW.

New York State has learned to do more with less. We were the first State in the Nation to offer electronic filing in addition to paper. Large businesses and consultants are provided certification data on CD-ROM in a database that is easy for them to use. New York has also promoted the tax credit programs through the State's economic development team. We have found that presenting employment tax credits as part of a full package of incentives makes them more attractive to employers and more effective in the long run. Our customers also appreciate the availability of a toll-free number, 1-800-HIRE-992, which serves as a single point of entry for a number of agency services. We are able to offer our customers excellent service and personal attention, and still keep our administrative costs low.

It is possible that next year even fewer funds will be allocated to support WOTC/WTW. Without adequate support, State agencies may not be able to process applications nor service their business, provider and local government partners in an effective and efficient manner. Backlogs will grow, exacerbated by our anticipated response to the provisions of the IRS TANF Revenue Ruling (IRS 2003-112), which clearly defined several WOTC eligibility categories. The ruling will effectively require State agencies to postpone reviewing current applications while staff is assigned to re-review applications denied in error due to incorrect interpretations of statutory language regarding the TANF and food stamp target groups. States across the country are still processing 2004 application requests that sat idle during the 9-month hiatus. Uncertainty about funding may dissuade States from developing long-term plans and committing resources to address the backlogs.

We also face new challenges associated with improving internal WOTC/WTW systems. As oversight over the activities of the financial and accounting sectors grows, driven largely by the passage of the Sarbanes-Oxley Act of 2002, there will be a ripple effect flowing into the public sector. To respond to the demands of their national business customers for real-time information quality controls, State agencies need to develop internal control mechanisms that ensure we administer the tax credit programs in a manner consistent with Federal statutes and USDOL program guidance. To that end, resources are needed to support the development and implementation of E-WOTC, a paperless application, certification and operations management tool designed to streamline the process, eliminate paperwork and provide better database management. New York State was proud to chair a joint Federal-State

workgroup, which prepared a draft report titled, *Phase II Report: Workgroup Recommendations for State Workforce Agency Integration of Electronic 8850*. This report will be submitted to the Assistant Secretary of Labor for Employment and Training. It provides a framework for E-WOTC to guide the States and USDOL in developing a paperless process that addresses the evolving human resource needs of the business community and enhances the ability of the SWAs to strengthen their system capabilities.

In New York, since August 1997, Governor Pataki's welfare-to-work programs have lowered TANF caseloads by 48.5 percent, or more than 500,000 individuals. The joint efforts of the New York State Department of Labor, local social services districts, provider agencies and our business partners enabled many of these individuals to use WOTC/WTW credits in their job search efforts. Yet there are many more low-income, hard-to-employ individuals who are currently out of reach of WOTC/WTW. Those released from prison and absentee fathers who must live up to their commitments need a helping hand. Legislation introduced by Senators Santorum and Baucus, which cuts red tape by combining the WOTC and WTW tax credits, raises the age limit for the food stamp and high-risk youth categories from 24 to 39, and eliminates the onerous burden of verifying income for recently released felons, is the next logical step for this program.

WOTC and WTW, often lost in the shadow of other larger and well-funded workforce development and employment programs, merits your attention. We support reauthorization, the program enhancements offered by Senators Santorum and Baucus and assurances that adequate funding will be made available for tax credit operations in the States.

Again, on behalf of Governor George E. Pataki and Commissioner Linda Angello, thank you for this opportunity to provide testimony in support of these valuable programs.

**The Work Opportunity Tax Credit
The New York State Experience
An Exploration of the Costs and Benefits
1996-2003**

**November 2003
NYS Department of Labor**

**George E Pataki Governor
Linda Angello Commissioner of Labor
Hy L Dubowsky Principal Researcher
Albany, New York**

Executive Summary

This analysis is designed to provide a framework for discussions on the Work Opportunity Tax Credit (WOTC) as part of the current re-authorization efforts. WOTC expires on December 31, 2003. The study focused on the New York State (NYS) WOTC experience, from the program's creation in 1996 through the close of the current FY 2003 program year. Using WOTC activity in NYS, a cost-effectiveness review is developed that indicates net recurring taxpayer savings totaling approximately \$200 million from reduced Temporary Assistance for Needy Families (TANF), correctional services and vocational rehabilitation spending, enhancing the ability of the hard-to-employ to secure private sector employment, makes good budgetary sense.¹

Obtaining a job has a myriad of benefits for any job seeker, but especially for the economically disadvantaged facing barriers to employment. Increased self-esteem, family well-being and a reduced reliance on public services are concurrent benefits associated with finding work.

This study is by no means conclusive. Rather it raises several interesting research questions which merit further study. Specifically:

- Do taxpayer benefits outweigh the one-time costs of WOTC?
- Are focused education and marketing efforts needed to stimulate WOTC utilization for the nine WOTC target groups?
- Do WOTC participants remain in the workplace?

Questions on this study should be addressed to Hy L Dubowsky PhD, Principal Researcher at 518-457-6823.

¹ Additional savings would be generated from reduced Medicaid, Food Stamps and SSI costs that are not included in this study.

NYS WOTC STUDY

The NYS Department of Labor analyzed the WOTC and Welfare-to-Work (WtW) tax credits to provide an assessment of its public benefits relative to their direct and indirect costs. The study is designed to provide a statistical framework to assess the effectiveness of WOTC/WtW in encouraging private sector employers to hire economically disadvantaged and hard-to-employ individuals. Several questions, notably, the churning issue, have been addressed in a previous monograph issued in 1998.² This analysis revisits the cost-benefit review with the context of a maturing program. The study will also examine the effects of WOTC/WtW on retention periods compared to targeted employees who were hired without any tax incentive. Specifically the study will address:

- o The benefits/costs of the WOTC;
- o The characteristics of the WOTC employee;
- o The effects of September 11 on WOTC hiring patterns of targeted workers; and
- o The effects of the WOTC credit on TANF recipients transitioning to private sector employment.

STUDY METHODOLOGY

Datasets

Labor Department staff from the Economic Development Services Unit (EDSU) and the Division of Research and Statistics (R&S) developed datasets from the tax credit database, social services wage reporting system (WRS) and employer combined quarterly wage records. There are 235,936 employee records in the WOTC database. This raw data set formed the basis for the WOTC benefit-cost analysis.

Time Period:

The following periods are used for this analysis:

- o 1996 (Q1) through 2003 (Q4) for the WOTC program;
- o 2001 (3Q) through 2003 (4Q) for an assessment of the effects of September 11 terrorist attacks on WOTC utilization;
- o 2001 (2Q) through 2003 (2Q) to explore the effects of WOTC on TANF employment.

² Hy L Dubowsky, "An Analysis of the Work Opportunity Tax Credit in New York State, October 1995-March 1998", NYS Department of Labor, (1998), Albany, NY.

Databases Used

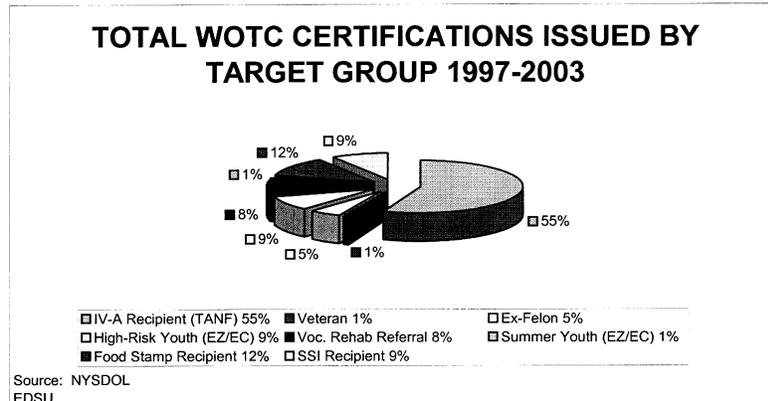
- Tax credit application and processing database-NYSDOL;
- Welfare Management System-NYS OTDA;
- Combined Quarterly Wage Records-NYSDOL.

BACKGROUND**WOTC and Employment Data**

WOTC recognizes nine target groups, each with its own distinct set of characteristics that, in and of themselves, form barriers to employment.

Figure 1 shows the composition of the WOTC employee population since the program's inception in 1996. Until 1997, WOTC recognized only eight target groups. In 1997 SSI was added. The WtW tax credit was also created in 1997. Sometimes referred to as the tenth WOTC group, it is a separate credit (Section 51a IRC) administered within the WOTC administrative frame.

Figure 1 WOTC Utilization by Certification



Since WOTC was first authorized in 1996, NYS has certified over 114,000 individuals with barriers to employment. The majority of the state issued WOTC certification activity derives from employing TANF and Food Stamp recipients. The emphasis on employability development for TANF recipients is the cornerstone of the Personal Responsibility of 1997, laying the foundation for the subsequent welfare reform efforts that swept the country. The policy shift that recognized the dependent nature of the existing welfare system focused resources and incentives towards independence through employment. Together, TANF and Food Stamp recipients comprise 67 percent of all WOTC certifications.

The remaining 33 percent of WOTC certifications are divided among the seven other target groups with mixed results. Despite an extensive employability network, the vocational rehabilitation community has yet to fully embrace the credit. Some have suggested that the success of the vocational rehabilitation efforts reduce the need for the added incentives. Still, others argue that identifying oneself, as a member of a target group may not only be self-denigrating but may dissuade an employer from making a job offer. Further study is necessary to more fully understand the complex nature of the hiring dynamic before a explanation as to why WOTC has not been more fully embraced by its other target communities.

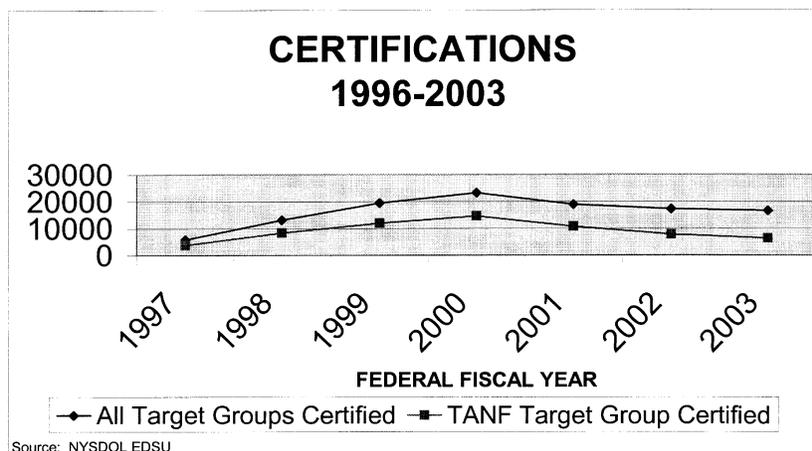
The sharp increase in WOTC, as shown in the Figure 2, started a year after the program's slow start, in 1997. Many in the WOTC community point to the widespread support by the employer community for welfare reform and the recognition of their critical role to provide jobs for people in need. These employer efforts were quite successful in NYS, supported in large part, by a partnership with Governor Pataki's welfare reform team.

The robust New York economy and the comprehensive welfare reform efforts led by Governor George Pataki had provided opportunity and the means to move those TANF recipients from the dependency of welfare into private sector jobs. Since July 1997, NYS has reduced TANF caseloads by nearly 60 percent: 219,496 cases representing over 679,000 individuals.³ While some TANF cases may have closed or aged out, many of these closures were due to the successful transition from welfare to work. The September 11 terrorist attacks, however, brought this economic growth to nearly a crawl and with it, a dramatic loss in retail and service jobs - the very first job opportunities available to those with barriers to employment.

³ TANF Caseload Data, BEAC Current News Reports, Office of Temporary and Disability Assistance, Albany, NY.

Figure 2 shows the trend in overall trend in WOTC utilization since the program's inception.

Figure 2
WOTC Certification Activity



The figure shows WOTC certification activity utilization reached its peak in 2000 as welfare reform efforts became integrated into corporate America's human resource's strategy and the national and state economies provided ample job openings. As New York successfully reduces its able-bodied TANF population through its combination of training and work first initiatives, the remaining TANF cadre requires greater concentration of services and job-readiness training. Within a year the national economic slowdown trickles down to the state and the catastrophic events of September 11 put a halt to the progress made in assisting job seekers with barriers to employment.

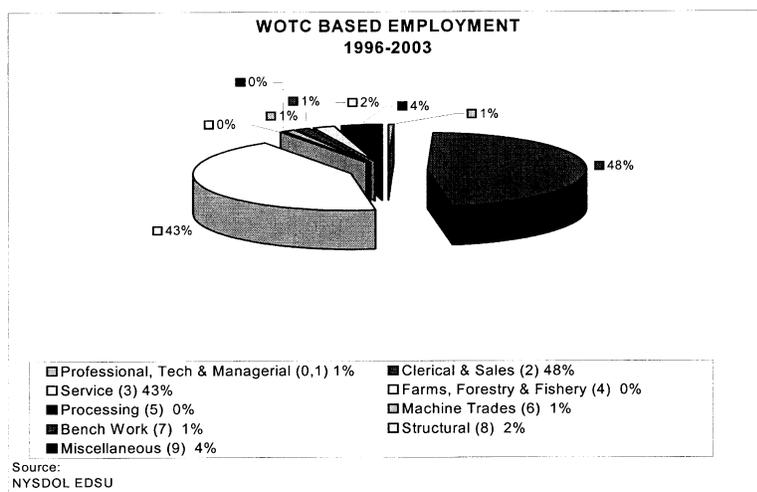
Wages and Positions

During the study period, 2001 (2Q) through 2003 (3Q) WOTC certified employees have earned in excess \$90 million in private sector wages.⁴ These wages, for many, represent the first paychecks ever received while for others it signifies a break from the vicious cycle of poverty. As shown in Figure 3, the majority of positions are

⁴ Data extrapolated using New York State Department of Labor, Research and Statistics Division, Combined Quarterly Wage reports.

either in the retail or service sectors of the economy, the traditional place where first and low skill jobs are located. Many of these employers offer career pathways and encourage new employees to remain and grow with the company. While not all represent career paths, securing a job is the essential first step.

**Figure 3
WOTC-Employment Categories**

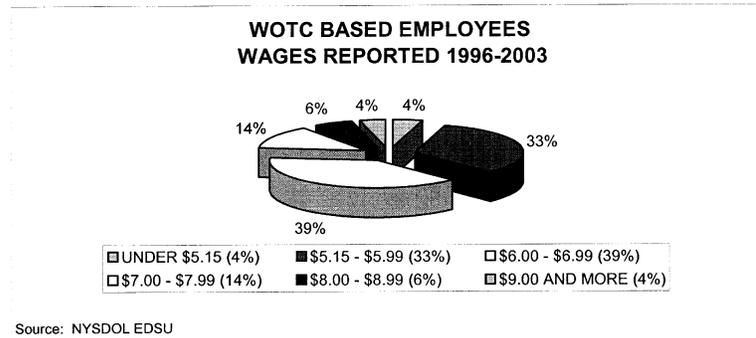


WOTC certified recipients earn slightly more on average than the federal and state minimum hourly wage, \$5.15 per hour, largely reflecting regional salary patterns. Seventy-two percent of the certified recipients earned between \$5.15 and \$8.99 per hour. Fifty-seven percent earned hourly wages totaling \$6.00 or more⁵.

⁵ NYS Department of Labor, EDSU database as reported on the ETA 9061 Individual Characteristics form.

Figure 4

WOTC-Employment-Wage Groupings



The number of WOTC-eligible jobs remained fairly constant following its decline starting in 2000 and accelerating after the September 11 attacks. The effects of the loss of higher paying financial service and tech positions ripped through the retail and service sectors, displacing tens of thousands of entry level workers and spilling further into neighborhoods through the City and throughout the state. With fewer employment openings, there are fewer opportunities for the hard-to-employ. This in turn necessitates the need to provide employer incentives to modify their hiring decision in order to encourage employing the economically disadvantaged hard-to-employ job seekers who face barriers to employment.

The Effects of WOTC

Business

WOTC provides a one-time federal tax credit totaling up to \$2,400 for each qualified hire. The credits are a loss of federal business tax revenue shown as tax expenditures by the Treasury Department and Office of Management and Budget. The one-time tax expenditures affect market behavior by lowering the effective wage of qualified WOTC/WtW employees, offsetting the inherent costs associated with hiring workers with barriers to employment.

In New York, employers have earned approximately \$275 million in potential WOTC credits since 1996. The net value of the credit is somewhat less after incorporating tax code offsets such as tradeoff of the payroll deduction for the credit on salaries paid to targeted workers roughly \$183 million. Examining these potential tax savings in terms of potential sales and business services translates into increased economic activity in excess of \$1.8 billion.⁶ This is a powerful economic stimulus from these one-time

⁶ Assumes a effective 35 percent federal tax rate and the gross value of the WOTC credit,

employment tax credits. No firm escapes these benefits, though the net benefit is a function of the unique nature of each firm's production and operating costs.

Taxpayers

As targeted workers transition from TANF and other public programs, recurring budget savings are generated. Freeing taxpayers' funds provides the Governor with greater discretion in allocating scarce state resources. Entitlement spending, notably TANF, is mandated by law. Ending the cycle of TANF dependence has multiple beneficiaries with the NYS taxpayers saving approximately \$6,600 in federal and state taxes for each case closed.⁷

Transitioning other targeted individuals to work has similar benefits. Direct, state vocational rehabilitation savings total approximately \$340 on average, per employee, as consumers leave direct VESID services and enter employment.⁸ The VESID support network is comprised of a myriad of private and not-for-profit partners who use the tax credit as an employability tool. WOTC is often combined with other incentives such as on-the-job training, to further enhance the job seekers ability to obtain employment.

Ex-felons generate the greatest taxpayer savings should they succeed in finding work and remaining out of prison. According to a report on the costs of prison costs, the daily cost to incarcerate an adult in New York State is approximately \$96.72, per day, annualizing to \$34,800.⁹ As ex-felons are released from state prisons, they face tremendous barriers to employment. Failing to obtain employment is a leading cause of recidivism. Efforts of the New York State Division of Parole, Department of Labor, Department of Corrections and numerous community-based organizations dedicated to serving this targeted population, have resulted in New York enjoying the Country's lowest recidivism rate, roughly 40 percent.¹⁰ Of those returning to prison, however, approximately 89 percent were unemployed at the time of their arrest.¹¹

Each successful private sector placement results in recurring societal benefits and taxpayer savings. Additional savings from reduced levels of government support, including food stamps, health-care, and SSI services are also generated by the placements.

Cost-Effectiveness

Comparing the cost of WOTC as measured by the value of the tax expenditures compiled by the Treasury Department, there is a net measurable benefit. Table 2

⁷ Average taxpayer savings from closing a TANF case for a NYS family of three using a median between 1998 and November, 2003 case cost estimates,

⁸ NYS VESID, Memorandum of Support to the Legislature, 2002, Albany, NY.

⁹ New York State Department of Corrections, Albany, New York, in Connecticut Office of Legislative Research, "Department of Corrections Issues", Report 2003_R-0469 Kevin E McCarthy, principal analyst, June 2003.

¹⁰ New York State Department of Corrections, Albany, New York

¹¹ New York State Division of Parole, Albany, New York.

provides information on the potential taxpayer cost of the WOTC credit compared to the overall benefits provided to New York State taxpayers.

TABLE 2
Potential Cost (Taxpayer Savings)
WOTC-based Employment
(Dollars in millions)

WOTC COSTS

Potential Value of WOTC tax credit certifications issued	\$275.39
Adjusted Value to Employers ¹²	\$183.59
Direct appropriation for administration	<u>\$ 9.05</u>
Total Costs	<u>\$192.59</u>

WOTC Potential Savings

TANF Cases Closed	\$423.21
VESID Services Reduced	\$222.75
Reduced jail spending	<u>\$ 3.28</u>
Total Gross Potential Recurring Savings	\$649.24
Adjusted Potential Recurring Savings ¹³	\$392.48

Cost Recurring Effectiveness: Net Savings/(Costs) **\$199.89**

The recurring benefit stream generated by transitioning the hard-to-employ to the world of work exceeds the one-time cost of the WOTC credit. As the table indicates, the total tax expenditure, as measured by the net federal tax revenue loss is lower than the recurring taxpayer savings. The WOTC program provides net benefits to the taxpayer. The additional benefit from the addition of new wages to the Gross Domestic Product (GDP) or reduced reliance on Medicaid and other public support programs provides further benefits.

Economic Benefits

Economic benefits are realized from the economic stimulus caused by the inclusion of the additional wages paid to targeted workers. The \$90 million in wages paid to WOTC workers since its inception in 1996, generated roughly

¹² Adjusted for the loss of corresponding deductions for payroll expenses.

¹³ Assumes 42 percent of WOTC-TANF certified employees and both 35 percent of WOTC-VR certified and Ex-felon certified employees, respectively, will terminate their employment and return to government supported services or be incarcerated thereby reducing the recurring taxpayer savings.

\$225 million in increased economic activity in the NYS economy using a “2.5 times” economic multiplier¹⁴. Encouraging employers to hire targeted workers with barriers to employment increases the GDP when projected across the nation. Entitlement payments are excluded from the GDP while wages are included. Providing incentives for hiring targeted workers and, therefore, not only makes good business sense but also offers elected officials to make a sound good public policy choice.

Additional Savings/Benefits

The Rockefeller Institute of Government released a report in 2002 that attempted to provide information on the outcomes of TANF families in NYS that affected by the welfare reform program started with the passage of the Personal Responsibility Act of 1996 and the NYS Welfare Reform Act of 1997 (which codified the state’s plan). The study tracked TANF recipients who entered into employment indicating that roughly 70 percent received some type of employee benefits package above the base salary. Of the sample populations studied, in excess of 60 percent of those working received health insurance benefits, paid vacation and sick days.¹⁵ These benefits generate even greater taxpayer savings as with the reduced reliance on publicly supported Medicaid as the health insurer of last resort.

The Report indicated that nearly 61 percent of the study’s respondents reported that employment was the main reason for leaving TANF. Most importantly, perhaps are the findings of “family well-being”.

“The Rockefeller study reported that “individuals with positive perceptions of post-welfare life experience, had, along with the better off group, higher levels of food security (though they were most likely to use a food bank or shelf) and were the least likely to have used a homeless shelter. They also reported the lowest use of domestic violence services, and no relatively lower levels of drug/alcohol counseling than either the status quo or the group with negative perceptions.”¹⁶

These family well-being indicators, while difficult to quantify, clearly have positive societal benefits. Similar satisfaction outcomes are also associated with the transition from supported services, direct government subsidy or incarceration by the state to the world of work.

Retention-Further Findings

The notion of welfare reform was transformed in 1997 from direct support to focused employability development leading to employment and independence. Using a sample of NYS TANF recipients who were certified as WOTC eligible during 2001 (2Q), indicate that WOTC has had a contributing effect on transitioning individuals from welfare to work. Examining NYS Welfare Management System (WMS) records and wage reports, roughly 58 percent of the TANF recipients who entered private sector

¹⁴ NYS Department of Labor, Research and Statistics, Albany, 2003.

¹⁵ “Leaving Welfare, Post-TANF Experience of New York State Welfare Families”, The Rockefeller Institute of Government, March 2002, Albany, NY.

¹⁶ *ibid*

employment with the assistance of WOTC were found not to receive any public assistance benefits when their cases were later examined in 2003. This is consistent with the findings in the Rockefeller study cited above.

Nearly 23 percent of the study group had remained with the original employer, two years after first being hired. This, despite turnover rates in the service and retail sectors totaling almost 100 percent. The credits apparently have had an effect on retention, especially the long-term Welfare-to-Work credit. Of this group, combined quarterly earnings increased by 27 percent over the two-year period—a rate well above inflation and changes in the minimum wage.¹⁷

Conclusion

The Work Opportunity Tax Credit program provides a one-time financial benefit to encourage employers to hire individuals with barriers to employment. In turn for this one-time benefit, recurring taxpayer savings are generated, community and family “well-being” is enhanced, and positive economic effects take place on a macro-economic basis. The program pays for itself and should be continued as integral part of the Nation’s workforce development strategy.

Further research is warranted on proposals to extend the program to other target groups. Consideration should also be given to broadening the study to include other large WOTC states in an attempt to create a national cost-benefit model.

¹⁷ NYS Department of Labor, Research and Statistics, Albany, 2003.

RESPONSE TO A QUESTION FROM SENATOR GRASSLEY

Question: As a follow-up, I’d like for you to offer recommendations on ways that the certification process can be improved. States are obviously incentivized to promote employment using the credit so as to reduce welfare and encourage productivity. Nevertheless, they fail to get the certifications done in a timely manner, and the suggestion seems to be that these offices are under-funded by the Department of Labor or that the program’s potential expiration is the problem. I would appreciate any recommendations you have on ways to streamline this process and make the credit more effective.

Answer: The WOTC/WTW tax credit programs are jointly administered by the U.S. Department of Labor and the Internal Revenue Service through 53 designated State agencies. The program has evolved since its inception. It has benefited them largely by the interaction among the States and our Federal partners as a result of national and regional Federal and State Coordinator Development Conferences, peer review and ad-hoc national workgroups such as the E-WOTC Workgroup, which New York was proud to share. We remain vigilant in our efforts to meet our statutory and fiduciary responsibilities and offer excellent service to our business, job-seeker and provider customers. We are constrained, however, by our resource allocation, statutory authority and the uncertainty surrounding the fate of the program.

Respectfully, I offer the following proposed actions for your consideration in an effort to strengthen the WOTC/WTW program, extend its reach to those job-seekers in need and encourage greater acceptance of the program in the overall workforce development system.

1. Support efforts to develop an E-WOTC initiative. The majority of New York’s tax credit applications are received electronically, followed up by corresponding paper forms. Most large employers and consultants use this option, speeding up processing and providing access to real-time status information from our database. E-WOTC would eliminate paperwork completely, streamline the process and provide real-time application status. Any State agency with a PC and Internet access, using off-the-shelf database software, could benefit from an E-WOTC system. E-WOTC will also provide real-time information on program operations that readily can be incorporated into USDOL reports to the Treasury Department and the Congress on program operations.

2. Combine the WOTC (Sec. 51 IRC) and WTW (Sec. 51-a IRC) credits as proposed by the Encouraging Work Act of 2005. Combining the two credits would eliminate paperwork, streamline the application process and make it easier for businesses to understand and take advantage of the credits.

3. Require States to enter into cooperative data-sharing agreements with their respective social services (TANF) and vocational rehabilitation agency, in order to obtain verification data on a timely basis. A number of States have had difficulty establishing agreements with their State program counterparts to facilitate the flow of information, which hampers and delays their ability to certify.

4. A long-term or permanent extension will provide a foundation to integrate the tax credits into the workforce delivery system. As I noted in my testimony, "Lacking some degree of comfort that the credits will be extended beyond the December 31, 2005 expiration date discourages businesses, providers and State tax credit operations from investing in application and processing system improvements, computer and database upgrades, staff development and field structures." In an era of limited resources and competing needs, it is difficult to sustain the program successes as we have in New York, over the long-term, without a commitment to the program.

5. We support the provisions of the Encouraging Work Act of 2005, S. 595, introduced by Senators Santorum and Baucus, which expands the food stamp and high-risk youth groups and eliminates the income check for ex-felons. These are welcome additions to the program. We also suggest eliminating the 2-year (24-month) eligibility window for individuals to qualify for the Welfare-to-Work credit under Sec. 51-a IRC. This is for individuals who exceed their respective State TANF limits. It would further extend the incentive to additional individuals with barriers to employment. By definition, individuals exceeding their State TANF eligibility and who remain unemployed have severe employment barriers and require intensive services and assistance in order to find a job.

6. Tax credit processing is best done in a tightly controlled, central office environment. The need for accuracy and consistent interpretation of the rules and statutes are of paramount importance. Decentralizing the process would weaken quality and internal controls, increasing the potential for fraud and abuse. We respectfully recommend that the WOTC/WTW programs remain under the central office control of a single designated State agency under the governor's control.

7. Give tax credit operations adequate resources to perform the tasks at hand. They will need more support to meet the anticipated challenges of program expansion, E-WOTC, responding to the IRS TANF Revenue Ruling and recent USDOL TEGE instructing States to use the revised eligibility criteria for TANF, Food Stamps and Veterans. At current program levels (estimating the program's annual cost at approximately \$450 million), administrative support totals less than 4 percent. Most public programs provide administrative funding in the 15 percent range. If WOTC/WTW was supported at even 10 percent of the revenue estimate, it would more than double our funding, providing the necessary resources throughout the State tax credit processing system. Funding for this increase is readily available from the taxpayer savings generated from reduced public spending, as these individuals move from dependence to the independence of a job.

8. Strengthen oversight of the tax credit program by authorizing USDOL to impose sanctions on tax-credit consultants and employers who are found to be in flagrant violation of the program statutes and rules. USDOL and the States have virtually no quality control tools to prevent fraud and abuse by scurrilous operators bent on abusing the program. Barring Federal criminal prosecution, we lack the ability to impose administrative sanctions or debar these violators from participating in the program. An administrative process, with sanctions, would greatly enhance our ability to maintain the high level of quality control for which the vast majority of employers and the consultant industry strive.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: Your testimony mentions the negative consequences that occurred when the WOTC/WTW credits were allowed to lapse for 10 months in 2004. Can you describe the challenges and problems resulting from this lapse, and can you estimate the number of individuals who missed out on jobs in New York as a result of this lapse?

Answer: From the expiration of the WOTC/WTW programs on December 31, 2003 until the program's reauthorization on October 4, 2004, State program operations existed in a state of flux. New York continued to process applications, issuing final determinations for applications with 2003 start dates. We were unable to bring closure, however, to the 35,327 applications received with 2004 start dates. We were forced to review and then file them, in anticipation of a program extension. During

this interim period, we curtailed our marketing efforts, limiting outreach to business and community-based provider groups. We were hopeful that reauthorization would be retroactive back to January 1, 2004 for applications received with 2004 start dates. However, we could not provide any guarantee to our business customers that they would receive a tax credit from hiring a hard-to-employ individual from one of the eight WOTC target groups. This uncertainty makes it very difficult to “do business.” Echoing this sentiment, the Iowa WOTC coordinator Jeanne Sorenson-Wright indicated that: “Hurt is not the word. I had been out working with employers and getting them ready to hire and get involved, and then to inform them that everything was pending really hurt.” This sentiment is echoed throughout the country by the respective State coordinators.

Historically, the programs have received only temporary authorization lasting 1 or 2 years. This uncertainty may discourage States from investing in application and processing systems. It hampers our ability to market and develop community-based partnerships, and, most importantly, it dissuades businesses from integrating targeted workers into their human resources and hiring practices.

Quantifying the effect of the loss of the tax credits on the ability of hard-to-employ job-seekers to obtain employment is a difficult task and falls beyond our analysis, requested by former Representative Houghton. While we suspect that hiring took place regardless of the immediate availability of the credit, the uncertainty surrounding reauthorization made it harder for providers to place their clients and for our workforce system to integrate the credits into their overall job development efforts.

We have been approached by representatives of the Treasury Department to develop a model to expand on our earlier analyses of the WOTC program, including the question of the effects of the credit on hiring practices. Because of the resource commitment and the limited availability of confidential tax data, we have yet to pursue this offer.

Question: I understand that you have done some research on the credits and found a \$200 million cost savings from this program for the State of New York. Since we are in the process of evaluating the cost-effectiveness of these incentives, can you provide greater detail about these savings?

Answer: The New York State Department of Labor, at the request of former Representative Amo Houghton, analyzed the costs and benefits associated with the WOTC program in New York State. The report titled, *The Work Opportunity Tax Credit Program, The New York State Experience, An Exploration of Costs and Benefits, 1996–2003*, concluded that the program benefits exceeded its taxpayer costs by \$200 million. As we indicated in the report, the recurring benefit stream generated by transitioning the hard-to-employ into private sector jobs exceeds the one-time taxpayer costs of supporting the WOTC credit.

Comparing the cost of WOTC to the savings, as measured by the value of the tax expenditures compiled by the Treasury Department, there is a net measurable benefit. Table 2 provides information on the potential taxpayer cost of the WOTC credit compared to the overall benefits provided to New York State taxpayers.

TABLE 2
Potential Cost (Taxpayer Savings)
WOTC-based Employment
(Dollars in millions)

WOTC COSTS	
Potential Value of WOTC tax credit certifications issued	\$275.39
Adjusted Value to Employers ¹	\$183.59
Direct appropriation for administration	<u>\$ 9.05</u>
Total Costs	<u>\$192.59</u>
WOTC Potential Savings	
TANF Cases Closed	\$423.21
Reduced Jail Spending	\$222.75
Reduced VESID Services	<u>\$ 3.28</u>
Total Gross Potential Recurring Savings	\$649.24
Adjusted Potential Recurring Savings²	\$392.48
Recurring Cost Effectiveness: Net Savings/ (Costs)	<u>\$199.89</u>

¹ Adjusted for the loss of corresponding deductions for payroll expenses.

² Assumes 42 percent of WOTC-TANF certified employees and both 35 percent of WOTC-VR certified and Ex-felon certified employees, respectively, will terminate their employment and return to government-supported services or be incarcerated, thereby reducing the recurring taxpayer savings.

Excerpt from the Report

“As targeted workers transition from TANF and other public programs, recurring budget savings are generated. Freeing taxpayers’ funds provides the Governor with greater discretion in allocating scarce state resources. Entitlement spending, notably TANF, is mandated by law. Ending the cycle of TANF dependence has multiple beneficiaries with the NYS taxpayers saving approximately \$6,600 in federal and state taxes for each case closed.³

Transitioning other targeted individuals to work has similar benefits. Direct, state vocational rehabilitation savings total approximately \$340 on average, per employee, as consumers leave direct VESID services and enter employment.⁴ The VESID support network is comprised of a myriad of private and not-for-profit partners who use the tax credit as an employability tool. WOTC is often combined with other incentives, such as on-the-job training, to further enhance the job seekers ability to obtain employment.

Ex-felons generate the greatest taxpayer savings should they succeed in finding work and remain out of prison. According to a report on the costs of prison, the daily cost to incarcerate an adult in New York State is approximately \$96.72, annualizing to \$34,800.⁵ As ex-felons are released from state prisons, they face tremendous barriers to employment. Failing to obtain employment is a leading cause of recidivism. Efforts of the New York State Division of Parole, Department of Labor, Department of Corrections and numerous community-based organizations dedicated to serving this targeted population have resulted in New York enjoying the Country’s lowest recidivism rate, roughly 40 percent.⁶ Of those returning to prison, however, approximately 89 percent were unemployed at the time of their arrest.⁷

Each successful private sector placement results in recurring societal benefits and taxpayer savings. Additional savings from reduced levels of government support, including food stamps, health-care, and SSI services are also generated by the placements”.

³ Average taxpayer savings from closing a TANF case for a NYS family of three using a median between 1998 and November, 2003 case cost estimates,

⁴ NYS VESID, Memorandum of Support to the Legislature, 2002, Albany, NY.

⁵ New York State Department of Corrections, Albany, New York, in Connecticut Office of Legislative Research, “Department of Corrections Issues”, Report 2003_R-0469 Kevin E. McCarthy, principal analyst, June 2003.

⁶ New York State Department of Corrections, Albany, New York

⁷ New York State Division of Parole, Albany, New York.

PREPARED STATEMENT OF DALE GIOVENGO

Chairman Grassley, Senator Santorum, and members of the committee, my name is Dale Giovengo, and I am the Director of Human Resources at Giant Eagle Markets in Pittsburgh, PA. I have been with Giant Eagle since 1970, and in those 35 years I have served in both a store operations and corporate Human Resource capacity.

I want to thank the committee for the opportunity to appear before you today to discuss the importance of the Work Opportunity and Welfare-to-Work tax credits to my company. These are very important and effective programs, and I am very pleased that this committee is considering legislation to permanently extend and improve them.

Giant Eagle has been in business for 75 years. Our corporate office is in Pittsburgh, where we opened our first store in 1930. We currently have 221 supermarkets, 101 of which are in Pennsylvania, 116 in Ohio, 1 in West Virginia and 3 in Maryland, our newest market, and 4 distribution centers. Combined, our stores, distribution centers and corporate office employ more than 35,000 people.

Giant Eagle has been an active user of the WOTC/WTW credits since their first enactment by Congress. I am proud to report to the committee that our company makes a special effort to reach out into the local community to recruit new employees who are eligible for the credit. In our community outreach effort, we work with a number of local community organizations, including the Allegheny Intermediate Unit, Goodwill, Pittsburgh Vision Services, Pittsburgh Public schools and the Cerebral Palsy Foundation.

Our company incurs additional training and acclimation costs in order to work with the special employment needs population. The WOTC/WTW credits support our outreach efforts by helping to offset these additional costs. For example, it is not uncommon for us to pay outside job coaches and trainers to work with some of those we hire. Without these credits, it would be cost-prohibitive for us to hire from the special needs population.

The individuals we hire with special employment needs often lack the basic work skills that our traditional new hires have, and we must provide additional training. Our experience has shown us that our spending on special training for this population is a good investment. We have found that many of our WOTC/WTW hires become loyal, well-trained employees with a turnover rate comparable to or better than our overall workforce. We are very pleased that by providing employment opportunities to these individuals we are helping families to move away from welfare dependence and become part of the productive, tax-paying workforce.

As part of our commitment to encouraging our store managers to hire WOTC/WTW eligible employees, all hiring credits earned by Giant Eagle are credited back to the store level, which contributes to that store's profitability. We prepare and distribute within our company monthly reports on store-level and corporate-wide participation in the programs, indicating how many new hires were credit-eligible and which of our stores hired these new employees.

We track our WOTC/WTW hiring very carefully, and maintain records that allow us to identify all applicants who are members of one or more of the target groups.

Allow me to share with you our WOTC/WTW hiring experience for 2003. Company-wide, we had 10,041 new hires, of which 9,405, or 94 percent, were pre-screened for tax credit eligibility, either as a referral from a community-based organization or in conjunction with our employment application. As part of that process, IRS 8850 forms were submitted for 1,386 of those individuals we hired. All in all, WOTC/WTW hires made up almost 14 percent of our work force in 2003.

Of course, not all WOTC/WTW hires ultimately get certified. As a result, we do not earn a credit for every employee with respect to whom we file an 8850. Due to a combination of factors, including unintentional inaccurate self-identification by applicants, difficulties in documenting eligibility, turnover, and the varying interpretations on program eligibility from State to State, a little over half of the WOTC/WTW hires were actually certified and resulted in a tax credit.

Despite the fact that some of our potential credit-eligible hires do not pan out, we are convinced that the WOTC/WTW credits are invaluable tools supporting our programs for employing individuals with disabilities, welfare recipients and other target group members. The tax credits we receive go a long way toward offsetting the additional administrative costs associated with our special outreach and training programs.

Our company treats our WOTC/WTW hires on an equal footing with more traditional hires. In that regard, they are entitled to the same benefits, including health insurance, dental, vision, life insurance, sick pay and vacation pay. This includes

part-time employees (those working 16–39 hours) as well as full-time. In addition, all of our full-time employees receive medical coverage for their dependents.

Mr. Chairman, we would like to take this opportunity to express Giant Eagle's strong support for S. 595, the Santorum/Baucus bill that would permanently extend these programs, simplify program administration by combining WOTC and WTW into one tax credit, and make a number of long-sought and needed program enhancements. I should like to note that many of the program enhancements were included in the President's fiscal year 2005 and 2006 budget proposals.

Giant Eagle supports the provisions in S. 595 because:

First, by making the credits permanent, Congress will send a strong signal of its commitment to the programs and end the harmful uncertainty that results when the programs are extended temporarily, or worse, the disruptions that occur when the programs expire.

Second, merging the Welfare-to-Work tax credit into the Work Opportunity Tax Credit will simplify program administration, because it will allow us to track only one program instead of having to track two different credits.

Third, the proposed expansion of the age eligibility for the high-risk youth and food stamp groups will help companies like ours move more unemployed men, who are often fathers of children on welfare, into the workforce. To date, the program has been very helpful in encouraging us to hire women on welfare, but, as currently structured, we receive no incentive to hire absentee fathers, who also face significant if not greater barriers to work than welfare moms.

Finally, we strongly support the proposal to remove the income test for the ex-felon category as a means of resolving the difficult dilemma of documenting family income for a group that has virtually none.

In conclusion, S. 595 will make important strides in improving these excellent programs and will provide our company with even greater incentives to reach out and hire structurally unemployed individuals.

I thank the committee again for the opportunity to appear today, and urge Members to support the Santorum/Baucus bill to permanently extend and improve the Work Opportunity and Welfare-to-Work credits.

RESPONSE TO A QUESTION FROM SENATOR GRASSLEY

Question: As a follow-up, I'd like for you to offer recommendations on ways that the certification process can be improved. States are obviously incentivized to promote employment using the credit so as to reduce welfare and encourage productivity. Nevertheless, they fail to get the certifications done in a timely manner, and the suggestion seems to be that these offices are under-funded by the Department of Labor or that the program's potential expiration is the problem. I would appreciate any recommendations you have on ways to streamline this process and make the credit more effective.

Answer: The primary concern employers have is receiving the WOTC/WTW tax certifications for qualified hires in a timely fashion from the State job services. Because of numerous program hiatuses and the inadequate funding of the State job services, there often is little stability in the State WOTC/WTW workforce which is responsible for processing certification requests. As a result, after every program hiatus, not only are there significant processing backlogs, but oftentimes a whole new processing workforce has to be trained when the program starts up again. This results in even further processing delays and, ultimately, this discourages employer participation in the program. The best way to encourage employers to maintain and expand their participation in the program would be to provide a long-term, if not a permanent, extension of the program and adequate processing funding to the States. While in the past the State job services have received as much as \$25 million to administer the program, current funding is at approximately \$18 million. A funding level of \$30 million would be more appropriate.

Another processing issue which is of major concern to employers concerns the administration of the Title IV-A category. We are pleased that IRS has issued Revenue Ruling 2003–112, which makes it clear that any member of a family which was on a welfare grant or food stamp grant, or anyone who was a member of a veteran's family for at least 1 day during the qualifying period is eligible and should have always been considered eligible. DOL, in its Training and Employment Guidance Letter (TEGL) to the States, has made it clear that the job services need only apply the ruling prospectively for "inventoried" (not yet processed certification requests) since November of 2003 when Revenue Ruling 2003–112 was issued. The TEGL goes on to indicate that IRS will be working out a settlement to this problem with taxpayers. Mr. Chairman, it now has been 3 years and 4 months since the original authors (Senator Baucus, Congressmen Houghton and Rangel) of the WOTC program

wrote IRS about this issue. Yet to date, despite IRS having issued a Revenue Ruling that says the State Job Services always should have certified all members of a family on these programs, no matter for how long they were on the program during the qualifying period, we are no closer to employers receiving the WOTC/WTW credits for those who were wrongfully denied certification. If employers are to continue to have faith in these programs, IRS needs to be told to reach an equitable settlement with employers that does not involve unreasonable burdens. In addition, settlement needs to recognize that the remedy provided must be national in scope and based upon the best survey data available—that which is provided by employers. Any re-survey of the State job services as to whether they properly administered the program will only result in the States verifying and justifying the methodology they already used.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: I read in your testimony that almost half of your workers eventually do not qualify for the WOTC/WTW credits. That seems to be a huge disincentive to participate. Why is this so, and what can we do about it?

Answer: The number one reason for the discrepancy in 8850s submitted versus certifications is the disruptions to the State Department of Labor Certification Units caused when WOTC and Welfare-to-Work authorizing legislation expires and goes into hiatus.

Even when funding exists, DOL staff gets anxious over the future of the program and often will try to transfer to a more stable program, and administrators are hesitant to invest resources on upgrades and improvements. This causes staffing shortages, and/or new/inexperienced staff in the units as well as the postponement of technology upgrades within these units. As a result, even pre-hiatus pending 8850s are sometimes treated with greater inefficiency. 8850s submitted during the hiatus in accordance with the now-expired statutory requirements are often just filed and stored until renewal. In the best-case scenario, a State will work on the 8850s submitted and determine whether or not a certification should be issued, and hold them in a pending file until WOTC is re-authorized. But even in this type of instance, forms are being worked with certain processing constraints and with a reduced sense of urgency.

When WOTC gets reauthorized after a hiatus, we always experience a delay in receiving certifications because of the backlog that exists within the State. In addition, we always find that some of our 8850 submissions seem to have disappeared into a “black hole” and can’t be found by the agencies. Although we send everything with a U.S. Postal Service Certificate of Mailing and keep copies of the original 8850s, any resubmissions we do often go to an agency where they are trying to deal with an existing backlog crisis.

The best solution to this problem would be a permanent or, at least, multi-year extension of the credits.

The second reason revolves around the fact that a significant number of our job applicants accidentally identify themselves incorrectly as a member of a group when they fill out the 8850. For instance, the Welfare category requires that someone receive TANF for 9 out of the 18 months prior to hire, and many people who have been on and off of assistance do not remember the exact months, so they may have only been on for less than 9 out of the last 18 months but checked the box anyway.

There is not much that can be done regarding accidental misidentification. Perhaps at a future date, simplifying the definition of the Welfare and Food Stamp categories should be looked at. But, the broadening of the age categories for Food Stamp families and persons living in the distressed Empowerment Zones and Renewal Communities, categories that have much more clear-cut identifiers (age and residence), will give unskilled and unemployed males more job opportunities.

The third reason for the discrepancy is that many State agencies defined the Welfare category incorrectly, as the IRS acknowledged in 2003. Now that the agencies have been redirected on their definition, we hope that this issue is resolved. At the same time, we are still waiting for Treasury to fairly compensate us for the credits we were entitled to but did not receive between 1996 and 2004.

The fourth reason for the discrepancy is inherent in documentation difficulties we encounter with some of the target groups, especially the Ex-Felon category, which requires the target group member to document family income in order to be certified. The change proposed in S. 595 to eliminate the income test will solve this problem.

I feel that the changes in S. 595 go a long way to making WOTC a better and more efficient hiring incentive.

Question: I was encouraged and interested by your statement that your employees hired through the WOTC/WTW program have a comparable rate of retention to other employees at Giant Eagle. Do you know why this is?

Answer: We know that the WOTC/WTW population has special needs and that, if they are to succeed, many of these individuals need extra support services, including special outside trainers and job coaches. Giant Eagle recognizes that, without the extra assistance, these individuals have little chance to succeed in our work environment. WOTC helps support these services.

In turn, many of the people receiving such extra help develop a special loyalty to Giant Eagle. In other cases, our WOTC initiatives give job skills to workers who are less inclined to leave us because of circumstances surrounding the reasons they qualified for the credit, such as a significant disability or having young children.

So in the end, WOTC is a win for people with limited skills who need jobs and a win for companies like Giant Eagle who need good employees.

PREPARED STATEMENT OF DAVID HERNANDEZ

INTRODUCTION

Mr. Chairman, Senator Baucus, and members of the committee, my name is David Hernandez. I am Vice President, Taxes and General Counsel, for EDS. I am here today on behalf of the R&D Credit Coalition (the "Coalition"), which represents more than 1,000 small, medium and large U.S. companies and 85 professional and trade associations.

EDS provides a broad portfolio of business and technology solutions to help its clients worldwide improve their business performance. EDS's core portfolio comprises information-technology, applications and business process services, as well as information-technology transformation services. EDS's A.T. Kearney subsidiary is one of the world's leading high-value management consultancies. With more than \$20 billion in annual revenue, EDS is ranked 87th on the Fortune 500. I am pleased to testify on behalf of the R&D Credit Coalition.

First, I want to express our appreciation for the Senate's longstanding commitment to a strong, vibrant, and permanent R&D credit. The Coalition commends Senators Hatch and Baucus, and all the members of this committee, for your leadership in promoting U.S.-based research and for recognizing the value of an effective Federal incentive to businesses that will result in more U.S. investment, jobs, innovation and economic growth. Last year, the Coalition worked with Senators Hatch, Baucus, and other members of this committee on legislation¹ to make the current R&D credit permanent and add an alternative simplified credit option to encourage even more companies to increase their U.S.-based research activities. We fully endorsed the proposal that was unanimously adopted last year as an amendment to the Senate's JOBS Act.² While we were disappointed that the Senate's improvements to the current credit were removed in conference with the House, it was critically important that the current-law credit was extended so that ongoing research projects could proceed without interruption in 2004 and 2005.

IMPORTANCE OF INNOVATION

Before turning specifically to the R&D tax credit, I want to talk briefly about the broader importance of innovation to job growth, economic vitality, and increased standards of living.

Economists agree that, in the long run, productivity growth is the principal source of improvements in living standards. There is consensus that the productivity growth in recent years has been driven by the combination of accelerated technical progress and the resulting investments in capital assets, research and development, human capital, and public infrastructure. In order to continue this pattern of growth, the focus of public policy must be on providing continued incentives to companies that invest, innovate, and create the new capital and knowledge that drive the U.S. economy.

In 2001, Federal Reserve Board Chairman Alan Greenspan told the Senate Budget Committee, "Had the innovations of recent decades, especially in information technologies, not come to fruition, productivity growth during the past 5 to 7 years, arguably, would have continued to languish at the rate of the preceding 20 years."

¹ S. 664, as introduced in the 108th Congress.

² S. Amdt. 2647, as amended, to S. 1637, March 3, 2004.

U.S. businesses and Federal policymakers should continue to work together to promote policies that will foster those same high levels of growth for decades to come.

Without a growing economy, Americans' standard of living, and our ability to support the needs of our aging population, will be in jeopardy. Faced with a static or decreasing workforce as U.S. demographics shift, U.S. lawmakers must focus on encouraging technological developments to increase productivity, enabling a smaller workforce to support a growing population of retirees.

It will take the continued support of both public and private investment in research and development to foster the level of innovation needed to keep the United States economically competitive. Research confirms, however, that private-sector R&D funding generally falls below the optimal level of spending necessary to provide maximum benefits to the overall economy. Corporate research is high-risk, long-term and limited by the "free rider" problem in economics. The benefits of R&D will not fully accrue to those businesses conducting the research, so there must be an additional incentive for businesses to undertake the costly and risky investment in additional research that benefits the public good. Thus, it makes public policy sense for the U.S. government to do all it can to encourage companies to further increase R&D spending in the United States.

Foreign jurisdictions also have recognized the value and importance of R&D investments and the high-quality jobs that flow from that investment. Governments around the world are competing for corporate R&D investment to help create a better economic future for their citizens.

RESEARCH INCENTIVES

According to the OECD³, "Support to business R&D remains a central feature of innovation policies across the OECD, especially as governments aim to boost business R&D spending. With the exception of several Eastern European countries, direct government support to business R&D has declined, both in absolute terms and as a share of business R&D, and greater emphasis is being placed on indirect measures, such as tax incentives for R&D."

Between 2002 and 2004, Belgium, Ireland, and Norway established new R&D tax incentive regimes, bringing to 18 the number of OECD countries employing tax incentives for R&D. Canada, which offers a 20-percent flat tax credit for R&D spending, continues on its mission of inducing U.S. companies to locate R&D operations in that country. The United Kingdom also developed an R&D tax incentive for large firms, complementing the incentives currently provided for small firms. Countries are also making efforts to stimulate entrepreneurship and boost R&D activities in small and medium-sized enterprises (SMEs) by, for instance, supporting venture capital and providing preferential support to SMEs.

In 2004, the European Commission requested the International Bureau of Fiscal Documentation to carry out an information survey on the current tax treatment of research and development expenditures in the 25 EU Member States and the United States and Japan. A stated purpose for this study was to provide information that would enable the European Commission to find an incentive to increase the R&D spending within the Member States that would be competitive with other countries such as the United States and Japan.⁴

The Federal R&D tax credit, according to many government and private-sector experts, has been a proven, effective means of encouraging increased research and development activity in the United States. Other countries are looking at our system and actively trying to compete for U.S. business's R&D investment.

Just this week, the World Economic Forum released its annual Global Information Technology Report. The rankings, which measure the propensity for countries to exploit the opportunities offered by information and communications technology (ICT), revealed that Singapore has displaced the United States as the top economy in information technology competitiveness. As a matter of fact, the United States has dropped from first to fifth place in this ranking. Iceland, Finland and Denmark are the countries ranked two, three and four out of the 104 countries surveyed. Iceland moved up from tenth last year.

We should respond to this development by acting this year to strengthen and make permanent our R&D tax credit so that we can regain our competitive edge.

³ OECD Science, Technology and Industry (STI) Outlook 2004.

⁴ International Bureau of Fiscal Documentation, *Tax Treatment of Research and Development Expenses*, December 2004, 230 pages. http://europa.eu.int/comm/taxation_customs/resources/documents/eu_rd_final_rep_dec_2004.pdf

There is a significant body of evidence produced by the General Accounting Office, Bureau of Labor Statistics, National Bureau of Economic Research, and others that concludes that the R&D credit represents a very sound investment in U.S. economic growth.⁵

In 1998, Coopers & Lybrand (now PricewaterhouseCoopers) completed a study, *Economic Benefits of the R&D Tax Credit*, which dramatically illustrates the significant economic benefits provided by the credit. According to the study, making the R&D credit permanent would stimulate substantial amounts of additional R&D in the United States, increase national productivity and economic growth almost immediately, and provide U.S. workers with higher wages and after-tax income.

It is clear that the current R&D tax credit reduces the cost of investing in additional U.S.-based research for companies that qualify under the current formulation. For these companies that undertake that research, that assistance can often mean the difference between a project getting the green light or being put back on the shelf. The fate of that additional research project not only matters to the researchers and technical personnel who would be hired to do the research, but it also matters to the unrelated small or medium-size company that might be hired to help take a product to market. Often, the discussion of the R&D tax credit centers on large companies that claim the credit. What has been overlooked, unfortunately, are those companies that don't claim the R&D credit, but whose livelihoods are linked to the products and services developed as a result of this additional research. Technology-based productivity increases benefit all businesses—even businesses that do no R&D.

Let me illustrate. Ace Clearwater Enterprises, Inc., a Torrance, CA company, makes many of the component parts that are used by large aerospace companies. When the large companies do more R&D in new and improved products and need to build and test more prototypes, Ace Clearwater does more business and hires more people. As R&D increases, so too does the need for suppliers, manufacturers, and ultimately a host of others when products are finally taken to market. Those firms and their employees are spread out in every community and every State, and their contribution to economic prosperity is vital.

These firms may not be the first thing that comes to mind when you hear about the R&D tax credit, but they certainly are among the first beneficiaries of increased investments in research and could be the first casualties if those levels of investment decline or move offshore.

Currently, companies of all sizes, across a wide range of industries and in every State, claim the R&D tax credit. A 2004 study⁶ by Washington Council Ernst & Young showed that the credit is highly beneficial to small firms. According to this study, in 2000:

- Nearly 16,000 companies claimed the R&D credit.
- More than 4,500 firms with assets of less than \$1 million (25 percent of all firms) claimed the credit. For the smallest firms in the study, those with assets between \$1,000 and \$99,000, on average the value of the credit claimed equaled 9.4 percent of their assets.
- Employees of companies in the manufacturing, services, retail and wholesale trade, construction, and real estate sectors were among the greatest beneficiaries of that investment.

If we want to maintain and improve that track record, it is important for Congress to adopt the changes embodied in S. 664, which was introduced in the last Congress by Senators Hatch and Baucus, that would—on a permanent basis—maintain the traditional credit, increase the Alternative Incremental Research Credit (AIRC) rates and provide for an Alternative Simplified Credit (ASC) in order to induce even more research-intensive businesses to undertake additional U.S.-based research spending.

Now, let me focus on the R&D credit and the proposed improvements included in legislation overwhelmingly endorsed by the Senate last year, that the business community firmly believes will strengthen the incentive value of the credit.

⁵See, e.g., Hall, Bronwyn H. and John Van Reenen. "How Effective Are Fiscal Incentives for R&D: A Review of the Evidence." Working Paper 7098. Cambridge, MA, National Bureau of Economic Research, April, 1999; U.S. General Accounting Office (GAO), *Tax Policy and Administration: Review of Studies of the Effectiveness of the Research Tax Credit*, May, 1996, 26 pages; Office of Technology Assessment, Congress of the United States, *The Effectiveness of Research and Experimentation Tax Credits*, OTA-BP-ITC-174, September, 1995, Washington, DC, 65 pages.

⁶Koch, Cathy. *Supporting Innovation and Economic Growth: The Broad Impact of the R&D Tax Credit*, Washington Council Ernst & Young, April, 2004, 15 pages. http://www.nam.org/s_nam/bin.asp?CID=155&DID=230921&DOC=FILE.PDF

HISTORY OF THE R&D TAX CREDIT

Congress first enacted the R&D credit in 1981 to provide an incentive for companies to increase their U.S. R&D activities. The Federal R&D tax credit is available only for research done in the United States. The bulk of the qualified expenditures are the salaries of workers directly involved in R&D.

The initial credit rate was equal to 25 percent of a company's incremental "qualified R&D expenditures" (QREs) in excess of a rolling base amount equal to average QREs for the prior 3 years. Currently, the credit rate is 20 percent of a company's QREs and the base amount calculation is linked to the taxpayer's gross receipts.

The original credit was scheduled to expire at the end of 1985. Recognizing the importance and effectiveness of the R&D credit, Congress decided to extend it and has extended it on ten subsequent occasions. In addition, the credit's focus has been narrowed by further limiting both qualifying activities and eligible expenditures—increasing the credit's incentive leverage. With each extension, the Congress indicated its strong bipartisan support for the R&D credit.

In 1996, Congress added the elective Alternative Incremental Research Credit ("AIRC") to the statute, making the credit available to R&D-intensive industries that could not qualify for the credit under the regular formula. The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns that are a normal part of a company's life cycle.

In 1999, the credit was extended until June 30, 2004, and a modest increase in the AIRC rates was adopted to bring the AIRC's incentive effect more into line with the incentive provided by the regular credit.

Most recently, in 2004, as part of the Working Families Tax Relief Act of 2004 (P.L. 108-311), the credit was seamlessly extended for the period beginning July 1, 2004 through December 31, 2005. This seamless extension was particularly important, as it ensured there was no disruption in ongoing research projects.

THE CURRENT CREDIT NEEDS TO BE STRENGTHENED AND MADE PERMANENT

In order to maximize its incentive effect, the R&D credit should be permanent. Research projects cannot be turned off and on like a light switch and generally represent multi-year commitments; if corporate managers are going to take the benefits of the R&D credit into account in planning future research projects and future hiring needs, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and extended gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital. The 12-month gap in the credit from July 1995 to June 1996 reduced the business community's willingness to plan based on assumed future extensions of the temporary credit.

In the normal course of business operations, R&D investments take time and planning. Businesses must search for, hire, and train scientists, engineers and support staff, and in many cases invest in new physical plants and equipment. There is little doubt that some of the incentive effect of the credit has been lost over the past 24 years as a result of the constant uncertainty over the continued availability of the credit. This must be corrected so that the full potential of its incentive effect can be felt across all sectors of our economy.

In order to provide for the maximum potential for increased R&D activity, and for the government to maximize its return on tax dollars invested in the credit, the practice of periodically extending the credit for short periods, and then allowing it to lapse, must be changed by making the R&D credit permanent.

Although the current statutory incentive is effective for many companies, many others that spend significant amounts on R&D in the U.S. get little or no benefit. Consequently, a simple extension of present law will provide insufficient incentive to maintain or increase their R&D spending in the United States. Moreover, the R&D inducements outside the U.S. will look relatively more favorable to these taxpayers.

For example, many taxpayers are no longer able to qualify for the traditional credit because their sales increased significantly in the intervening years, or they entered into an additional line of business that generated additional gross receipts but performed little R&D, or they became more efficient in their R&D processes and were able to spend less to perform the same R&D activity.

In 1996, the addition of the AIRC at significantly reduced rates partially addressed this issue for many companies. It is time to take the next step by both increasing the AIRC rates and providing for an Alternative Simplified Credit (ASC) calculation that will improve the credit's incentive value for increased research activity and job creation in the United States.

The U.S. business community needs a stable, consistent, and improved R&D credit that will strengthen its incentive value, stimulate the Nation's economic growth and sustain the basis for ongoing global technology. We urge the Congress to enact the Hatch/Baucus proposal in 2005.

PROPOSED CHANGES TO CURRENT LAW

In addition to the need for permanency for the R&D credit, changes to the statute need to be made in order to maximize the credit's incentive value. In order to extend an incentive for U.S.-based R&D to more companies, Congress should adopt the Alternative Simplified Credit ("ASC"). The ASC is an elective credit that equals 12 percent of the excess of current-year qualified research expenses ("QREs"), over 50 percent of the taxpayer's average QREs for the prior 3 years. These credit and base amounts are designed to provide an effective credit rate comparable to that provided on average by the traditional credit. Importantly, the ASC is calculated without reference to gross receipts, a feature of the traditional credit that, as discussed above, has left many research-intensive companies unable to qualify for the credit.

While the new ASC may provide a greater incentive for many AIRC companies over time, AIRC firms should be given a more meaningful incentive to continue and increase their research activities in the United States as they assess the value of the new regime. In order to move closer to the incentive value provided by the traditional credit, Congress should increase the AIRC rates to 3 percent, 4 percent and 5 percent, respectively, which will bring those rates in line with the levels envisioned when the AIRC was originally proposed in 1996.

While the ASC increases the incentive value of the credit for certain businesses, it is equally important to avoid disrupting the current incentive for companies that benefit under the traditional credit and AIRC. The traditional credit, in its current form, provides a strong incentive for many companies that continue to increase R&D activities in the United States at an equal or higher rate than revenue. For companies whose R&D investments continue to increase, the traditional credit calculation may yield a higher credit amount for that company than under the new ASC.

Overall, the introduction of an elective new credit calculation is intended to provide a comparable incentive to other companies engaged in research that have been unable to qualify for the traditional credit while avoiding penalizing those companies that have responded to the incentives provided by the traditional credit by significantly increasing their U.S.-based R&D spending.

CONCLUSION

Private sector R&D in the United States stimulates investment in innovative products and processes that greatly contribute to overall economic growth, increased productivity, new and better U.S. jobs, and higher standards of living in the United States. By creating an environment favorable to private sector R&D investment in the United States, Congress can encourage companies to site new research projects here and maintain and attract the high-skill, high-wage jobs associated with those projects in the United States. Investment in R&D is an investment in U.S. jobs. A strong, vibrant, and permanent R&D credit is essential for the competitiveness of U.S. companies, as many foreign countries have chosen to offer direct financial subsidies and reduced capital cost incentives to "key" industries.

The R&D Credit Coalition applauds the Senate Finance Committee and the full Senate for its commitment to fostering economic growth through effective Federal tax policies that support private sector investments in innovation, and will continue to work with you to achieve a strong and permanent R&D credit.

Thank you for inviting me to speak on this important subject. I am happy to take any questions.

RESPONSES TO QUESTIONS FROM SENATOR BAUCUS

Question: You testified that some foreign countries, such as Canada, are aggressively courting U.S. research, which would mean a drain on U.S. jobs and the U.S. economy. Could you explain for the committee how these countries are trying to lure U.S. research dollars out of the U.S. and into other countries, and whether they are being successful?

Answer: Today's global R&D incentive regime is rooted in global competitiveness concerns. National governments in more than 30 countries use tax policy to attract investment and have enacted research and development tax incentives in the form of credits or enhanced deductions. These countries are trying to lure research dollars out of the U.S. through a variety of means, including:

- Lower tax rates;

- Direct cash incentives and investment subsidies;
- Tax credits and “super” deductions tied directly to research and development activities; and
- Other tax incentives designed to attract foreign investment.

All of these are actively marketed to tax executives and corporate officers through direct marketing calls, seminar presentations and even print and television media campaigns.

I am not aware of any way to specifically measure the success of such efforts. The simple fact that the list of countries offering such incentives continues to increase would indicate that policy makers in an increasing number of countries believe that the incentives must have an impact on corporate behavior.

Question: Do you have an estimate of the total amount of R&D investment that the U.S. has lost as a result of these efforts by foreign countries?

Answer: I am unaware of any publicly or privately sponsored data or studies which have quantified the total amount of R&D investment that the U.S. has lost as a result of these efforts by foreign countries. The evidence seems to be more anecdotal in nature. The R&D Credit Coalition will continue to look for any such studies or information and provide it to the committee if located.

PREPARED STATEMENT OF DR. DAVID E. MARTIN

Senate Finance Committee Hearing on Expiring Tax Provisions**March 16, 2005****Transparency and Audit Capacity for the Research and Experimentation Tax Credit**

Testimony of Dr. David E. Martin

CEO, M-CAM

Fellow, Batten Institute, Darden Graduate School of Business Administration, University of Virginia

Thank you, Mr. Chairman, and distinguished Committee Members, for the opportunity to join you in your vital work in advocating for transparency and accountability in the complex area of public innovation investment in our country. It was, indeed, an honor to work side-by-side with you and your able staff in the interdiction of abusive tax shelters masquerading as innovation last year as this Committee boldly confronted members of industry and academia who had exploited patent donations with impunity.

M-CAM has worked with the Congress for close to three years and with the Internal Revenue Service for the past one and one-half years in the enforcement of legitimate collections in the area of patent donations. In the midst of this effort, we were struck by the fact that the IRS did not have, nor yet has, a mechanism to formally audit a topic of far larger economic consequence than the donation abuse – namely, the use, and possible misuse, of research and experimentation tax credits. It is imperative to open my remarks with a disclaimer. Considerable ambiguity exists in this topic because explicit transparency of activities, allegedly making justifiable the application of the credit, is not readily surfaced to the IRS or to the public. Accounting firms, and the corporations they represent, may apply the credit without any independent review of its appropriateness. Given the absence of adequate reporting, no mechanism exists today to insure that the U.S. taxpayer receives any of the intended benefit afforded this considerable public investment. In light of this, my remarks are drawn from what we can see through the glass of somewhat opaque disclosure in public company records. At present, this is the only window.

Enacted as part of the Economic Recovery Tax Act of 1981, the Research and Experimentation Tax Credit was established by Congress to encourage operating businesses to continue and to expand their own private research. In the wake of abuse concerns, the credit has undergone a number of clarifications in its twenty-four year history ever circling around the tension between stimulation of economy-building discovery of information and the unintended use as a tax accountant's tool to lower tax liabilities *ex post facto*.

Reciting the fundamental assumptions and mechanics of the credit is outside the scope of my testimony today. Rather, it is my intent to focus on two direct concerns. First, I would like to address the accretive value of the credit as evidenced in an independent review conducted by M-CAM. Second, I would like to consider the competency concerns faced by the IRS in the oversight of this important national investment.

Credit Utilization – A New Perspective

The R&E Tax Credit has been lauded as a significant weapon in the arsenal of business competitiveness in America. Job creation and economic development are frequently used to justify its existence together with recent calls for the establishment of a permanent and expanded credit. While numerous studies have supported the general economic premise that research expenditures have a positive effect on the growth of the economy, few have carefully considered the precise impact of a public investment in the form of a tax credit. In a 1995 report to the Congressional Office of Technology Assessment, Professor Bronwyn Hall highlighted the challenge of documenting, with precision, the value of a tax credit on the stimulation of research and reported a reliance on statistical models that attempt to estimate the impact of a credit using a number of tenuous assumptions¹. Implicit in this report was the assumption that the “social return to industrial R&D in the United States exceeds the social cost at the current level of tax subsidy.”²

The Joint Committee on Taxation reported that the majority (84.94%) of the claimed R&E credit was taken by corporations with assets greater than \$50 million. While the predominant beneficiaries of the credit are extremely large corporations, during the past several years it was the private equity venture capital backed companies that saw employment growth of 6.5% between 2000 and 2003 compared to the national private sector employment which shrank 2.3% during the same period³. Between 1984 and 2003, firms with fewer than 500 employees saw an increase of their share of U.S. R&D rise from 5.9% to 20.7%. During the same period, small company R&D rose from an estimated \$4.4 billion to \$40.1 billion⁴.

Given the tax credit bias toward large companies and the availability of disclosed financial data, M-CAM undertook an independent investigation of the use of the R&E tax credit among publicly traded corporations in the United States. For this study, M-CAM examined the public financial filings (quarterly and year-end) for all publicly traded firms in the U.S. between 1998 and 2003. All SEC financial filings were reviewed for explicit reference to the use of the research tax credit. Two hundred public companies were identified as self-reported users of the credit. This number under samples the probable number of actual users as many companies don't itemize the tax credits used in their tax planning (Figure 1). Approximately 20% of the companies using the tax credit also reported receiving grant or contract research support from the U.S. government or other sources during the same period – many relying on federal grants and contracts for the majority of their R&D and business. This data is presented in Figure 2. The principal funding sources for companies relying on both tax credit and contract or grant sources of R&D support include: National Institutes for Health (NIH); Defense Advanced Research Projects Agency (DARPA); National Institute of Standards and Technology (NIST); Department of Defense

¹ Bronwyn H. Hall. “Experimentation Tax Credits: Critical Literature Review and Research Design.” Report for the Office of Technology Assessment, Congress of the United States. June 15, 1995.

² Ibid. pg. 10.

³ Global Insight. “Venture Impact 2004: Venture Capital Benefits to the U.S. Economy”.

⁴ Ibid. pg. 9.

(DOD); Department of Energy (DOE); and, National Aeronautics and Space Administration (NASA).

Figure 1. Distribution, by industry, of the companies explicitly reporting the use of the R&E tax credit.

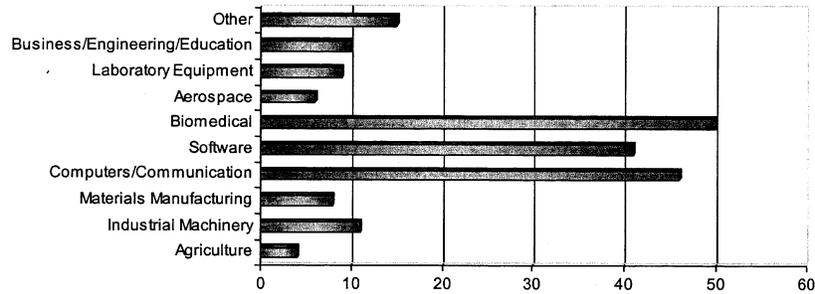
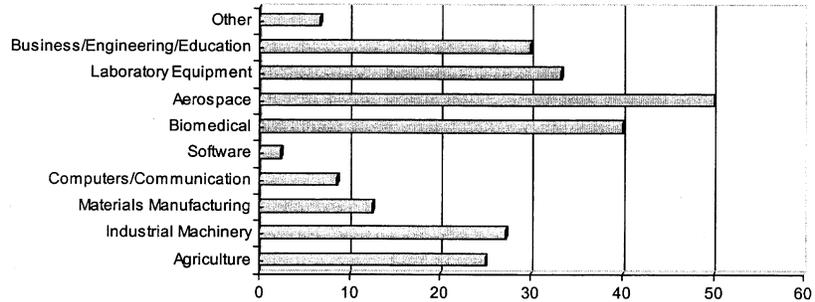


Figure 2. Percentage of companies in each sector conducting government sponsored research (contracts and grants) while simultaneously claiming the tax credit.



While IRC § 41 (d)(4)(H) explicitly states that funded research is excluded from the definition of “qualified research,” the data presented in Figure 2 is informative – not necessarily an indictment of misuse or abuse. One can certainly appreciate the fact that a company may engage in both

eligible and non-eligible research and carefully document the bright line between the two to be in compliance with the applicability requirements for the credit. This said, in a detailed review of the disclosures of the companies represented in Figure 2, no such overt clarification was found.

I will return to this observation in the second portion of my remarks but, in the interest of highlighting additional insights into the credit and its potential applicability for stimulating the economy, it is illuminating to consider a number of financial performance metrics to apply when assessing the credit's consequence with respect to jobs and economic growth.

From 1998 to 2003, considerable volatility existed in the public markets. However, by the end of this period, the market was beginning its upward climb. M-CAM measured the stock performance of the companies using the tax credit compared to Standard & Poor's 500. At their last reporting valuation during the period, 78 companies (39%) out-performed the S&P while 87 (44%) under-performed, filed for bankruptcy, were de-listed or otherwise liquidated. When one closely examines the data, a more intriguing finding emerges. For the companies that remained operational throughout the study period, the average share price difference between a company's use of the tax credit and their last reporting valuation during the study period was +9.1% (median difference +4.3%) and -67.8% (median difference -11.9%) for the out-performers and under-performers, respectively. One wonders if the frequent beneficiaries of the research tax credit are, in fact, the accounting firms who research past tax filings for opportunities to use the credit⁵ – research that was not intended to be underwritten by the public.

This data implies that the benefits of the tax credit are not uniform. Further, one may infer that the credit is more likely applicable in situations when companies are facing market value decrements. Our findings indicate that additional study may be warranted to test the true market impact of the R&E tax credit on the intended benefits of job creation and economic growth as the data from public companies seems to indicate that the use of the credit – many times applied in restated tax filings two or more years after the investment in R&D – may do less as a stimulus than is desired by the credit's advocates.

This leads us, however, to an even greater challenge. Until recently, the IRS had no credible means to detect or interdict innovation abuse in the form of patent donations. In point of fact, as late as January, 2003, the IRS did not have a uniform ability even to verify the existence of allegedly donated property as its form 8283 often contained either inadequate or fictitious statements made by taxpayers or their accountants. In this context, it is informative to consider the current R&E tax credit's oversight capacity of the IRS.

Infrastructure Enforcement Challenges

Since its creation, the R&E tax credit has presented a considerable enforcement challenge for the IRS. Much of this comes from statutory ambiguity surrounding a taxpayer's obligation to qualify research with any documented clarity. Since 1986, what constitutes qualified research has remained fraught with controversy based on the statement that research must be to discover

⁵ <http://www.bizjournals.com/sanantonio/stories/2004/09/20/story7.html> (accessed March 14, 2005)

information that is technological in nature⁶. A great deal of public comment and policy debate has accompanied the qualified research definitions. I wish to focus on a number of the excluded activities defined under IRC § 41 (d) (4), as it is in this arena where our experience with the IRS highlights enforcement inadequacies that serve as ideal targets for abuse.

Excluded activities...

- A. Any research conducted after the beginning of commercial production of a business component. – *It is helpful for the Committee and the IRS to recall that under U.S. Patent Law, a patent applicant is under no duty to disclose evidence supporting their assertion of invention. In instances covered under § 41 (d) (4) (A), the IRS does not have an ability to set forth a disclosure standard or practice covering continuation or divisional filings for patent applications that may evidence research conducted after the beginning of commercial production. Additionally, as the patent applicant is under no duty to disclose information from their own due diligence, the likelihood that tax credit users will voluntarily adopt a more rigorous review for tax purposes than they use for securing state-sanctioned monopolies, is low.*
- B. Any research related to the adaptation of an existing business component to a particular customer's requirement or need. – *In a number of industries, most, if not all of the production by a company is an adaptation for a particular customer's needs or requirements. This is particularly the case in the area of software, commercial and industrial computer technology and communications. In these areas, the IRS has no way to document and verify that the qualified research was undertaken absent a specification provided by an existing or intended customer.*
- C. Any research related to the reproduction of an existing business component from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business components. – *In our experience, we know that the IRS continues to ignore patent filings, technical disclosures, and 3rd party data on innovations when considering the innovations made by a taxpayer. In no case that M-CAM has reviewed has the existence of 3rd party innovation, technical disclosures or commercially competing offerings been factored, in any way, into valuations made for the purpose of tax valuation. More importantly, no appraisal or tax planning standards body has any explicit guidance on the review of publicly available information on specifications held by others when considering the eligibility for innovation claims made for tax purposes. Therefore, the IRS' incapacity to evaluate tax claims in the context of market data leaves it open to considerable, undetectable abuse.*
- D. Surveys, studies, etc. Any:

⁶ R&E Tax Credit for Qualified Research...

1. Cost of your activity must be deductible R&E expenditures under IRS Code § 174.
2. Purpose must be to discover information which is technological in nature.
3. Application of the technological information must be intended to be useful in your new or improved business component.
4. Substantially all of the activities related to your research must constitute elements of a process of experimentation.

- i. Efficiency survey
 - ii. Activity relating to management function or technique
 - iii. Market research, testing, or development (including advertising and promotions)
 - iv. Routine data collection
 - v. Routine or ordinary testing or inspection for quality control.
- E. Except to the extent provided by regulations, any research with respect to computer software which is developed by you or for your benefit primarily for internal use by you other than for use in activities which constitute a) qualified research or, b) a production process which meets the requirements of IRC § 41 (d) 1.
- F. Any research conducted outside the United States.
- G. Any research in the social sciences, arts, or humanities.
- H. Any research to the extent funded by any grant, contract, or otherwise by another person or governmental entity. – *As documented above, many well-established government contract research firms take advantage of the R&E tax credit. This is the case not only in aerospace and defense though it is in these areas where the use is most prevalent as a percentage of the population. In the absence of explicit accounting for qualified research expenses related to qualified projects, neither the company seeking the credit, nor the IRS has any capacity to accurately calculate the applicable credit. M-CAM is aware that current government funding agencies – including those listed above, together with their SBA counterparts – have no formal standard for reviewing grants and contracts for existent intellectual property covering the proposed research. Given this absence, it is doubtful that careful considerations of novelty are being done at any step of the process, thereby making the auditing of this exclusion impractical, if not impossible under current paradigms.*

As was the case in the area of patent donations – in which a predisposing factor to the widespread abuse was industry’s correct assumption that the IRS had neither the knowledge nor technical infrastructure to detect illegitimate reporting – even more so, in the area of R&E tax credits, do these assumptions hold. While having loosely formed guidance for oversight, the IRS currently has no formal process to verify essential prerequisites to the application of the credit.

Plato’s *Republic* best summarizes the paradox facing this Committee – in whose presence throngs will laud the innovative imperative of our country’s great past and glorious future – all the while casting a blind eye to the fact that it is only in transparent systems that we truly can know whether we are as innovative as we claim to be. As was the case with patent donations, the loudest advocacy supporting unfettered use wrapped economic self-interest devoid of accountability in the public interest. So too, in the R&E tax credit, rather than embracing transparency and considered due diligence, the credit is simply heralded as a necessity to stimulate investment in the face of data indicating that it is often used after the investment in research has been made – an election often informed by those seeking to support sagging economic performance.

“Consider... [the] highest form of injustice in which the criminal is the happiest of men, and the sufferers or those who refuse to do injustice are the most miserable – that is to say tyranny, which by fraud and force takes away the property of others, not little by little but wholesale; comprehending in one, things sacred as well as profane, private and public; for which acts of wrong, if he were detected perpetrating any one of them singly, he would be punished and incur great disgrace - they who do such wrong in particular cases are called robbers of temples, and man-stealers and burglars and swindlers and thieves. But when a man besides taking away the money of the citizens has made slaves of them, then, instead of these names of reproach, he is termed happy and blessed, not only by the citizens but by all who hear of his having achieved the consummation of injustice.”

Remember, this – accountability is neither anti-business nor anti-American. We the People pride ourselves on holding truths self-evident. If we have no visibility, we can have no accountability. While public investment in research has served the country, our current lack of transparency in validating the uniqueness of our innovation has led us to support antiquated models without consideration for their fitness in current market conditions. It is time to support the R&E tax credit by insuring that it is used when true innovative business is supported.

Effective immediately, this Committee could:

- 1) Establish affirmative duty to disclose the research for which the credit is being applied; given that the public is paying for it, the public could reasonably expect a general idea about the quality of it’s investment;
- 2) Require credit users to have documented internal processes whereby either internal management panels, or external 3rd party interests, would be required to audit the use of the credit by confirming that the research did not overlap disclosed research or commercial offerings made by others. At a minimum, this review should include efforts undertaken by others within the industry sector and research conducted at academic institutions;
- 3) Authorize the IRS to conduct a complete investigation into historical use of the tax credit to assess the economic performance and R&E activities of the users of the credit compared to industry constituents who do not claim the credit;
- 4) Provide the IRS with specific documentation collection requirements so that the Service can conduct audits in a timely fashion; and,
- 5) Advise the IRS that, when it encounters cases of overt abuse or taxpayer obfuscation based on either inadequate or non-existent documentation justifying the use of a credit, settlement is not in the public interest any more than it would be if one were to negotiate a partial restitution with a bank robber – giving him some reward for his initiative. We have seen, in the case of patent donations, a considerable incentive for the IRS to settle claims – using vehicles such as the Fast Track system – without confronting the overt evidence that

taxpayers knew that the information provided to justify deductions was inaccurate and incompatible with their own due diligence standards. As long as the IRS rewards the rapid closure of cases more than the eradication of abuse, abusers will simply up the ante in a reverse auction on tax benefit.

In the long term, the Committee may wish to consider balancing the use of the credit with national research and experimentation industrial priorities. In this model, the credit would be claimed based on *a priori* statements made by companies indicating both the field in which they intend to conduct research and their expectation of the attendant cost for which they wish to claim the credit. While corporations have protested documentation requirements as onerous, opting into qualified research with the foreknowledge that certain minimal record-keeping would be required, would place no substantial burden on the corporation and would enhance the transparency of the credit's use by those in the IRS who must review its applicability when claimed.

As the economy continues to draw more of its output from increasingly intangible models, the need for accountability and transparency grows in direct proportion. Irrational exuberance serves short-term exploitative interests but does not advance our long-term economic imperatives. We look forward to working with this Committee as it appropriately seeks to balance the revenue mandates of our country with the public investments it can encourage to fuel the growth of our corporate innovative future.

PREPARED STATEMENT OF HON. RICK SANTORUM

THE ENCOURAGING WORK ACT OF 2005

Mr. Chairman, thank you for the opportunity to review important tax incentives scheduled to expire, such as the Work Opportunity Tax Credit (WOTC) and Welfare-to-Work tax credit (WTW). I was pleased to join Senator Baucus, Senator Smith, Senator Rockefeller, and Senator Jeffords last week in the reintroduction of the Encouraging Work Act of 2005, S. 595. I would particularly like to thank Dale Giovengo, Human Resource Director, Giant Eagle Markets in Pittsburgh, for his compelling testimony on the effectiveness of the WOTC and WTW credits in providing work opportunities for many who are disadvantaged or disabled in Pennsylvania and throughout the country.

The Work Opportunity Tax Credit (WOTC) and Welfare-to-Work tax credit (WTW) are tax incentives that encourage employers to hire public assistance recipients and other individuals with barriers to employment. The combination of Welfare Reform passed by Congress in 1996 and the assistance to employers found in the WOTC and WTW has enabled expanded opportunity for many Americans. Yet more can be done. We were pleased that the Senate JOBS bill passed last year included a permanent WOTC/WTW provision along with helpful reforms largely supported by the administration. Unfortunately, it was only extended in the final conference report. Without action by Congress WOTC and WTW will expire on January 1, 2006.

Under present law, WOTC provides a 40 percent tax credit on the first \$6,000 of wages for those working at least 400 hours, or a partial credit of 25 percent for those working 120–399 hours. WTW provides a 35 percent tax credit on the first \$10,000 of wages for those working 400 hours in the first year. In the second year, the WTW credit is 50 percent of the first \$10,000 of wages earned. WOTC and WTW are key elements of welfare reform. A growing number of employers use these programs in the retail, health care, hotel, financial services, food, and other industries. These programs have helped over 2,700,000 previously dependent persons to find jobs.

Eligibility is limited to: (1) recipients of Temporary Assistance to Needy Families (TANF) in 9 of the 18 months ending on the hiring date; (2) individuals receiving Supplemental Security Income (SSI) benefits; (3) disabled individuals with vocational rehabilitation referrals; (4) veterans on food stamps; (5) individuals aged 18–24 in households receiving food stamp benefits; (6) qualified summer youth employees; (7) low-income ex-felons; and (8) individuals ages 18–24 living in empowerment zones or renewal communities. Eligibility for WTW is limited to individuals receiving welfare benefits for 18 consecutive months ending on the hiring date. More than 80 percent of WOTC and WTW hires were previously dependent on public assistance programs. These credits are both a hiring incentive, offsetting some of the higher

costs of recruiting, hiring, and retaining public assistance recipients and other low-skilled individuals, and a retention incentive, providing a higher reward for those who stay longer on the job.

After 8 years of experience with these programs, their value has been well demonstrated. In 2001, the GAO issued a report that indicated that employers have significantly changed their hiring practices because of WOTC. With the resources provided by WOTC, employers have provided job mentors, lengthened training periods, engaged in recruiting outreach, and listed jobs or requested referrals from public agencies or partnerships. WOTC and WTW have become a true public-private partnership in which the Department of Labor, the Internal Revenue Service, the States, and employers have forged excellent working relationships.

But the challenges for employers and those looking for better opportunities are real. The job skills of eligible persons leaving welfare are sometimes limited, and the costs of recruiting, training, and supervising low-skilled individuals cause many employers to look elsewhere for employees. WOTC and WTW are proven incentives for encouraging employers to seek employees from the targeted groups. Despite the considerable success of WOTC and WTW, many vulnerable individuals still need a boost in finding employment. There are several legislative changes that would strengthen these programs, expand employment opportunities for needy individuals, and make the programs more attractive to employers.

- *Combine WOTC and WTW.* The administration's fiscal year 2006 budget proposes to simplify these important employment incentives by combining them into one credit and making the rules for computing the combined credits simpler. The credits would be combined by creating a new welfare-to-work target group under WOTC. The minimum employment periods and credit rates for the first year of employment under the present work opportunity tax credit would apply to WTW employees. The maximum amount of eligible wages would continue to be \$10,000 for WTW employees and \$6,000 for other target groups (\$3,000 for summer youth). In addition, the second-year 50-percent credit under WTW would continue to be available for WTW employees under the modified WOTC.
- *Eliminate requirement to determine family income for ex-felons.* Under current law, only those ex-felons whose annual family income is 70 percent or less than the Bureau of Labor Statistics lower living standard during the 6 months preceding the hiring date are eligible for WOTC. The administration's fiscal year 2006 budget proposes to eliminate the family income attribution rule.
- *Permanent extension of WOTC and WTW.* Permanent extension would provide these programs with greater stability, thereby encouraging more employers to participate, make investments in expanding outreach to identify potential workers from the targeted groups, and avoid the wasteful disruption of termination and renewal. A permanent extension would also encourage the State job services to invest the resources needed to make the certification process more efficient and employer-friendly.
- *Raise the WOTC age eligibility ceiling from 24 to 39 years of age for members of food stamp households and "high-risk youth" living in enterprise zones or renewal communities.* Current WOTC eligibility rules heavily favor the hiring of women because single mothers are much more likely to be on welfare or food stamps. Women constitute about 80 percent of those hired under the WOTC program, but men from welfare households face the same or even greater barriers to finding work. Increasing the age ceiling in the "food stamp category" would greatly improve the job prospects for many absentee fathers and other "at risk" males. This change would be completely consistent with program objectives, because many food stamp households include adults who are not working, and more than 90 percent of those on food stamps live below the poverty line.

WOTC and WTW are also key elements of welfare reform. Employers in the retail, health care, hotel, financial services, and food industries have incorporated this program into their hiring practices and, through these programs, more than 2,700,000 previously dependent persons have found work. A recent report issued by the New York State Department of Labor bears this out in economic terms. I am pleased that Dr. Dubowsky is here from the New York State Department of Labor to elaborate on the study. Comparing the cost of WOTC credits taken by New York State employers during the period 1996–2003 (for a total of \$192.59 million) with savings achieved through closed welfare cases and reductions in vocational rehabilitation programs and jail spending (for a total of \$199.89 million), the State of New York concluded that WOTC provided net benefits to the taxpayers even without taking into account the additional economic benefits resulting from the addition of new wages to the GDP.

In that regard, the New York State analysis concluded that the roughly \$90 million in wages paid to WOTC workers since 1996 generated roughly \$225 million in increased economic activity. Perhaps even more importantly, the study found that roughly 58 percent of the TANF recipients who entered private sector employment with the assistance of WOTC stayed off welfare. I mention the New York State study because it is the first of its kind; however, I am certain that similar conclusions would be reached in the Commonwealth of Pennsylvania or any of the other 48 States and the District of Columbia. These programs work and do so at a net savings to taxpayers. In fact, over a 7-year period there were more than 110,000 certifications for both WOTC and WTW in Pennsylvania alone, enabling many to leave welfare and find private sector work. The legislation is supported by hundreds of employers throughout Pennsylvania and around the country. WOTC and WTW have received high praise as well from the Federal Government. A 2001 GAO study concluded that employers have significantly changed their hiring practices because of WOTC, by providing job mentors, longer training periods, and significant recruiting outreach efforts.

WOTC and WTW are not traditional government jobs programs. Instead they are precisely the type of program that we should champion in a time when we need to be fiscally responsible. These are efficient and low-cost public-private partnerships that have as their goal to provide a means by which individuals can transition from welfare to a lifetime of work and dignity.

The Work Opportunity Credit and Welfare-to-Work credit have been successful in moving traditionally hard-to-employ persons off welfare and into the workforce, where they contribute to our economy. However, employer participation in these important programs can be increased, particularly among small and medium-sized employers. This is due to the complexity of the credits and the fact that they are both only temporary provisions of the tax code subject to renewal every year or two. Small, medium, and even some large employers find it difficult to justify developing the necessary infrastructure to administer and participate in these programs when their continued existence beyond 1 or 2 years is constantly in question.

This legislation will remedy this problem by combining WOTC and WTW into one, more easily administered tax credit, and by making it a permanent part of the tax code. Many organizations, including the National Council of Chain Restaurants, National Retail Federation, Food Marketing Institute, National Association of Convenience Stores, National Restaurant Association, American Hotel and Lodging Association, National Roofing Contractors Association, National Association of Chain Drug Stores, American Nursery and Landscape Association, and the American Health Care Association, support this legislation. Representatives Jerry Weller (R-IL), Charles Rangel (D-NY), and Phil English (R-PA) are introducing identical legislation in the House of Representatives. I look forward to working with Senator Baucus and my colleagues to move this important legislation forward this year.

COMMUNICATIONS

March 30, 2005

Statement by

The Active Financial Services Working Group

**For the Record of the Hearing On
Expiring Tax Provisions
Before the
Committee on Finance, U.S. Senate
On
March 16, 2005**

**The Subpart F Active Financial Services Provision
Should Be Made Permanent**

The Active Financial Services Working Group, which is comprised of a broad cross-section of U.S. financial services and manufacturing companies with financial services operations urges support for the enactment of a permanent subpart F active financial services provision.

Introduction

Under the U.S. tax system, U.S. companies generally are subject to U.S. tax on the active foreign earnings of their foreign subsidiaries only when those earnings are distributed to the U.S. parent. The U.S. subpart F rules operate to subject U.S. companies to current U.S. tax on certain passive income earned by their foreign subsidiaries. The subpart F active financial services provision ensures that income from active foreign business operations in the financial services sector is not subject to current U.S. taxation. This treatment of active financial services income was the law for the first seventy-seven years of the corporate income tax. Changes made in 1986 to raise revenue imposed current U.S. taxation on active financial services income earned by foreign subsidiaries for the first time, but the historical treatment of such income was reinstated in 1997 as a temporary provision. The active financial services provision has been renewed three times, most recently for a five-year period ending on December 31, 2006. We believe the Congress should act to make the active financial services provision permanent this year. Doing so is critical to the growth and vitality of the financial services operations of U.S. companies and the hundreds of thousands of U.S. jobs this sector supports.

I. The Active Financial Services Provision is Critical to U.S. Competitiveness

Without the subpart F active financial services provision, the active foreign financial services operations of U.S.-based companies would be subject both to tax in the market in which they operate and also to immediate U.S. tax (to the extent not offset by foreign tax credits). In contrast, foreign competitors are subject only to tax in the market in which they operate. Allowing the subpart F active financial services provision to expire would subject the foreign financial services operations of U.S. companies to a current tax burden not imposed on any of their competitors. No other country subjects its companies to current tax on active financial services income earned abroad.

Expiration of the subpart F active financial services provision would represent a substantial tax increase on U.S. companies with global financial services operations. In the financial services business, companies compete almost exclusively on price and not on product differentiation or brand loyalty. If the U.S. tax law puts U.S. companies at a competitive disadvantage in the global financial services markets, foreign firms will use their advantage to take business and market share. The ability of U.S. financial services companies to compete for customers or business acquisition opportunities in foreign markets will be compromised. In addition, the ability of U.S. manufacturing firms to finance the goods they produce for sale in foreign markets will diminish, which could mean the loss of sales and U.S. jobs.

II. Competitiveness Requires Stability in the Law.

Whether financing the sale of manufactured goods, pricing leasing contracts, entering into other financial transactions, or making acquisitions of financial services businesses worldwide, many of the decisions made by the financial services operations of U.S. companies are long-term in nature. These decisions and the resulting business obligations cannot be stopped and started on a year-to-year basis. The U.S. tax implications must be taken into account in setting prices for proposed transactions and in determining which global business opportunities to pursue. The current temporary nature of the subpart F active financial services provision has an adverse effect on the ability of U.S.-based financial services firms to make current business decisions and to plan for the future. Uncertainty about whether active financial services income earned in the global markets will be subject to current U.S. tax in addition to local tax must be factored into business planning. In a business where pricing a transaction comes down to a fraction of a point, this uncertainty can mean the difference between success and failure for U.S.-based companies. Indeed, this uncertainty can make it impossible for U.S. firms to even make a bid on a transaction.

A U.S. company competing against a foreign-owned financial services company is at a competitive disadvantage if it cannot assume a stable, rational U.S. tax system for the duration of the contemplated transaction. A permanent subpart F active financial services provision will allow U.S.-based financial services businesses to compete effectively with the same certainty that their foreign competitors enjoy. Active financial services

operations are universally recognized as generating active trade or business income by our major trading partners (*e.g.*, France, Germany, the United Kingdom, and Japan). The competitiveness of the industry is evidenced by the fact that foreign acquisitions of U.S. companies in the financial services sector have far exceeded U.S. acquisitions of foreign companies. The objective of leveling the playing field for U.S. companies competing in the global financial services markets will be realized only by making the subpart F active financial services provision permanent.

III. U.S. Jobs Are at Stake.

The stability and growth of the U.S. financial services sector depends on its ability to compete effectively in foreign markets. If the U.S. tax law operates to disadvantage U.S. firms in global markets, foreign firms will fill the void. The U.S. companies' loss of the opportunity to serve the foreign markets will be felt here at home. The thousands of back office and other jobs associated with supplying and supporting these foreign business operations could be threatened. In contrast, a permanent subpart F active financial services provision that allows U.S. companies to compete successfully in the global markets will translate into growth in the domestic operations that support that international business and that provide high-paying U.S. jobs.

The ability to compete in foreign financial services markets also is critical to the U.S. manufacturing sector. In order to be able to compete for the export sale, U.S. companies must be able to offer competitive financing. Thus, a permanent subpart F active financial services provision is critical to the maintenance and expansion of U.S. manufacturing operations and jobs.

IV. A Permanent Subpart F Active Financial Services Provision Represents the Right Tax Policy Choice.

When Subpart F was first enacted in 1962, the intent was to impose current U.S. tax on foreign income that was passive in nature. Thus, the 1962 law was drafted to avoid subjecting active business income to current taxation. Income derived from transactions with unrelated parties in the active conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves, was specifically excluded from current taxation. As part of the revenue raising component of the 1986 Act, however, an immediate U.S. tax was imposed on active business income of foreign financial services subsidiaries.

From a tax policy perspective, financial services businesses should be eligible for the same U.S. tax treatment of worldwide income as that afforded other active businesses. Therefore, Congress reversed the 1986 changes in the Taxpayer Relief Act of 1997, and again provided the financial services industry the basic treatment provided to other active business income.

The subpart F active financial services provision includes strict and detailed rules for qualification for the provision. These qualification requirements ensure that foreign

affiliates of U.S. corporations must be actively engaged in a financial services business in a foreign market serving local customers. The provision is working as the Congress and Treasury Department intended.

A permanent subpart F active financial services provision will ensure that American financial services businesses can rely on continuing to be taxed in a manner that is consistent with the long-standing tax policy goal of leveling the playing field between U.S. businesses and their foreign competitors.

CONCLUSION

We urge the Congress to make the subpart F active financial services provision permanent this year. Without this legislation, the foreign financial services operations of U.S. companies would be subject to a current tax burden not borne by their foreign competitors. This legislation, which will afford America's financial services industry parity with other segments of the U.S. economy, is essential to ensuring the ability of U.S. companies to compete successfully in the global financial services markets.



AMERICAN FOREST & PAPER ASSOCIATION

GROWING WITH AMERICA SINCE 1861

WRITTEN STATEMENT FOR THE HEARING RECORD ON

**“Description and Analysis of
Certain Federal Tax Provisions Expiring in 2005 and 2006”**

COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, DC

April 15, 2005

The American Forest & Paper Association (AF&PA) is the national trade association for the forest products industry. We represent more than 200 companies and related associations that engage in or represent the manufacturers of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from the state-of-the-art paper mills to small, family owned sawmills and some 10 million individual woodlot owners. The U.S. forest products industry is vital to the nation's economy. We employ approximately 1.3 million people and rank among the top ten manufacturing employers in 42 states with an estimated payroll of \$50 billion. Sales of the paper and forest products industry top \$230 billion annually in the U.S. and export markets. We are the world's largest producer of forest products.

Today, the U.S. forest products industry is facing serious domestic and international challenges. Since 1997, 101 pulp and paper mills have closed in the U.S., resulting in a loss of 70,000 jobs, or 32% of our workforce. An additional 67,000 jobs have been lost in the wood products industry since 1997. New capacity growth is now taking place in other countries, where forestry, labor, and environmental practices may not be as responsible as those in the U.S.

Energy is the third largest operating cost for the forest products industry. In the pulp, paper and paperboard sector of the industry, energy makes up 10-15 percent of the total operating costs. Since 1972, our industry has reduced its average total energy usage by 17 percent through increased efficiencies in the manufacturing and production process. In addition, we have reduced our fossil fuel and purchased energy consumption by 38 percent, and increased our energy self-sufficiency by 46 percent.

The American Jobs Creation Act (H.R. 4520) included a provision to expand the Section 45 tax credit to include open-loop biomass. For purposes of the credit, open-loop biomass is defined as any solid, non-hazardous, cellulosic waste material which is segregated from other waste materials and which is derived from forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill and harvesting residues, pre-commercial thinnings, slash, and brush. The 2005 credit for electricity produced from open-loop biomass facilities is 0.9 cents per kilowatt hour compared with 1.9 cents per kilowatt hour of electricity generated from closed-loop biomass facilities. To qualify for the credit for both open and closed-loop biomass, the facility must be placed in service prior to January 1, 2006.

The forest products industry is the largest user of biomass for energy production, which is used largely to fuel our wood and paper manufacturing facilities. In addition to biomass like bark, sawdust, and other residues from the wood harvesting and product manufacturing processes, the industry uses biomass in the form of "spent pulping liquors." Spent pulping liquors are created as a residual during the pulping process, and the wood residuals (mostly lignin) are burned in a process that separates and recovers the chemicals for reuse and captures the heat value from the lignin to create steam and electricity. In total, the forest products industry currently uses biomass to generate 60% of its power needs. With continued research and development of new technologies, and expanded tax incentives, the potential exists to greatly increase our industry's capacity for energy production.

Regarding Section 45, the placed in service date for facilities that produce electricity from open-loop biomass needs to be extended from January 1, 2006 to January 1, 2010. Such projects take several years to complete and the industry needs the certainty of knowing that the current tax credit will be available in the future to take the risk of making the investment. At the very minimum, Congress should extend the placed in service date to January 1, 2008 as the Administration proposed in its FY 2006 budget.

Also, clarification is necessary to the Section 45 definition of open-loop biomass to ensure inclusion of the lignin content from spent pulping liquors used to produce electricity at new or expanded facilities. Wood is composed primarily of cellulose (wood fibers) held together by lignin. Wood bark is composed of hemicelluloses. Pulping chemicals are used to dissolve the wood used for making paper. The cellulose fibers become paper products, the pulping chemicals are recycled from recovery boilers for reuse in the pulping process, and the wood residues (mostly lignin) are used to generate heat for making steam and electricity.

Finally, the current inflation adjusted tax credit of 0.9 cents per kilowatt hour needs to be increased to 1.5 cents per kilowatt hour to make the additional electricity produced competitive with other traditional forms of electric generation. The increased tax credit would provide a critical incentive for new investments in energy production facilities connected to current paper mill infrastructure, thus helping to improve the competitive position of the forest products industry.

We appreciate the Committee's interest in our thoughts on the need to extend and modify the Open-Loop Biomass component of the Section 45 tax credit.



655 15TH STREET, N.W., SEVENTH FLOOR
 WASHINGTON, D.C. 20005-5701
 TELEPHONE: 202/452-8444
 FAX: 202/220-0873
 E-MAIL: FMI@FMI.ORG
 WEBSITE: WWW.FMI.ORG

March 16, 2005

The Honorable Charles Grassley
 Chairman
 Senate Finance Committee
 United States Senate
 Washington, DC 20510

Dear Chairman Grassley:

On behalf of the Food Marketing Institute, your neighborhood supermarkets, I submit this statement as part of the hearing record for the March 16 hearing regarding the extension of the Work Opportunities Tax Credit (WOTC) and the Welfare-to-Work (WWTC) tax credit.

We strongly support legislation introduced by Sen. Rick Santorum and Sen. Max Baucus, S. 595, making these credits permanent and preventing them from expiring on December 31, 2005. For the labor-intensive food retailing industry, the WOTC has helped integrate economically disadvantaged Americans into the national work force and often in grocery stores within their own neighborhoods. Our industry believes these credits are an effective approach for encouraging private sector employers to hire individuals from groups that otherwise would have difficulty securing employment in either good or bad economic times. You heard testimony by Dale Giovengo, on the innovative program run by Giant Eagle, Inc., headquartered in Pittsburgh, PA.

We also support the improvements to the programs proposed in the legislation to consolidate the WOTC with the WWTC. With more individuals entering the workforce from welfare, our neighborhood supermarkets are increasingly training and hiring those who are less skilled and more costly to train.

Supermarkets play an important role in creating and maintaining strong neighborhoods. Our members are significant employers in many inner city and rural communities across America. They provide basic products and services essential to life and health. They are places where neighbors gather and interact in productive ways. Many young people find their first job in a supermarket. They provide flexible work schedules, with many stores open 24 hours a day, 365 days a year. These characteristics provide supermarkets with the unique opportunity to play a leadership role in developing programs to address the social and economic challenges of the neighborhoods and communities they serve.



Y O U R N E I G H B O R H O O D S U P E R M A R K E T S

Page 2
Food Marketing Institute

The WOTC program has provided incentives for employers to take a risk they might not normally have taken. It has become a recruitment tool for store managers. For employees, it has taught skills, helped to develop good work habits, established independence, created a positive job profile and helped with employment history. New hires have started as cashiers, baggers, deli, grocery or produce clerks and over time remain with the store, gaining experience and receiving important benefits, such as health care coverage.

Since WOTC was first enacted in 1996 on an experimental basis, with WWTC following a year later, hundreds of thousands of welfare recipients have moved into the productive work force. The credits offset a portion of the higher costs of recruiting, hiring, training and supervising those with few job skills and little or no work experience. Unfortunately, the one-year extensions granted in the past two years have limited the program's effectiveness. Last year's 10 month hiatus prompted some companies to stop participating, while others reduced their hiring efforts. By making these credits a permanent part of the tax code, companies will have a longer planning horizon, better outreach to eligible workers and the ability to develop more cost effective recruitment and training programs. Thank you for considering FMI's views.

FMI also strongly supports permanent extension of the 15-year depreciation life for leasehold improvements. The provision should provide policy parity by also providing a 15-year life for improvements to retail property that is owned by the taxpayer. Without this modification, supermarkets that own their store property will be placed at a competitive disadvantage to other retailers who lease their property. The American Jobs Creation Act of 2004 included a provision returning the depreciation period for improvements to 15 years, but only for improvements made to leased property. In addition, the change was temporary, with the period returning to 39 years at the end of 2005 if not extended by Congress. The 39-year period greatly exceeds the life of improvements, often made every five to seven years.

Please make the 15-year depreciation period permanent and extend it to include owned stores in addition to leased stores. Approximately half of retail stores are owned and the other half leased.

Depreciation legislation has yet to be introduced in the Senate, but House legislation introduced by Representative Clay Shaw, R-FL, would apply the 15-year period to all retail property -- both owned and leased -- and make it permanent.

Sincerely,



John J. Motley III
Senior Vice President
Government and Public Affairs

cc: Senator Rick Santorum
Senator Max Baucus



March 30, 2005

The Honorable Chuck Grassley
 Chairman, Senate Finance Committee
 United States Senate
 219 Dirksen Senate Office Building
 Washington, DC 20510-6200

Dear Chairman Grassley:

On behalf of the 87 Washington, DC hotels in our membership, I respectfully request that the Senate Finance Committee support an available and predictable extension of the DC Enterprise designation and the Homebuyer's Credit through 2009, which would simply conform the termination of the District's designation to the expiration of every other Empowerment Zone and Renewal Community in the nation.

As you well know, the District of Columbia cannot rely on state support to provide a fiscal cushion in periods of economic downturn and distress. Despite this lack of support, Washington, DC has witnessed marked financial stability and growth, in large part due to the available and consistent incentives in the Enterprise Zone designation and the First-Time Homebuyer Tax Credit, local initiatives, as well as the city's reliance on the substantial activity of the federal and tourism sectors. The abrupt loss of our federal partner will have a direct, negative impact on the economic momentum that our partnership is creating.

Nothing discourages capital investment and economic development like uncertainty. During last year's "temporary" expiration of the DC Zone, for example, prospective EZ Bond clients were forced to cancel or significantly curtail their development plans. To ensure that the economic revitalization in the District we are witnessing reaches the areas of the DC Zone that have not been transformed as well as those adjacent areas that continue to exhibit consistently high levels of poverty, unemployment, business disinvestment and crime, it is extremely important that these federal incentives remain predictable and certain. Extending these benefits will further increase our city's tax base by encouraging our members to hire District residents.

I thank you for the opportunity to provide comments to your Committee and I look forward to continuing a partnership to encourage the viability of the nation's Capital city.

Respectfully,

Emily Durso
 President

cc: The Honorable Max Baucus, Ranking Member
 Members – Senate Finance Committee
 The Honorable Eleanor Holmes Norton
 Joe McInerney, President, American Hotel & Lodging Association

HOTEL ASSOCIATION OF WASHINGTON, D.C.
 1201 NEW YORK AVENUE, N.W. ♦ SUITE 601 ♦ WASHINGTON, D.C. 20005-3931
 (202) 289-0584 phone ♦ (202) 289-8849 fax
 www.hawdc.com



**Comments Submitted by the National Employment Opportunities Network
In Response to the March 11, 2005 Report of
The Joint Committee on Taxation on
“Certain Federal Tax Provisions Expiring in 2005 and 2006”
Submitted
April 15, 2005**

The National Employment Opportunities Network (NEON), an association of companies that participate in and/or assist others who participate in federal and state employment incentives programs, is grateful to Senators Grassley and Baucus for the opportunity to submit these comments relative to the Joint Committee on Taxation’s (JCT’s) recent report on “Certain Federal Tax Provisions Expiring in 2005 and 2006.” We are also grateful to the Committee on Finance for considering proposals to improve and extend the work opportunity and welfare to work tax credits early in this session of Congress.

While we agree with the Joint Tax Committee staff’s general overview of the operation of these credits, we believe that the JCT staff’s comments are far more pertinent to WOTC’s predecessor, the targeted jobs tax credit (“TJTC”), which ceased to exist in 1996.

With that in mind, however, we do agree with the JCT staff’s opening statement in their analysis that “WOTC is intended to increase the employment and earnings of targeted group members” and that “employers will not hire certain individuals without a subsidy, either because the individuals are stigmatized (e.g., convicted felons) or the current productivity of the individuals is below the prevailing wage rate.” WOTC as well as its predecessor program, TJTC, were designed to provide certain groups of individuals with little or no basic work skills and experience a hiring preference in order to encourage employers to hire them before they become altogether unemployable. Economists generally refer to individuals in these categories as “structurally unemployed.”

Given this background, we are surprised at the JCT staff’s following statement that the “number of jobs created by the WOTC is certainly less than the number of certifications of eligible workers. To the extent employers substitute WOTC-eligible individuals for other potential workers, there is no net increase in jobs created.”

In fact, WOTC was never designed as a job creation program, but rather, its purpose is to encourage employers to hire certain individuals who might otherwise never get hired. The success of WOTC cannot and should not be measured by whether employment generally increases in the aggregate, but instead, as to whether employment among WOTC-eligible individuals increases, and in that respect, WOTC has been extremely cost efficient and successful.

We take issue as well with the suggestion that “[t]he structure of the WOTC appears to lend itself to the potential of employers churning employees who are eligible for the credit” by firing employees after they earn \$6,000, the maximum amount that is creditable, and replacing them with new WOTC-eligible employees. In fact, it is in any employer’s interest to reduce employee turnover and promote workers who perform successfully, and the potential of \$1,560 in tax savings that the JCT staff identifies as resulting from hiring a WOTC-eligible employee over one who is not eligible is hardly enough to offset the additional training costs, workplace disruption, and administrative burdens that would result from churning.

Perhaps the JCT staff’s conclusions suffer from a misunderstanding of the differences between WOTC and its predecessor program, TJTC, and in that regard, we cannot help but note the statement, which is grounded on studies of the TJTC, to the effect that “[a] necessary condition for the credit to be an effective employment incentive is that firms incorporate WOTC eligibility into their hiring decisions.”

It is true that under TJTC employers generally engaged in only a limited amount of outreach to prospective credit-eligible employees. In large part, employers were concerned about asking prospective employees questions about their credit eligibility because of the possibility that such questions might subject prospective employers to liability under various nondiscrimination statutes, a concern that was raised repeatedly to Congress and to the EEOC. As a result, employers often operated on the basis of an “educated guess” regarding whether a potential hire was TJTC-eligible, and the law only required that they attempt to narrow the possible categories to which any prospective employee might qualify to no more than two.

The opposite is true with respect to WOTC; in effect, employers participating in WOTC **must** make the program a part of their hiring decision. As part of the program, Congress incorporated the requirement that prospective WOTC-eligible employees complete IRS Form 8850 (Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare to Work Credit) prior to being offered employment. That form, which has been approved by the Equal Employment Opportunity Commission, requires employees to disclose to their prospective employers the WOTC category they would fall under. The WOTC statutory requirements for pre-screening impose strict deadlines on employers: (1) the pre-screening notice must be completed on or before

the day on which the prospective employee is offered employment; and (2) the pre-screening notice, signed by both the employer and the employee, must be sent to the state employment services agency no later than twenty-one (21) days after the individual begins work. In order to meet these deadlines with respect to credit eligible employees, companies that participate in WOTC make a major investment in internal procedures and rules for hiring managers to ensure that the forms are properly completed and timely filed, and participate in outreach programs to locate and recruit credit-eligible employees.

The changes that were made by way of the enactment of WOTC have succeeded in ensuring that “firms incorporate WOTC eligibility into their hiring decisions.”

Given the changes in the law as a result of the enactment of WOTC, we believe that prior studies of TJTC are no longer relevant. However, a more recent study of the operation of WOTC by the New York State Department of Labor entitled “The Work Opportunity Tax Credit/The New York State Experience – 1996-2003” is responsive to the JCT staff’s concerns regarding retention and churning.

According to the New York State study, “roughly 58 percent of the TANF recipients who entered private sector employment with the assistance of WOTC were found not to receive any public assistance benefit when their cases were later examined in 2003,” suggesting that these individuals remained in the job market fulfilling the basic purpose of WOTC. Moreover, despite the extreme high turnover rates that exist traditionally in the service and retail sectors (almost 100 percent), New York found that nearly twenty-three percent (23%) of TANF recipients who entered the job market with WOTC remained with their original employer for **two years** after being hired. In effect, after making a considerable investment to locate and recruit WOTC-eligible employees, employers have every incentive and desire to keep them on their payrolls. According to the New York State study, in most cases when an employee left, it was because they received a hire wage, found a job closer to home or more convenient to better transportation, or found a better day care option

New York also concluded that the cost of WOTC in terms of reduced tax revenues was more than offset by the savings to taxpayers in reduced public assistance and incarceration expenditures as a result of moving individuals from welfare to work. (A copy of the New York study is attached).

While WOTC has been a very successful program and a significant improvement in many respects over its predecessor, there is always room for additional improvement. NEON is therefore very grateful to Senators Santorum and Baucus for proposing S. 595 which would add additional improvement to the program and to Chairman Grassley for holding a hearing in March to consider improvements to WOTC, and urges the Committee on Finance to enact this legislation as early as possible in this Congressional session.



March 15, 2005

The Honorable Charles E. Grassley
United States Senate
Washington, DC 20510

The Honorable Max Baucus
United States Senate
Washington, DC 20510

Dear Mr. Chairman and Senator Baucus:

The National Retail Federation submits the following comments in conjunction with the March 16 Senate Finance Committee hearing on "Certain Federal Tax Provisions Expiring in 2005 and 2006." In particular, the NRF offers comments on the provisions relating to leasehold improvements, work opportunity tax credit (WOTC) and welfare-to-work tax credit (WWTC).

The NRF strongly supports permanent extension of the 15-year depreciation life for leasehold improvements but believes the provision must be modified to also provide a 15-year life for improvements to retail property that is owned by the taxpayer. If this modification is not made, retailers that own their property will be placed at a competitive disadvantage vis-à-vis retailers that lease their property.

The NRF also supports permanent extension of WOTC and WWTC. However, the NRF believes that these two tax programs should be combined to reduce administrative burden and complexity.

By way of background, NRF is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet and independent stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers - and 2004 sales of \$4.1 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

Depreciation of Leasehold Improvements

The existing 39-year recovery period for real estate grossly overstates the useful life of structures and, even more so, the improvements made to structures, increasing the cost of capital and distorting business decisions. Studies conducted by the Treasury Department¹, Congressional Research Service² and private economists³ have all found that the depreciation life for buildings is too long and that the depreciation life for building improvements is even worse. In fact, tax depreciation rules for investment in nonresidential structures may be the only type of investment where tax rules provide for decelerated cost recovery. As a result, current depreciation allowances generate high tax costs for these investments and reduce investment in these projects.

In the retail trade sector of the economy, structures and especially their improvements rarely last 39 years. Retailers generally remodel their stores every five to seven years to reflect changes in customer taste and needs. Remodeling is needed to maintain the retailer's customer base and compete with newer stores. Moreover, many improvements, such as interior partitions, ceiling tiles, restroom accessories, paint, etc., may only last a few years before requiring replacement.

A provision to temporarily reduce the depreciable life of *leasehold* improvements from 39 to 15 years was included in the American Jobs Creation Act of 2004. Under this provision, improvements made to buildings that are leased would be depreciated over 15 years, but improvements made to buildings that are owned would still have to be depreciated over 39 years. The leasehold improvement provision will expire for property placed in service after December 31, 2005.

Approximately, half of retail stores are leased and about half are owned by the retailer. For retailers that lease their property, the leasehold improvement provision greatly reduces the cost of improvements to their stores. However, the leasehold improvement provision puts retailers that own their stores at a competitive disadvantage because they must continue to write-off store improvements over a 39-year period.

¹ *Report to the Congress on Depreciation Recovery Periods and Methods*, Washington, D. C.: U.S. Department of the Treasury, July 2000.

² Jane G. Gravelle, *Depreciation and the Taxation of Real Estate*, Congressional Research Service, The Library of Congress, Washington, D.C.: May 5, 1999.

³ See, for example, Deloitte and Touche, LLP., *Analysis of the Economic and Tax Depreciation of Structures*. Washington, D. C., June 2000.

For example, if a small retailer who owns his store on Main Street needs to refurbish his customer restroom facilities, he will have to depreciate the cost over 39 years. However, if a chain store that leases space in a strip mall has to refurbish its customer restroom facilities, it can depreciate the cost over 15 years. This creates a large discrepancy in tax treatment based on whether the store is leased or owned.

The Joint Tax Committee in its report on expiring tax provisions questions whether the leasehold improvement provision's bias toward leasehold retail property improvements over non-leasehold retail property improvements is appropriate⁴. We agree that the tax code should not provide an incentive to lease rather than own similar property. However, this bias can easily be remedied by extending the terms of the provision to apply to improvements to retail space, regardless of whether leased or owned.

Complexity

The Joint Tax Committee report also states that the leasehold improvement provision creates complexity by creating an additional property class. The NRF does not believe that creating a new property class for improvements to buildings will add complexity. On the contrary, we believe that it can ease a lot of complexity currently associated with determining whether an asset is a structural improvement or tangible personal property.

Because there is such a large difference between the depreciable life of a building improvement (39 years) and tangible personal property in the retail industry (generally 5 years), taxpayers go through great efforts to try to prove that assets are personal property. Many sophisticated taxpayers engage service providers to perform cost segregation studies to prove that assets are not, in fact, structurally part of the building. These studies may itemize hundreds or thousands of individual elements used in constructing a building and distinguish whether they are structural components or personal property. IRS' auditing of the issue of asset classification is one of the largest areas of controversy between IRS and retailers.

On December 16, 2004, the IRS issued a Field Directive on Planning and Examination of Cost Segregation Issues in the Retail Industry, the purpose of which was to provide direction to agents so that they might more efficiently utilize resources in examining depreciation issues. That guidance lays out the IRS' position on virtually every asset used in retail facilities. Because one of the primary tests IRS uses to determine if the asset is a structural improvement is whether the asset is *affixed* to the property, the Directive seems to have some absurd results. For example, the Directive tells agents that restroom accessories, like toilet paper holders and baby changing stations, have a 39-year life as

⁴Joint Committee on Taxation, *Description and Analysis of Certain Federal Tax Provisions Expiring in 2005 and 2006* (JCX-12-05), March 11, 2005, at p. 50.

structural building improvements because they are mounted on walls or partitions. This Field Directive is likely to increase controversy between the retail industry and the IRS.

If Congress created a single 15-year life for improvements to retail structures, we believe it would increase simplicity by eliminating a lot of controversy and need to focus so many resources on segregating assets.

Work Opportunity Tax Credit and Welfare to Work Tax Credit

The NRF supports permanent extension of WOTC and WWTC and believes that combining these programs would ease administration.

WOTC and WWTC are important tools for employers to add jobs, especially among certain classes of individuals that might otherwise face difficulty in gaining employment. These programs provide the resources for job training that is so important in bringing these targeted classes into the labor market.

Conclusion

The economic data is clear that the depreciable life for improvements to buildings is far too long. The shortened depreciation life for leasehold improvements needs to be expanded to include improvements made to non-leasehold retail property, and the provision should be made permanent. Shortening the depreciable life for building improvements should greatly ease complexity in the tax law by reducing the tension on segregation of assets.

WOTC and WWTC should be combined and made permanent. Eliminating the temporary nature of tax provisions also reduces complexity in the system.

**Help Is Needed to Enable the Federal Research Tax Credit
to Meet Its Intended Purposes**

**Written Testimony Submitted by
Professor Annette Nellen*
College of Business
San José State University
March 16, 2005**

**For a Senate Finance Committee Hearing:
"Expiring Tax Provisions: Live or Let Die"
March 16, 2005**

Key Consideration – Make the Credit Permanent

On December 31, 2005, the federal tax research credit will expire for the 11th time since this temporary provision was added to the Internal Revenue Code in 1981. There are economic reasons for having the research credit, as explained in numerous reports. It is unlikely that the research credit is fully achieving its intended purpose due to some imperfections, most notably its continuous temporary nature. This testimony notes some of the questions that need to be examined in helping to make the research tax credit as effective as possible in promoting and supporting U.S. research. It should be noted though, that the most significant improvement would be to make it permanent so it can be more effectively relied upon and incorporated into research and financial planning decisions businesses need to make in order to operate.

Brief Background to the Research Credit

The credit for increasing research activities (IRC §41) was originally enacted as part of the Economic Recovery Tax Act of 1981 (ERTA) (P.L. 97-34, 8/13/81). ERTA was part of same tax act that created ACRS to provide an "investment stimulus" necessary for economic expansion. ERTA has been described as a "tax reduction program [to] help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy..." In 1981, Congress was "concerned that the performance of the economy had fallen far below its potential."¹

The credit was set to expire after five years so its effectiveness could be determined before making this incentive a permanent part of the law. It has been extended numerous times since 1985 and the formula to calculate the credit has been modified and the category of qualified research expenses eligible for the credit reduced. The credit is currently set to expire on December 31, 2005 – its 11th expiration date since 1985.²

¹ General Explanation to the Economic Recovery Tax Act of 1981 (Blue Book) prepared by the staff of the Joint Committee on Taxation, Section III.

² There are many reports on the federal research credit. For a recent one, see Staff of the Joint Committee on Taxation, *Description and Analysis Of Certain Federal Tax Provisions Expiring in 2005 & 2006*, JCX-12-05, March 11, 2005.

* This testimony represents the view of Professor Annette Nellen and not necessarily that of her employer.
Contact information: anellen@sjsu.edu (408) 924-3508, San José State University, San Jose, CA 95192-0066

Policy Points

Based on legislative histories related to the research credit, the credit is intended to:³

- Encourage businesses to incur costs for research projects despite the reluctance owing to uncertain rewards and significant costs;
- Serve as an incentive to stimulate productivity to lead to greater private activity in research;
- Address the decline in R&D activities in the U.S. that adversely affect economic growth and competitiveness in world markets; and
- Encourage taxpayers to conduct research in the U.S.

The credit was designed to reward research beyond a base amount. The rationale for an incremental credit is that it does not reward research that would have been done anyway.

There appears to be a consensus that there is an economic rationale for government support of research, such as by a tax credit. In a 1985 study on the effectiveness of the credit, the Joint Economic Committee stated:

“[T]he total rate of return on private R&D greatly exceeds the private rate of return. That is, private R&D gives rise to benefits to society at large well in excess of the profits it generates for the company that funds the R&D. Such "spillover benefits" or "neighborhood effects" thereby put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility.”⁴

Various government and private studies have indicated that government incentives for research are justified in that society's rate of return on research exceeds that of the company incurring the research costs and risks. Thus, the company conducting the research and incurring the costs will not be able to completely reap the rewards of its research because some of the benefit will spill over to others. For example, although research leading to an innovative new drug can be protected by a patent to help a company obtain the economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.

Of course, despite the economic basis for government support of research, the question remains as to how best to support it and how much support should be given. As noted in a 2000 Congressional Research Service report, very little support for research is provided by the government via the tax credit.

“Within the broad spectrum of federal support for R&D, the credit has played a relatively minor role in dollar terms since its inception in July 1981. This can be readily seen by comparing the cost of the credit (measured in equivalent federal outlays) to total federal spending on R&D.¹³ In FY 1998, according to estimates by the U.S. Office of Management and Budget, the outlay equivalent of the credit totaled \$3.3 billion, or 4.3% of federal R&D outlays that year. From FY 1993 through FY 1997, the outlay equivalent of the credit averaged 2.5% of federal R&D spending.”⁵

³ For example, see Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 31, 1981, pages 119 to 121.

⁴ "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4.

⁵ Gary Guenther, *The Research and Experimentation Tax Credit: Current Law and Selected Policy Issues for Congress*, CRS Report, March 20, 2000.

¹³ The outlay equivalent of the R&E tax credit is the federal dollars that would have to be spent to give firms the same after-tax benefits provided by the credit. In effect, it estimates how much the federal government would have to spend to duplicate the added research stimulated by the credit. See Office of Management and the Budget, *Budget of the United States Government, Fiscal year 2000: Analytical Perspectives*. Washington, U.S. Govt. Print. Off., 1999. P. 116-117.

Both government and private studies have shown that the research tax credit has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, *The Research Tax Credit Has Stimulated Some Additional Research Spending*, stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."⁶ This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between \$1 billion and \$2.5 billion of additional spending for the 5 years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.⁷

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional spending of about \$2 billion per year with foregone tax revenues of about \$1 billion per year.⁸

As noted in two government reports, studies of the research credit may not have captured its complete benefits because of the sometimes long lead times for research projects and changes made to the credit since 1981, particularly in 1989.⁹ A 1993 report noted that the 1989 changes likely increased the credit's incentive effect "substantially" and may have increased the credit's impact "beyond what is shown by the existing data."¹⁰

The federal research tax credit is intended to encourage increased research spending in the U.S. This incentive was intended to serve to help companies overcome the reluctance to incur significant costs of research for uncertain rewards. "The Congress believed that the provisions of the Act, which are designed to stimulate a higher rate of capital formation and increased productivity, appropriately include incentives for greater private activity in research by operating businesses."¹¹

There are issues regarding the operation of the credit which may limit the ability of the credit to best reach the goals established for it back in 1981 which have been re-emphasized in later legislative changes to the credit. A review of the policy behind the credit as evidenced from legislative histories to Acts modifying the credit indicates a fairly constant intent since 1981. The operation of the credit calculation, use of ambiguous terms, and the non-permanence of the credit though, call into question whether the goal

⁶ "The Research Tax Credit Has Stimulated Some Additional Research Spending," by GAO, GAO/GGD-89-114, Sept. 1989, pg. 22.

⁷ 1989 GAO report, *supra*, pg. 22.

⁸ "R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, pg. 29. The author also noted that the investment incentives of the research tax credit should also consider the interaction of the foreign tax credit and the AMT. Pgs. 28 - 30.

⁹ Prior to the 1989 changes to the research tax credit, the amount of the credit was based on a rolling base period of research expenditures. There was some disincentive built into such a system because more dollars spent on research today would result in a smaller credit in future years. "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4., also noted that the temporary nature of the credit "has detracted from its effectiveness" (pg. 1).

¹⁰ "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 1 and Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993.

¹¹ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 31, 1981, page 120.

of encouraging increased research in the private sector is best being achieved. Several of these issues are explained next.

Issues Affecting the Credit's Ability to Meet Its Policy Goal of Encouraging and Increasing U.S. R&D Activities

As noted earlier, making the credit permanent would be a significant improvement to its effective operation, which is long overdue. It is important to note though, that the research credit has other imperfections that should be addressed to ensure it is best meeting its intended goals of improving the economy through increased research activities. Key issues with the research credit are summarized below.

- 1) Non-permanency— Research activities generally involve a long-term view; thus, research incentives that focus on the short-term cannot be fully beneficial and effective. Also, in making long-term plans, a short-term and uncertain incentive will not factor completely into all aspects of the decision-making process. Therefore, with only a temporary credit, the complete goal of increasing research activities may not be fully realizable by businesses, and ultimately, the U.S. economy. Additional support for a permanent credit is the premise that increased research activity increases productivity and growth in GDP, wages and labor skills.
 Also, arguably, lack of a permanent incentive puts the U.S. at a competitive disadvantage in the global economy because many countries offer permanent incentives. Many of these countries actively pursue U.S. companies encouraging them to open R & D facilities in their country and to take advantage of tax savings opportunities.
 "Foreign governments are competing fiercely for U.S. research investments by offering tax and other financial incentives. We can no longer assume American companies will automatically choose to site their R&D in the U.S. A permanent, robust U.S. R&D tax credit is essential to help ensure that U.S. companies keep the majority of their R&D function, and R&D jobs, in the U.S."¹²
- 2) Size of benefit—While the standard research tax credit formula uses a 20% rate, the effective rate is much smaller due to the incremental nature of the credit and the reduction required by IRC §280C(c). The maximum credit possible equals 6.5% of the current year's qualified research expenditures (QRE). Also, since not all §174 expenditures qualify as QRE, the ratio of the credit to total IRC §174 R&D expenditures is in most cases less than 6.5%. Query: Is the rate high enough for the credit to best achieve its intended purpose?
- 3) In-house and contract research expenses—"Because of difficulties for taxpayers and the [IRS] in distinguishing research expenditures from nonresearch expenditures, and in order to limit the credit to principal types of research expenditures which distinctly reflect the extent of increased research activities, the credit is limited to certain direct wage, supply, and equipment research expenditures (or a specified percentage of contract research expenditures). The credit is not allowed for other types of research expenditures, or for indirect, administrative, or overhead expenditures."¹³ An additional rationale for limiting the types of §174 expenditures that qualify for the credit is to better enable the credit to focus on expenditures that might not have been incurred but for the research tax credit (the incentive nature of the credit).

¹² Statement of Congressman Neal (MA), before House Subcommittee on Oversight, Committee on Ways and Means, May 10, 1995; 95 TNT 92-59.

¹³ Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 31, 1981, page 120.

It has been estimated that QRE covers about 60% of all R&D actually conducted.¹⁴

The selection of limited categories of R&E expenditures that qualify for the research credit can have varying impacts on different industries. For example, a labor-intensive taxpayer may be able to generate a higher research tax credit than a capital-intensive one because depreciation is not a QRE. Is the limitation on the types of R&D expenditures that qualify for the credit appropriate given the purpose of the credit?

- 4) Base amount—The base amount serves to reward the research credit only for research that would not have otherwise been undertaken. The credit began in 1981 with a moving average approach to calculating the base amount. However, this was changed in 1989 because the moving average encouraged taxpayer's to increase QRE, yet that resulted in a potentially lower percentage in the next period. Some of the issues with the base amount tied to a ratio of QRE to gross receipts for the period 1984 – 1988 is that the base becomes outdated or too rigid for some companies. For example, because product mix and research strategies change over time, requiring all taxpayers to use a fixed period of 1984 through 1988 in calculating the credit can demand unrealistic activities in future years in order to obtain any incentive for research. For example, the product mix and research spending and strategy for many aerospace and defense companies have changed since 1984 due to decreased defense spending by the government. However, the current version of the research credit ignores this fact and requires such companies to engage in unrealistic levels of research spending in order to receive any incentive for their research.

Because the research tax credit provides an incentive for research spending beyond the taxpayer's base amount, a credit might be denied to a taxpayer that has become more efficient at research, and thus spends less, but has actually increased research activity. Of course, it would be difficult to account for this change in the credit formula.

- 5) 50% base amount limitation—If the actual base amount is less than 50% of the current year QRE, then 50% of current year QRE must be used as the base amount. For example, if a company's base amount is \$50 and its current year QRE is \$120, its base amount for calculating the credit is \$60 (50% of current year QRE), rather than \$50 (the actual base amount). Since a lower base amount generates a higher credit, the 50% base limitation reduces this taxpayer's research tax credit.

The 50% base amount limitation serves as a cap on the credit (basically limits it to 10% of QRE – which is then further reduced to 6.5% by §280C(c)). This 50% base rule serves to limit the credit for companies with a large increase in QRE over the base amount.

Example: Base amount = \$10

Current QRE = \$20

Credit = 20% x \$10 = \$2

Modification: Base amount = \$10

Current QRE = \$30

Credit = 20% x \$15 = \$3 (so additional \$10 of current QRE only generated \$1 of credit — 10%, not 20%)

A 1995 GAO study found that for 1992 almost 60% of corporations were subject to the 50% minimum base rule.¹⁵

¹⁴ Office of Technology Assessment, *The Effectiveness of Research and Experimentation Tax Credits*, September 1995, page 55.

- 6) Fixed base percentage limitation—The maximum fixed base percentage is 16%. A required maximum is beneficial to taxpayers because the lower the fixed base percentage, the higher the credit. The question is, though, what should the maximum fixed base percentage be? Biotech companies have lobbied to have the maximum reduced to 8%. “The 16% limit is based on tax qualified R&E. Since only approximately one-half of book R&E qualifies for the R&E Credit, the 16% limit, therefore, effectively requires companies to invest over 32% of future sales in book R&E to get ANY credit in the future. This is an impossible base amount to exceed on a long-term basis, since the industry average is only about 4% and as shown in the *Business Week* survey, no industry averages over 11% on a book basis.”¹⁶
- 7) Complexity of terms—The research credit involves numerous terms and definitions, such as for “qualified research.” After the term “qualified research” was tightened up in the TRA’86, it took over ten years to see regulations defining these terms. In the meantime, the courts ended up providing guidance with no effective mechanism for taxpayers to provide input on whether they believed the guidance followed congressional intent.
- 8) AMT—Changes in the alternative minimum tax (AMT) in the Tax Reform Act of 1986 caused more corporations to be subject to the AMT. The research tax credit cannot be used to offset AMT; any unused credit can be carried back three years and then carried forward 15 years. However, for corporations that are in an AMT position for several years, the research tax credit will only be usable in some future year (assuming the carryforward period does not expire for the taxpayer). The value of the credit in encouraging research is greatly reduced when the benefit will not be realizable for a company until a future year.

¹⁵ GAO, *Additional Information on the Research Tax Credit*, GAO/T-GGD-95-161, May 10, 1995, page 6.

¹⁶ Testimony of Harry H. Penner, Neurogen Corporation, before the Oversight Subcommittee of the House Ways and Means Committee, May 10, 1995; 95 TNT 92-67.

ELEANOR HOLMES NORTON
DISTRICT OF COLUMBIA

**SELECT COMMITTEE ON
HOMELAND SECURITY**

SUBCOMMITTEES:
EMERGENCY PREPAREDNESS
AND RESPONSE
INTELLIGENCE AND
COUNTERTERRORISM



**Congress of the United States
House of Representatives
Washington, D.C. 20515**

**COMMITTEE ON
TRANSPORTATION AND
INFRASTRUCTURE**

SUBCOMMITTEES:
AVIATION
ECONOMIC DEVELOPMENT,
PUBLIC BUILDINGS, AND
EMERGENCY MANAGEMENT

**COMMITTEE ON
GOVERNMENT REFORM***

SUBCOMMITTEES:
CIVIL SERVICE AND
AGENCY REORGANIZATION
CRIMINAL JUSTICE, DRUG POLICY
AND HUMAN RESOURCES

*COVERS D.C. ISSUES

April 4, 2005

The Honorable Charles Grassley
Chair
U.S. Senate Committee On Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Max Baucus
Ranking Member
U.S. Senate Committee On Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Mr. Grassley and Mr. Baucus:

I am writing to clarify important issues that are not in your committee record concerning the origin and goals of the District of Columbia Enterprise Zone ("D.C. Zone") credits and the homebuyer tax credit enacted as part of the Taxpayer Relief Act of 1997. I ask that you include this letter as part of the record of the March 16, 2005 hearing before the United States Senate Finance Committee entitled "Expiring Tax Provisions: Live or Let Die."

The D.C. credits are the handiwork of this committee, which was chiefly responsible for tailoring them specifically to address the unique disabilities of the nation's capital as a city without a state, in order to encourage self-sustaining approaches to permanent economic stability. These credits have been so effective in meeting the intent of the Congress to move the nation's capital from insolvency toward the goal of economic self-sufficiency and stability that it should be unthinkable to withdraw them prematurely after they have demonstrated that they can meet their intended mission. Written testimony from Mayor Anthony Williams documents in detail the effectiveness of the credits even beyond expectations.

529 14TH STREET, N.W., SUITE 900
WASHINGTON, D.C. 20045-1928
(202) 783-9085
(202) 783-5211 (Fax)

2136 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515-5101
(202) 225-8859
(202) 225-3002 (Fax)
(202) 225-7829 (TDD)
www.house.gov/horton

2041 MARTIN L. KING AVENUE, S.E.
SUITE 300
WASHINGTON, D.C. 20020-5734
(202) 678-8900
(202) 678-8844 (Fax)

The credits were structured not only to attract self-sustaining revenue sources, but also to encourage homeownership and viable businesses because homeowners and businesses who pay taxes also would increase pressure on the D.C. government to make the corollary and necessary service improvements in their neighborhoods and downtown. The D.C. committees in the Senate and House have documented the results in extensive hearings and have often praised the remarkable D.C. government service and operational gains as well as the positive effects of the zone credits.

The D.C. zone was enacted as one part of a long-range, two-part federal approach to remedy problems caused by the city's stateless status, structural financial problems, and chronic revenue losses, resulting from the flight of businesses and residents. The Clinton administration took the leadership on the immediate crisis of insolvency while the Congress focused on the long-range problem of assisting the District to obtain permanent financial stability through the D.C. zone. The administration assumed the crippling pre-home rule federal \$5 billion pension liability and the cost of two among several state functions that the District still carries. As essential as this relief was to return the District to solvency, it was not intended to address the District's dangerous, chronic revenue problems. These problems resulted from the loss of residents and businesses typical of American cities. Congress recognized that in remedying this problem without back-up from a state to channel funds from a broader state tax base, the District encounters unique disadvantages. Moreover, the city's problems are compounded by the District's inability to tax its most valuable land because it is occupied by federal offices; by the requirement to provide services to 200,000 federal employees without authority to tax any of the income at its source that these workers take back to their home jurisdictions; and by a number of other revenue reducing restrictions unique to the nation's capital. A 2004 GAO report stated that these problems – which remain – were caused by a federally imposed structural imbalance and that short of additional revenue, the District compensates for the imbalance with high taxes and the highest debt load in the nation.

Under these unique adverse conditions, it was clear that permanent stability would be impossible unless the District found a way to generate a continuing and improved revenue stream the only way jurisdictions can – by retaining and attracting tax paying residents and businesses. After working with my local business community, I filed a bill for a progressive flat tax, the District of Columbia Economic Recovery Act, to relieve residents at every income level of substantial federal income tax liability, as a way to quickly attract taxpaying residents and overcome the big city competitive disadvantages between the District and the region. I reasoned that federal responsibility for the District's structural imbalance (see the 2004 GAO report) and for the nation's capital itself justified this unique federal tax treatment. The bill enjoyed considerable support, including advocacy by the leaders of both Houses, Senator Trent Lott, who was Majority Leader and a member of the Finance Committee, and former Speaker Newt Gingrich, who testified in favor of the bill at a House hearing.

When this approach proved too costly, I turned to friends and colleagues in the Senate. The D.C. credits were the result of this work. In evaluating the expectations of the Committee in creating the D.C. credits, it is important to bear in mind that this approach was a fallback alternative to the progressive flat tax all of us preferred. Much of the leadership was provided by Senator Connie Mack, a former member of this committee, who was then chair of the Joint Economic Committee. From the beginning Senator Trent Lott also was a major advocate for all of the credits and later was so impressed with the quite extraordinary early homebuyer credit results that in 1999 he led this committee in a vote raising the qualifying income for the homebuyer credit. (The tax bill in which this change was included ultimately was not enacted.) The support of the credits in this committee and in the Senate was bipartisan. Senator Kent Conrad, a member of the committee, and Senator Joe Lieberman were leaders in the effort. Senator Sam Brownback, then chair of the D.C. authorizing subcommittee, played a major role. I attended a number of meetings in the Senate with the Senators where they themselves worked out the major policy details of the credits.

The credits brought Republicans and Democrats together around an unprecedented goal: to use specially designed tax credits instead of subsidies to help revitalize and permanently stabilize a city of moderate size and population. The city's financial crisis provided an opportunity for the first time to address the financial problems of a city rather than sections of cities. Although not all sections of the city were targeted, a broad enough swath was zoned in anticipation of promoting a citywide effect. We had no illusion that the goal could be achieved quickly, but we believed that if the credits could be maintained long enough, a significant turnaround could be achieved. As the Mayor's testimony documents, the results in many sections of the city clearly and visibly are meeting the goals of the credits.

As impressive as the results in zone neighborhoods are, the credits have not been in place long enough to spread these results to many parts of the zone, creating "before and after" evidence of what the credits can do and what remains to be done. Similar, bordering communities in the same condition show even starker contrast. Consequently, recognizing that the District is much smaller than the large cities that have been the models for the zones, I introduced a bill to eliminate disparate treatment of similar neighborhoods by making the entire city an enterprise zone. In the District's case, a citywide approach was justified because of the difficulty of zoning national poverty tracks in a small, compact city without excluding similarly situated neighborhoods; the adverse effects of population poverty zoning on virtually every neighborhood business corridor; and the unique goal of the D.C. zone to use these particular credits to revitalize the city itself. Regardless of whether the zones should be expanded however, we believe that it is clear that at least the District's zone should not be treated unfairly compared to other zones by extinguishing it before 2009.

Mayor Williams in his recent State of the District address outlined a plan to complete revitalization by reaching deeper into areas covered by the credits that have benefited significantly less than others. There had been criticism that revitalization has not yet benefited many parts of the target neighborhoods. However, the Mayor's plan to focus federal and city resources on these sections has won praise citywide.

The combination of the homebuyer and the business credits is necessary to do the work Mayor Williams has laid out. Both credits working together are particularly essential if the District is to meet the goal set by the D.C. Control Board established by the Congress, which completed its work in 2001. The control board (which in case of certain financial difficulties is automatically reactivated) warned that permanent solvency and stability had not been achieved. The board said the greatest dangers remained, particularly the absence of the traditional state safety valve in times of economic downturn or distress, the continuing structural imbalance, and population and the business losses that were far from reversed. These issues remain.

The board said that the key goal for the city should be to attract 100,000 new residents because homeowners in particular not only bring a cross-the-board tax revenue, but also spend most of their disposable income in the city. Mayor Williams adopted this goal. With the help of the credits, the city's residential and business population shows promising stabilizing signs. The homebuyer credit is chiefly responsible for stemming taxpayer losses. The great majority or 62% of homeowners using the credit were D.C. residents, most of them renters, according to an independent study conducted by the Washington Research Center. This result was particularly important because it demonstrated that the homebuyer credit was effective in stemming crippling taxpayer resident losses. The most important cause of the District's financial instability has been home ownership rates well below national and regional norms, reinforcing flight from the city. Renters have less attachment to neighborhoods and to the city than homeowners and are the first to leave. The District must continue to convert its renting population, who are disproportionately modest and moderate in income, to homeownership. However, the city cannot retrieve its taxpayer base without attracting new residents, and the District has not yet begun to make up for its devastating losses over recent decade by adding residents and businesses. The difficult challenge of not only converting renters to homebuyers, already well along, but actually rebuilding the tax base with 100,000 new residents would become impossible without renewal of the homebuyer credit at least to 2009, as the law affords other jurisdictions.

Moreover, the business tax credits are particularly vital to the goal that Congress and the Mayor have set. Costs and demographic differences between the District and the region would be insurmountable under the best of circumstances, including changes in tax rates that have been ongoing. The testimony of the Mayor documents many details concerning the great importance of the business tax credits to maintaining and attracting businesses to the city. Let me therefore offer one significant way in which the

homebuyer and business credits are joined together in meeting the goal of permanent economic stability.

The core goal of 100,000 residents, of course, cannot be achieved by converting renters to buyers. The business tax credits, apart from their indispensable intrinsic value, are necessary to achieving the residential goal and vice-versa. Unlike renters who know the city and its possibilities, new residents are far less likely to move to neighborhoods without the usual neighborhood amenities. The District's business corridors in particular are a deterrent to attracting new residents. These corridors criss-cross the city through neighborhoods of many income varieties. These corridors as well as retail businesses inside the target zones will often determine the residential potential of entire neighborhoods.

There is no testimony in the committee's record that documents the effect of the D.C. credits or that supports prematurely ending them. However, the studies that have been possible to conduct during the time period of the credits indicate the effectiveness of the credits. See the study by the Greater Washington Research Center Research Report entitled "Home Buyer Credit Widely Used" (May 1999) and the study by Zhong Yi Tong (March 2005). No one seriously doubts the significant positive effects of the D.C. credits or their contribution to the improved economic condition of the city and of the zone communities. In many ways, the mission of the credits amounted to an experiment. That experiment is succeeding so well that states would do well to examine the specially designed D.C. homebuyer and business tax credits as a model to help mitigate flight and draw homeowners and businesses to large American cities. Particularly considering the extraordinary success of the credits to revitalization of the economy of the nation's capital, it would be tragically short sighted to pull the plug while they are cresting.

I respectfully request that the D.C. zone credits and homebuyer tax credit be accorded equal treatment with zones in other jurisdictions by renewing them at least until 2009.

Sincerely,



Eleanor Holmes Norton

Puerto Rico, USA Foundation
600 – 13th Street, N.W.
Washington, D.C., 20005
Ph: 910-246-2718; E-mail: holmespe@earthlink.net

April 14, 2005

Statement Submitted

By

Peter E. Holmes

Executive Director

On behalf of the

Puerto Rico, USA Foundation

Commenting on

**“Description and Analysis of Certain Federal Tax Provisions
Expiring in 2005 and 2006”**

Since 1921 the U.S. Tax Code has contained incentives for job-creating investments in the U.S. possessions, and particularly in the Commonwealth of Puerto Rico. Current incentives -- sections 936 and 30A – are scheduled to terminate for tax years beginning after December 31, 2005. As a result, for the first time in 84 years, the U.S. Tax Code will have no provisions specifically fostering economic development in the U.S. possessions.

The Puerto Rico, USA Foundation (PRUSA), formed in 1984, is a coalition of a number of the major mainland corporations with manufacturing operations in Puerto Rico. Under sections 936 and 30A and their predecessor provisions, mainland U.S. manufacturers have created tens of thousands of quality, high-paying jobs in Puerto Rico rather than in foreign locations not associated with the United States. These jobs and the personal income generated by them have contributed significantly to Puerto Rico’s remarkable economic development over the past 50 years. Even so, Puerto Rico continues to have an unemployment rate nearly twice the U.S. average and a per capita income of less than half that of the poorest state.

In the Fall of 2003, during a mark-up of corporate tax legislation by the Senate Committee on Finance, Senators Breaux (D La.) and Santorum (R Pa.) unveiled an amendment proposing a replacement incentive for sections 936 and 30A, which at the time were scheduled to terminate two years hence at the end of 2005. During that mark-up Chairman Grassley and ranking Democratic member Baucus asked Senators Breaux and Santorum to withdraw their proposed amendment, which they did. Shortly thereafter, on October 16, 2003, Senators Grassley and Baucus announced that they had requested the General Accounting Office (GAO) and the Joint Committee on Taxation (JCT) to undertake a

comprehensive study of Puerto Rico's economy and of federal tax legislative options and to report their findings to the Committee by mid-July 2004.

At the time, it was anticipated that the GAO and JCT would complete their joint study in a timely fashion, thus affording the Congress an adequate opportunity to consider and, hopefully, to enact a replacement incentive prior to the termination of sections 936 and 30A at the end of 2005. However, on June 30, 2004, Chairman Grassley and Senator Baucus announced an indefinite delay in completion of the joint GAO/JCT report due to the need for obtaining certain economic data; they suggested, however, that the study might become available near the end of 2004.

To date, the joint GAO/JCT study on Puerto Rico is still not available and some unconfirmed reports suggest that the study may not be completed until late Fall 2005 – some two years after being launched and only a matter of weeks prior to the termination date for sections 936 and 30A.

Under the circumstances, we respectfully urge the Congress to consider a limited --- one or two-year -- extension of the termination date for existing tax incentives to afford Congress an adequate opportunity to consider replacement incentives for the terminating provisions and to allow Puerto Rico and credit claimants a reasonable period in which to transition to a new regime of incentives, if enacted.

Thank you for your consideration.



The Real Estate Roundtable

**TESTIMONY
TO
SENATE FINANCE COMMITTEE
HEARING ON EXPIRING TAX PROVISIONS**

MARCH 16, 2005

Section 168 Leasehold Improvement Depreciation and Section 198 Environmental Remediation Cost Expensing

As the Senate Finance Committee considers the extension of expiring tax provisions, The Real Estate Roundtable (the "Roundtable") urges the Committee to make permanent, or at a minimum extend, Internal Revenue Code Section 168(e)(3)(E)(iv) which provides 15 year depreciation for qualified leasehold improvements. We urge similar treatment for Section 198 which provides for the expensing of environmental remediation costs. Both these laws expire at the end of 2005.

The Real Estate Roundtable is a federal policy organization comprised of real estate industry leaders. Its members are the Chairmen, Presidents or Chief Executive Officers of the nation's 100 leading commercial and multifamily firms, and the Managing Directors of major financial institutions. The Roundtable also includes the elected membership leaders of Washington's major real estate trade organizations.* It serves as the vehicle through which industry leaders come together to identify, analyze and advocate policy positions on issues important to real estate. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at more than \$450 billion.

15 Year Leasehold Improvement Depreciation – S. 621 (Conrad, Kyl)

Background

Leasehold improvements are the build outs to tenant space from floor to ceiling. They include: internal walls, ceilings, partitions, plumbing, lighting, duct work, floor coverings, wiring, electrical and communication outlets and computer data ports. The 15 year depreciation enacted into law as part of the American Jobs Creation Act of 2004 ("Jobs Act") enjoys broad, bipartisan support among the Senate Finance Committee and the entire Senate as well. Senator Conrad and Senator Kyl are the lead sponsors of legislation, S. 621, to make current law permanent. It has similar support in the House.

Statement Regarding Expiring Tax Provisions
March 16, 2005
Page 2

The reason for this level of support is simple...leasehold improvements typically don't last longer than 15 years before they are replaced. Nevertheless, prior to the Jobs Act, the law required that improvements be depreciated over 39 years – an outcome that simply did not make economic sense.

Unfortunately, until the enactment of the Jobs Act, 39 year depreciation for leasehold improvements went beyond just an illogical result. It meant that the tax recovery of new investment in leasehold improvements was longer than the economic life of the property. As a result, rental income generated by the improvements and the corresponding tax recovery of expenses incurred to generate that income, were mismatched forcing the owner of the improvements to carry a tax burden that was unjustified relative to the economics of the transaction.

This resulted in a higher capital cost for leasehold improvements that tended to hamper investment in the tenant occupied space of buildings across the country. Small businesses, in particular, felt the affect because they have a dynamic growth rate and their space needs change along with their growth. The right leasehold improvements are critical to that work space being the best suited for their business productivity and efficiency. Overly burdensome tax treatment jeopardizes the ability of our members to achieve that outcome.

15 Year Leasehold Depreciation Boosts Growth

The temporary 15 year depreciation for leasehold improvements largely alleviates the growth hampering effect caused by 39 year depreciation. This new law, (IRC Section 168)(e)(3)(E)(iv)) broadly supported by the real estate industry and among its highest tax policy priorities, is a shining example of good tax policy. Like the recently expired 30 and 50 percent bonus depreciation provisions, it will have a positive impact on motivating leasing activity and creating efficient, modern work environments. Permanent 15-year depreciation is needed to help continue to foster this productive result.

Almost \$250 billion is invested in commercial real estate improvements *annually* -- with \$15 billion of that amount going to leasehold improvements. The impact of this investment on the economy doubles to \$30 billion as it filters through the economy primarily because it increases the output and employment of construction companies, building material suppliers and construction-related services.

This kind of capital investment is something our economy sorely needs. Real estate is fueling, and will continue to fuel, the engine of economic growth. There are more than .10 million people involved in virtually every aspect of the real estate business. Real estate accounts for approximately 20 percent of the nation's gross domestic product and contributes well over \$1 trillion to it *annually*.

Statement Regarding Expiring Tax Provisions
March 16, 2005
Page 3

JCT Comments Regarding Owners and Tenants

Finally, in a recent Joint Committee on Taxation report (JCX-12-05) analyzing the expiring tax provisions, the JCT generally concludes that *tenants* who place improvements into service should be allowed to depreciate them over 15 years as this probably represents an average lease term. However, the JCT goes on to question whether an owner/lessor should be allowed similar treatment since it will continue to own the property after the lease term ends. In theory, this analysis might have some credence if leasehold improvements lasted more than 15 years. In reality, however, they do not.

As we note in this testimony and have demonstrated to lawmakers over the years, leasehold improvements are typically removed by the owner/lessor at the end of the lease term. The new tenant will want the space re-configured to suit its specific business needs. Even if the lease is renewed by the same tenant, a customary feature of lease renewal is new leasehold improvements. Old improvements wear out, become obsolete from a technological and market standpoint and simply don't fit the tenant's business needs going forward. Therefore, their economic life is closer to 15 years (actually closer to 10 years), than to 39 years regardless of who places them in service.

Conclusion

Again, we urge the Committee to make permanent Section 168 (e)(3)(E)(iv), 15-year leasehold depreciation as part of the budget reconciliation bill. At a minimum, it should be extended along with other expiring provisions. Allowing it to expire would not be good tax policy and would serve as a significant tax burden increase on real estate owners and tenants.

Environmental Remediation Cost Expensing -- S. 398 (Santorum, Bayh)

Senators Santorum and Bayh are sponsors of S. 398, legislation to make permanent Section 198 which provides for the expensing of environmental remediation costs. President Bush's FY 2006 budget also calls for Section 198 to be made permanent. S. 398, however, also would amend Section 198 in two additional important ways:

- Expand the scope of Section 198 to cover petroleum contamination
- Repeal the provision that recaptures the deduction amount as ordinary income on sale of the property.

History of Section 198

Redevelopment of existing sites and properties is an important component of any community's development plans. The Environmental Protection Agency estimates that there are 400,000 to one million brownfields sites across the country. Development of these sites would help restore many blighted areas, create jobs and ease pressure to develop beyond the fringes of communities. Small, urban centered businesses often benefit most directly by this redevelopment. Many brownfields properties are located in inner cities -- precisely where many businesses want to be. The economics are often right. Critical infrastructure, including transportation, is already in place and the workforce is in close proximity.

Section 198 was enacted in 1997 but its applicability was targeted narrowly to only those brownfields located in high poverty census tracts. In 2000, the Community Renewal and Reinvestment Act of 2000 removed the geographic targeting requirements of Internal Revenue Code Section 198. This allowed developers of "brownfields" to expense the clean up costs of brownfields wherever they are located. However, for revenue reasons, Congress scheduled the expensing provision to expire in 2004.

In a report to Congress dated December 2004, the General Accounting Office noted that. "All of the stakeholders we spoke with ... believed that a federal brownfield tax credit, which would allow developers to offset a portion of their federal income tax with remediation expenditures, could complement EPA's Brownfields Program by attracting developers to brownfield sites on a broader national basis."

We strongly believe clean up cost expensing for all brownfields should be extended permanently. S. 398 would do this and we urge its immediate enactment.

Broadening the Definition of "Hazardous Substance" to Include Petroleum

In addition to extending Section 198 permanently, we also believe Section 198 should be amended to work more as intended by Congress. S. 398 would amend Section 198 to broaden the types of hazardous substances that are eligible for expensing treatment if cleaned up to include petroleum.

The current version of IRC Section 198 relies on the term "hazardous substance" used in the Comprehensive Environmental Response Compensation and Liability Act ("CERCLA") to identify which contaminated sites would be eligible for tax relief. Section 198(c)(1)(A)(iii) defines a "qualified contaminated site" as one "at or which there has been a release (or threat of release) or disposal of hazardous substance." The term "hazardous substance" is defined in Section 198(d)(1) to have the same meaning as in sections 101(14) and 102 of CERCLA. Section 198(d)(2) further states that the term "hazardous substance" shall not include any substance for which a removal or remedial action is not permitted under section 104(a)(3) of CERCLA.

Statement Regarding Expiring Tax Provisions
March 16, 2005
Page 5

At first glance, it appears logical that Section 198 borrows the term “hazardous substance” as used in CERCLA, the principal federal statute concerning environmental remediation, rather than coming up with a new term or a new definition. But, the problem created by this approach is that it assumes that the CERCLA definition of the term is broad enough to encompass all types of toxic materials that might be found at a brownfield site. That is not the case.

When CERCLA was adopted in 1980, Congress made the decision that it did not want the federal Superfund used to clean up certain types substances – such as petroleum and certain pesticides – or to be spent cleaning up the interiors of buildings. While the decision not to authorize the spending of federal funds on these types of cleanups had significance for the administration of the Superfund program, the same rationale does not apply to a statute intended to provide a tax incentive to private parties cleaning up brownfield properties.

At the time of CERCLA adoption, the term “hazardous substances” was expressly defined not to include “petroleum.” The reason for this was that Congress made a decision to rely on other statutory mechanisms to effectuate cleanups. In 1984, Congress adopted subtitle I of the Resource Conservation and Recovery Act (“RCRA”), 42 U.S.C. section 6991 et seq., which addressed the cleanup of releases from underground storage tanks, many of which contain gasoline, fuel oil, or other petroleum products. In 1990, Congress adopted the Oil Pollution Act, 33 U.S.C. Section 2701 et seq., to address oil pollution into navigable waters. Thus, the exclusion of “petroleum” from the CERCLA definition of “hazardous substances” was not an indication that Congress believed that petroleum pollution did not need to be cleaned up. Petroleum simply was covered in other statutes.

Petroleum pollution is common at brownfield sites. Petroleum products in the forms of fuel oil, heating oil or gasoline, were often used at these sites. Indeed, these materials were often stored in above ground or underground tanks. Also, some of these sites have been contaminated by migrating gasoline spills from nearby service stations. S. 398 would cover these sites and we urge that any extension of S. 398 include this important modification.

Recapture of Deduction Amount

Finally, another amendment that S. 398 would make to Section 198 is to repeal the recapture requirement of Section 198(e). Currently, any qualified environmental remediation expenditure expensed under Section 198 is subject to recapture as ordinary income when the property that was contaminated is sold or otherwise disposed of.

In effect, the amount expensed as a cleanup cost is treated as depreciation on IRC Section 1245 property. Thus, when the property is sold, gain to the extent of the cleanup cost deduction is treated as ordinary income.

Statement Regarding Expiring Tax Provisions
March 16, 2005
Page 6

Example

In 2004, Owner purchased an acre of land that was contaminated with a hazardous substance. The land cost \$10,000 and Owner spent \$5,000 in remediation expenses. Currently, he is allowed to claim a current deduction for the \$5,000 instead of adding it to his basis in the land. If one year later he sells the land for \$16,000, he would be required to treat \$5,000 of his \$6,000 gain (\$16,000 sale proceeds less \$10,000 cost) as ordinary income taxable at the 35% tax rate (assuming the highest tax rate applicable). The remaining \$1,000 gain would be taxed at 15% (assuming the highest capital gain tax rate).

In the example above, if Owner sold the land the year after he cleaned it up, he would receive little or no benefit from having deducted the clean up costs. This immediate repayment to the government leaves Owner with little tax incentive to clean up the property.

We believe that a more appropriate result would be to treat any gain in excess of Owner's original investment/acquisition cost in the property (\$5000 in this case) as capital gain by repealing the recapture requirement. This provides an incentive for Owner to clean up the property without having the deduction effectively rescinded after the improvement is made.

If the clean up expenditure were recaptured as a capital gain, rather than as ordinary income, each party is in a stronger position. It would allow the government to recover a portion of its tax incentive from the developer, the developer retains a significant incentive for bearing the expense and associated risks of the clean up activity, and the community receives an improved property with the prospect of job creation.

This treatment would be particularly helpful for developers who acquire brownfield properties with the intent of reclaiming them and then selling the improved property shortly thereafter. If a developer were to acquire a brownfield, clean it up and restore it to a viable market use, but then immediately lose the benefit of the clean up deduction at the time of sale, the developer is left with little, if any, incentive effect. If the recapture provision were repealed, as S. 398 provides, Section 198 would become far more of a redevelopment incentive than it is now.

Conclusion

In conclusion, we urge the Committee specifically to make Section 198 permanent or at a minimum extend it and to modify it as provided in S. 398. The result will be the injection of new capital into rehabilitation projects. Many small, urban centered businesses will benefit resulting in substantial job creation and economic revitalization. Also, the viability of existing space will improve and ease the pressure to develop "greenfields" allowing for the preservation of more open space.

Statement Regarding Expiring Tax Provisions
March 16, 2005
Page 7

We also urge the Committee to make permanent 15-year leasehold depreciation as part of the budget reconciliation bill as provided in S. 621, or at least extend it along with other expiring provisions. It will have a positive impact on motivating leasing activity. Approximately \$15 billion worth of leasehold improvements are made annually. The impact of this investment on the economy doubles to \$30 billion as it filters through the economy primarily because it increases the output and employment of construction companies, building material suppliers and construction-related services. Allowing it to expire would not be good tax policy and would serve as a significant tax increase on real estate owners, tenants and contractors.

If you have any questions, please contact Steve Renna, Roundtable Senior Vice President and Counsel. Thank you.

*Real Estate Trade Association Members of The Real Estate Roundtable

National Association of Real Estate Investment Trusts
National Association of Realtors
National Association of Homebuilders
National Association of Real Estate Investment Managers
National Multi-Housing Council
National Association of Industrial and Office Properties
Pension Real Estate Association
Mortgage Bankers Association of America
International Council of Shopping Centers
Commercial Mortgage Securities Association
Building Owners and Managers Association International
American Hotel & Lodging Association
American Resort Development Association
Association of Foreign Investors in Real Estate
Urban Land Institute



1700 N. Moore Street, Suite 2250, Arlington, VA 22209
 Phone: 703-841-2300 Fax: 703-841-1184
 Email: info@retail-leaders.org www.retail-leaders.org

April 13, 2005

Chairman Charles Grassley
 Ranking Member Max Baucus
 U.S. Senate Committee on Finance
 219 Dirksen Senate Office Building
 Washington, D.C. 20510

Dear Senators Grassley and Baucus:

I am writing on behalf of the Retail Industry Leaders Association (RILA) to express our views on three of the expiring tax provisions outlined in the Joint Tax Committee's Report JCX-12-05. Specifically, I would like to express our interest in the Work Opportunity Tax Credit (WOTC) and Welfare to Work (W-t-W) credits, the leasehold improvement provision, and the deductibility of state and local general sales tax.

The Retail Industry Leaders Association (RILA) represents the nation's most successful and innovative retailer and supplier companies – the leaders of the retail industry. Retail is the second largest industry in the U.S., representing \$3.8 trillion in annual sales and 12 percent of our nation's workforce. RILA member retailers and suppliers operate 100,000 stores, manufacturing facilities and distribution centers throughout every congressional district in every state, as well as internationally.

I. Work Opportunity Tax Credit and Welfare to Work

RILA supports permanent extension of both the Work Opportunity Tax Credit (WOTC) and Welfare-to-Work (WtW) tax credit. Many retailers use the programs to offset the added costs of hiring and training workers who have been on public assistance programs. Thousands of disadvantaged individuals have found meaningful employment in retail and other settings through WOTC and WtW. They are important tools in efforts by retailers to help needy individuals become productive employees.

RILA urges the Committee to consider making the programs permanent. Permanent extension will help retailers administer these programs more efficiently. For the last few years, these programs have been allowed to lapse, only to be reauthorized retroactively. The resulting uncertainty hinders expanded participation and improvements in program administration. A permanent program would give employers the confidence they need to expand their recruitment efforts using these credits. RILA is also supportive of combining the programs into one streamlined program.

II. Leasehold Improvements

RILA supports the 15-year recovery period for qualified leasehold improvements contained in the American Jobs Creation Act (AJCA) and urges the Committee to make the reduction of the cost recovery period permanent. The fifteen-year recovery period more accurately reflects the true economic life of leasehold improvements. Retailers spend significant resources on "build out" and leasehold improvements. An inviting, up- to-date, and visually attractive shopping environment is paramount to the retail customer's experience, whether it be in a large format retail operation or smaller store. Stores are generally remodeled every five to seven years.

Retailers should be able to depreciate these improvements over the life of the improvement, rather than using an arbitrary recovery time set by the IRS. RILA supports shorter depreciation periods for all retail operations, regardless of whether retailers own or lease their stores.

III. Deductibility of State and Local General Sales Tax

RILA supports the provision contained in the American Jobs Creation Act to allow the itemized deduction of state and local general sales tax in lieu of state and local income tax. The AJCA restored a deduction for state and local sales taxes that was repealed in the 1986 Tax Reform Act. The restoration of the deduction restores fairness to the system, especially for taxpayers who live in states that do not levy income taxes. We concur with the assessment of the Joint Tax Committee that the provision has a neutralizing effect on the types of taxes that state and local governments utilize. However, support of this provision should not be construed as favoring replacement of the income tax with consumption taxes.

We appreciate the opportunity to weigh in on issues of importance to the nation's leading retailers. Please do not hesitate to contact Shannon Campagna, Vice President of Government Affairs or Paul Kelly, Senior Vice President of Federal and State Government Affairs, if RILA can be of assistance to you during your consideration of expiring tax provisions.

Sincerely,



Sandra L. Kennedy



March 30, 2005

The Honorable Charles E. Grassley
Chair, Senate Finance Committee
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Grassley:

The undersigned, on behalf of their members, respectfully request that the Senate Finance Committee support the extension through 2009 of the District of Columbia Enterprise Zone designation and the District of Columbia \$5,000 Homebuyer Tax Credit. Such an extension would put these tax incentives on a par with all of the other empowerment zones, as well as renewal communities, in the nation—which do not expire until December 31, 2009.

Our members represent many of the businesses in Washington, D.C. The Enterprise Zone legislation and the Homebuyer Tax Credit have had a significant impact in strengthening the local economy and stabilizing the population in the Nation's Capital. They represent an important example of the successful partnership between the federal government and the local government to encourage economic growth and stability in our city.

The Enterprise Zone legislation has enabled more than \$115 million in tax-exempt financing to District businesses, including the highly successful International Spy Museum. The employment tax credit has helped thousands of District residents to find and retain jobs in hotels, restaurants and construction companies. Many of the employers are small neighborhood businesses that operate on thin profit margins. The capital gains tax exclusion has helped generate significant investment that might otherwise not have been made in our inner city, like the \$200 million Gallery Place development in Chinatown.

While parts of the Nation's Capital have made significant economic progress, other parts of the city are in dire need of redevelopment, with rising unemployment among our neediest residents and significant infrastructure needs. These areas in particular, and the businesses that would venture into them, need targeted economic development assistance to encourage investment. And since our Nation's Capital cannot tax 65% of its work force and a large portion of its land, the only way the city can obtain a stable tax base is by encouraging business growth and increasing home ownership.

**500 New Jersey Avenue, NW Suite 310
Washington, DC 20001**

The First Time Home Buyer Credit has been highly instrumental in stemming the flight from DC that eroded the District's tax base in the 1980s and first half of the 1990s. The IRS reports that from 1998 through the third quarter of 2003, more than 21,000 taxpayers have claimed this credit. It has been used widely to ensure that families are able to build equity and to contribute to the city's revitalization. Among those middle and low-income families who have had an opportunity to take advantage of the credit are federal workers who would not otherwise be in a position to buy a home in the District of Columbia in the current market.

According to a recent study by the Research Division of the National Association of Realtors, a significant portion of the *increase* in home purchases in the District in the previous five years was attributable to the first-time homebuyer credit – more than were aided by increased employment and declining mortgage rates.

The District of Columbia has waged a valiant and successful effort to stabilize its tax base through the revitalization of its downtown core and some neighborhood business corridors over the past six years, in the hope of using those taxes to continue the revitalization of other parts of the city that have long suffered from neglect and low expectations. Home ownership has soared, and home sales throughout the District of Columbia have reflected the city's success in delivering that revitalization. Expiration of the EZ designation or the homebuyer credit now would necessarily hamper that progress in the neediest and most neglected parts of the District.

To be effective, economic development assistance must be predictable. It would send a very bad message to business if this legislation were allowed to expire just when we are beginning to see some benefit from the federal investment in our Nation's Capital. Similarly, considerable business uncertainty will persist if the legislation continues to come up for reconsideration every year or two.

Our organizations, therefore, join in urging the Senate Finance Committee to extend through 2009 the DC First Time Homebuyer Credit and the Enterprise Zone designation, and to continue the partnership between Congress and the District of Columbia to make the Nation's Capital a city of which the entire nation can be proud.

Respectfully yours,

Washington, DC Association of REALTORS®
Elizabeth Blakeslee, President

Greater Washington Board of Trade
Robert Pack, President

The District of Columbia Chamber of Commerce
Barbara Lang, President

Hotel Association of Washington, DC
Emily Durso, President

Restaurant Association of Metropolitan Washington
Lynne Breaux, Executive Director

District of Columbia Building Industry
Association, James S. Williams, President

cc: The Honorable Max Baucus, Ranking Member
Members - Senate Finance Committee
The Honorable Eleanor Holmes Norton

WORK OPPORTUNITY TAX CREDIT COALITION
5920 Munson Court
Falls Church, VA 22041
703-820-7718
703-820-7726 (fax)
wotc@cox.net

March 16, 2005

**STATEMENT
OF**

**PAUL E. SUPLIZIO
PRESIDENT
WORK OPPORTUNITY TAX CREDIT COALITION**

**SENATE FINANCE COMMITTEE HEARING
“EXPIRING TAX PROVISIONS: LIVE OR LET DIE”**

**JOBS FOR LESS-SKILLED AND DISABLED WORKERS:
THE WORK OPPORTUNITY TAX CREDIT**

- 1. The Work Opportunity Tax Credit is a market incentive for employers to hire less-skilled and disabled workers in a trade or business in the private sector. The companion Welfare-to-Work Tax Credit encourages hiring of long-term welfare recipients. The primary object is to increase employment, skills, and real earnings of these workers to benefit themselves, their families, and the economy. A secondary object is to reduce the drain on public funds by helping workers and families attain self-sufficiency. Child care support for workers with young children is encouraged by the Employer-Provided Child Care Tax Credit.**
- 2. Less-skilled and disabled workers comprise about 20% of the U.S. workforce, some 30 million persons. The less-skilled are mainly school dropouts or low-performing high school graduates ages 16 to 30. A sizeable number have begun to form families or are single parents. (1) The disabled population is youthful as well, as there are about 4 million children with disabilities attending school, and many of these will seek to enter the workforce. (2)**
- 3. Each year, a new cohort of a million dropouts, a half-million young people with disabilities, and a sizeable number of low-performing high school**

graduates feed into the American workforce. We know statistically—from the low rate of labor force participation—that many have a hard time connecting to the world of work and leave the workforce. The rest enter and re-enter the workforce sporadically, experiencing chronic unemployment and relatively low earnings. This is not a temporary condition—it's a permanent condition rooted in demography and culture in cities and countryside, and in our system of education and preparation for work. (3)

4. Yet, according to Labor Department projections, between now and 2050 our economy will enter a period of slower workforce growth, reducing the nation's potential economic output. With a declining ratio of active to retired workers coupled with rising demands for defense, healthcare, and maintenance of America's technological leadership, it is clear our fundamental challenge is to maximize use of the nation's human resources and make every worker count. (4)
5. Chronic unemployment, sporadic work, and minimal attachment to the labor force are the lot of some 15 million disabled citizens and workers receiving public assistance like food stamps, welfare, Medicaid, and Supplemental Security Income. This group has a high percentage of inner-city and rural poor, school dropouts, immigrants, single parents, and some veterans, lacking skills to get ahead in the job market; and these workers are the principal concern of the Work Opportunity Tax Credit and its companion Welfare-to-Work Tax Credit. First enacted in 1979 and reformed in the first Reagan tax bill of 1981, the Work Opportunity Tax Credit gives private employers an incentive to locate and hire these workers with a minimum of bureaucracy and red tape. The WOTC Coalition was formed in 1980 to promote market-incentive employment and training strategies relying on tax incentives to private employers, and helped shape the reforms of the 1981 and 1996 legislation that are in effect today.
6. The jobs tax credits offset part of an employer's cost of recruiting and hiring less-skilled or disabled workers, and training them to become productive citizens. Through employer outreach, many such workers who had given up looking for work are drawn back into the labor force, and the tax credit raises their chance of selection in the hiring process. Voluminous research by the Bureau of Labor Statistics demonstrates that labor force participation and earnings of school dropouts are dismally low—lagging 30 percent behind high school graduates. By raising the employment-population ratio of school dropouts to the level of high school graduates, our country could increase its labor force by some 15 million workers. (5) With more people working, our communities would benefit through lower public assistance and less family hardship. Keep in mind that between now and 2050 the U.S. labor force will grow more slowly than at any time since the 1930's. Everyone of working

age will be needed to maintain our country's competitiveness and meet its growing demands for health, education, retirement security, and defense.

7. If Congress combined the WOTC and W-t-W tax credits to simplify their use, and made them a permanent part of the tax code, the present scarcity of private sector jobs for welfare recipients could be alleviated (only 25% of adult welfare recipients entered private employment in recent years, according to GAO). The number of WOTC/W-t-W jobs could be raised from about 500,000 currently to 800,000 by 2014 through greater participation by businesses in construction, manufacturing, and services, at an estimated 10-year budget cost of \$5 billion according to the Joint Tax Committee. Joint Tax cost estimates from 1997 to 2002 show the average cost of a WOTC/W-t-W job is approximately \$900 for 4 months average tenure; this compares to \$4,480 for a 4-month public service job, and *makes WOTC/W-t-W the most cost-effective Federal jobs program*. The FY 2002 WOTC/W-t-W placement rate for welfare recipients is 258,000 per year—about 59% of total placements. If a permanent extension were granted, there could be 500,000 placements in 05 through 07, 600,000 in 08 through 2010, 700,000 in 2011 through 2013, and 800,000 in 2014 and thereafter—a total of 6.2 million jobs over the 10-year period 2005-2014. Since 59% would be receiving welfare, some 4 million welfare recipients could be placed in jobs using WOTC/W-t-W over the next 10 years. These same jobs would cost States \$13.2 billion using welfare or training block grants for public service jobs, more than twice the \$5 billion cost for the entire WOTC/W-t-W program during the next 10 years (6).

8. Recently, Congressmen Jerry Weller (R-IL) and Charles Rangel (D-NY) introduced a bi-partisan bill (H.R. 1272) to merge the tax credits and authorize them permanently. Senators Rick Santorum (R-PA) and Max Baucus (D-MT) have introduced the same bill in the Senate—S. 595. That bill was passed overwhelmingly by the Senate last year. President Bush has recommended a one-year extension to December 31st, 2006 and merger and simplification of the two tax credits.

9. The WOTC Coalition supports the following changes to improve the effectiveness of the jobs tax credits:
 - (A) Set the wage base for the combined tax credit at \$10,000—the current wage base for the W-t-W credit—to give employers an incentive to retain workers for a longer period than the current \$6,000 wage base for WOTC allows (under the law, the WOTC credit is computed on the first \$6,000 of wages). Congress originally intended a one-year incentive when it enacted the jobs credit in 1979, but the current \$6,000 wage base has been eroded by inflation and now provides only a 6-month incentive. A \$10,000 wage base will not significantly raise cost because

average job tenure (4 months) and weekly hours (30 hours) of WOTC workers has been steady over time, due to the frequency of part-time work and job changes as they seek better jobs. (7) However, it would encourage employers to raise wages to improve retention as workers gain in skills, which is a major goal of the program.

(B) Cover food stamp recipients ages 18-50, disabled workers referred by an Employment Network established under the Ticket-to-Work Act, and all youth age 15-19 in employer-sponsored summer youth programs, not just youth in empowerment zones.

(C) Make armed forces veterans without a college degree, discharged on or after 9/11/01, eligible without an income or food stamp test to help them make a successful transition to society; and create a new target group for veterans with 20% or more disability who are receiving disability compensation from the Veterans Administration.

(D) Many small businesses do not make enough profit and pay enough income tax to fully utilize the jobs credits; since small businesses create the bulk of new jobs in the economy, and hire an above-average share of less-skilled workers and welfare recipients, Congress should allow small businesses to apply the jobs tax credits to offset payroll taxes.

(E) Lay the groundwork for increasing the number of assisted workers from 500,000 today to 800,000 a year by 2014, by permanently authorizing the jobs tax credits. The number of jobs going to welfare recipients would double to nearly 600,000 a year by 2014, helping more people with private sector work with than with State-funded work experience jobs. In 1999, 400,000 welfare recipients obtained private sector employment according to the General Accounting Office; this was 25% of adult recipients required to work. In the same year, 284,000 welfare recipients were placed in private sector jobs using the Work Opportunity and Welfare-to-Work tax credits. Thus 7 out of 10 of all private sector placements were made using jobs credits. (8)

(F) To provide jobs and training while struggling with tight budgets, States should be encouraged to economize their limited welfare and training block grant funds. For hard-to-employ individuals requiring work preparation, states are paying \$7-\$8 an hour for community service jobs. One state, Minnesota, pays \$9 an hour (9). Thus, the annual cost of a \$7 an hour full-time community service job is about \$14,000 while the comparable cost of a WOTC job is \$900 for 4 months average job tenure or \$2,700 per year. (10) The private sector bears the wage and benefit costs of WOTC jobs, and the cost does not subtract from a State's grant funds for welfare or training. Subsidized community service jobs will continue to be needed to assist some workers, but the more WOTC placements made, the more States can economize their funds.

(G) States should be encouraged to use part-time WOTC/WTW jobs combined with education and training to increase skills and earnings of assisted workers. GAO-HRD-91-33 reported significant earnings gains for workers after leaving job credit employment, which GAO attributed to work experience in the job.

(H) The Departments of Labor and Commerce should encourage greater business participation in the jobs tax credits and support a permanent program. The W.E. Upjohn Institute for Employment Research has calculated there is a *shortage* of 5 to 9 million jobs every year to employ heads of household of all the nation's poor (11). Greater employer participation in WOTC could make available nearly a million of these needed jobs if Congress authorizes a permanent program. Many low-income workers have withdrawn from the workforce, but are in touch with community service organizations. Experience has shown that most employers—especially small businesses—will not change their hiring practices to institute outreach to community organizations and recruitment efforts aimed at increasing hires of eligible workers if the tax credits are authorized for only two or three years.

(I) The Administration should recognize the job-creating effect of employment and training tax credits. A consistent body of research over 20 years shows that the real-wage lowering effect of the jobs credit causes 3 out of every 10 jobs created by an employer for WOTC workers to be *net new jobs* (12). Without WOTC an employer would hire 7 workers, with WOTC he will hire 10. This stimulative effect means WOTC's use should be maximized to increase job creation in the economy. The jobs would be targeted on 1.4 million adult welfare recipients, 4 million at-risk youth, 9 million persons with disabilities who want work, 3 million absentee fathers of children on welfare, and 10 million less-skilled workers who are not employed (mainly school dropouts—sixty percent of dropouts are not employed) in households eligible to receive food stamps. (These numbers are not additive due to overlaps.)

(J) The Small Business Administration should encourage greater small business use of the jobs tax credits. Currently, about 50,000 employers participate in WOTC and W-t-W and the potential for greater participation by small business is large. Small businesses employ more than half of the private sector workforce and account for a large part of job growth. In 1998, small firms employed a higher percentage of school dropouts than large firms (20 percent versus 12 percent), and employed 730,000 workers on welfare compared to 530,000 for large firms. The smallest firms (under 25 employees) had the highest rate of employing workers on welfare. About twice as many Hispanics worked for small firms in 1998—8.2 million versus 4.3 million in large firms. African-Americans were more evenly divided—6.6 million in small firms and 6.4 million in large firms. The Small Business Administration's Brian Headd concludes, "Small firms' number and share of employees on financial or public assistance, along with their higher number and share of employees with lower education levels, suggest that small businesses may play a major role in aiding those making the transition from welfare to work (emphasis supplied)(13).

(K) All persons receiving Social Security Disability payments should be made a WOTC target group. GAO found that 44 percent of welfare recipients have physical or mental impairments, while fewer than half were receiving services to move them into employment (14). About 700,000 workers each year complete vocational rehabilitation which makes them WOTC-eligible, but there are another one million workers receiving Social Security disability benefits who should be eligible but are not. The Wall Street Journal has noted a 28 percent increase in Social Security disability claims since 1998 due in part to low job opportunities for disabled workers (15). SSA paid \$50 billion in cash benefits to over 5 million disabled workers in 2000, about 20 % of whom could return to work. (16) Many WOTC employers are companies with positive attitudes toward hiring disabled workers and providing necessary supports. Last year they hired 120,000 disabled workers using WOTC, and making Employment Network referrals under the Ticket-to-Work Act eligible will raise this number soon. The Ticket-to-Work Act contains incentives to increase the *supply* of disabled workers, but does not address employer *demand* for those workers. Making disabled workers receiving cash assistance a WOTC target group would encourage more hires and save the Federal government money.

(L) Establish a new target group to strengthen families by making non-custodial parents of children in families receiving public assistance eligible for WOTC. There is a crisis of job opportunities for absentee fathers that is contributing to poverty and inability to meet child support obligations, according to studies by the Brookings Institution and Urban Institute (17). This is illustrated by the fact that the *employment rate* of young African-American women has *increased* from 39 percent to 52 percent over the past twenty years, while young black men have seen their employment rate *fall* from 62 percent to 54 percent. *Male school dropouts of all races also suffered similar declines since 1979* (18). Women on welfare get structured help finding jobs, absentee fathers do not. There were 3.1 million absentee fathers with low income (below 130 percent of the poverty line) in 1990, according to the Urban Institute study. More than half of these men didn't live with their own fathers as teenagers. Most were in their twenties and early thirties, nearly half had dropped out of high school, half were white and 40 percent were African-American. The authors conclude, "Just as state and federal governments provide employment-related services to custodial mothers on welfare to help them become self-sufficient, so should public policies offer similar assistance to poor non-custodial fathers so they can meet their child support obligations"(19). About 25 percent of low-income absentee fathers (about 470,000 fathers) received food stamps in 1990. Food stamp recipients age 18-24 are a WOTC target group, so by lifting the eligibility age from 24 to 50 we can reach most of the 25 percent of low-income absentee fathers receiving food stamps, as well as many school dropouts who are poor and have given up looking for jobs. Welfare agencies track both custodial and non-custodial parents who meet the criteria of (1) not having completed secondary school; (2) require substance abuse treatment; or (3) have a poor work history; so the agencies are in a position to identify these absentee fathers and refer them to employers who are seeking WOTC-eligible workers. Low-income fathers need jobs

to make child support payments. Congress should authorize a new WOTC target group, “non-custodial parents, designated by an appropriate State agency, of children in families receiving public assistance”—a target group of 3.1 million low-income men whose limited means contribute importantly to failure to meet child support obligations.

(M) Within the Administration, the Department of Labor should work to increase the WOTC wage base to \$10,000 from \$6,000 where it has been stuck since 1979 despite years of inflation. There is a great deal of confusion about such a policy change, with many jumping to the conclusion that it will raise the cost of the program by more than 60%. This is not so, because the \$10,000 incentive will be reached only as wages rise gradually over time for less-skilled workers, and then by only a small percentage of workers who stay with their employers. The benefits far outweigh the costs. Increasing the WOTC wage base from \$6,000 to \$10,000 will have two important effects: first, it will increase the incentive for participation in the program by employers who offer higher entry-level wages and higher-skill jobs; second, it will give current WOTC employers greater incentive to invest in the training and retention of their workers because the additional wages paid as workers become more valuable to the firm will be partially offset (up to the \$10,000 limit) by the tax credit. Both these results would benefit workers, while more than 80 percent of job costs would continue to be borne by employers. For a worker earning \$10,000, the employer’s job cost including payroll taxes, training, family leave, non-wage compensation, etc., is estimated to be about \$15,000. The employer’s WOTC credit would represent a tax saving of \$2,640—40% of \$10,000 less \$1,360 if the firm is in a 34% tax bracket, because under the law the employer’s wage deduction is reduced by the amount of the tax credit. The firm’s *maximum* tax saving would be \$2,640, compared to \$1,584 under current law. The maximum tax saving would be 18% of the estimated \$15,000 job cost, the employer bearing 82% of the cost. *But initially, only a handful of workers will reach \$10,000 in wages, so the total cost to the government will not increase significantly. Here’s why.*

- Labor mobility is high among entry-level workers generally, and according to a GAO study only a small percentage of WOTC workers are currently staying long enough with an employer to reach the maximum tax credit wage. Turnover for many is so rapid that the law allows the employer to claim only a 25% rather than 40% tax credit if employment is for less than 120 hours (20). Whether a firm’s *average* tax saving per WOTC worker (and, conversely, the government’s average cost) will rise depends on the extent to which employee turnover is reduced, weekly hours rise, or higher wages are paid to eligible workers. The current *average* cost (in terms of revenue lost to the Federal government as a result of the tax credit) per placement for WOTC and WTW workers can be obtained by dividing total program costs (contained in tax expenditure estimates provided by the Joint Committee on Taxation) by total worker placements for the year. We have calculated this figure to be approximately \$900 per worker based on FY 1997-2004 official data. We can assume that average entry-level employee turnover will remain the same in the near term (this can readily be

verified because BLS now provides turnover data on the workforce) because our free labor market allows workers to try different jobs and move on. This means that, at current wage rates, since no more than a handful of workers are reaching the current \$6,000 maximum wage, even fewer will reach \$10,000; so based on turnover alone there is no reason to assume the current average cost per worker will change significantly. Whether it increases will depend on whether hours worked or wage rates rise. There is no reason to expect the wage profile or work-hours of current WOTC/WTW workers to change in the near term, as there is no tightness in the labor market. There are built-in increases in every wage bargain, of course, but in the near term we can expect current rates to continue. It is also unlikely average hours worked will rise because the WOTC group includes many persons working part-time and average hours change very slowly. *Average wages, job tenure, and work hours can be expected to rise gradually over the long term in response to the larger retention incentive, with benefits to the worker, employer, and society. It is smart policy, and not costly, to raise the wage base to \$10,000 to attract higher-wage employers and provide an incentive to hire a worker for a full year rather than 6 months, while investing in the skills of that worker..*

- A higher wage base may have the additional positive effect of encouraging employers to invest more in worker training to raise productivity and reduce turnover. This is an important goal of firms in construction, manufacturing, and services who are large employers of entry-level workers and whose cost reductions come mainly from productivity gains. More training and retention would lower costs and increase profits for the firm, while raising skills and wages for the employee, who becomes more valuable to his employer. Even if the employee leaves the firm, any additional skills he or she has acquired represent a spill-over benefit to the economy at large. In sum, giving employers greater motivation to train workers is good policy because it can raise productivity and have positive effects on worker earnings—which is the goal. The average cost of the jobs credit would rise gradually as worker productivity and earnings rise.
- *Viewing the government's cost of the tax credit as an investment in human capital, the return to the economy in output and income if employers' investments in worker skills has increased productivity may exceed the entire cost of the tax credit (see references in Footnote 5). The Federal government can and should continue its investments in human capital because of their cumulative return to national productivity and income.*

Thank you for the opportunity to bring this important matter to your attention. My staff and I will be happy to answer any questions.

FOOTNOTES

1. U. S. Department of Labor, Bureau of Labor Statistics, "Turning Thirty—Job Mobility and Labor Market Attachment," Report 862, December 1993. For a profile of a 31-year old man, a new father making

\$7.50 an hour, whose family is on welfare, see Washington Post, June 17, 2002, p. 1.

2. See Addendum
3. See Addendum
4. See Addendum
5. See Addendum
6. GAO-01-368, *Welfare Reform—Moving Hard-To-Employ Recipients Into the Workforce*, March 2001, pp. 12-13. Department of Labor statistics of WOTC/WTW enrollment for 1997-2002 and Joint Committee on Taxation tax expenditure estimates for the same years were used to compute average cost per worker of approximately \$900, including cost of program administration. Because of high labor mobility in entry-level jobs, the cost of a WOTC/WTW job with roughly 4 months average job tenure is compared to the 4-month cost of a welfare recipient in “work experience” public employment at \$7 per hour for 12 weeks at 40 hours per week, or \$4,480 for 4 months from State welfare block grant funds—about 5 times the cost of a comparable WOTC job. From DOL, welfare recipients were 1,160,625 out of 1,957,133 total WOTC/WTW placements during FY 1997-2001, or 59%. To the extent States use the additional placements cited in the text for 2004-2009 instead of public service jobs costing 5 times as much, they could economize on their welfare block grant funds.
7. GAO-01-329, “Work Opportunity Tax Credit”, March 2001
8. GAO-01-368, *op. cit.*
9. Governor Jesse Ventura, “Welfare—Not the Feds Job”, Washington Post, May 8, 2002
10. The maximum cost of a WOTC job to the Federal Treasury is actually around \$1,620 assuming a 34% corporate tax rate, because employers are required by law to reduce their deduction for wages by the amount of the credit. The \$900 approximate average cost of a WOTC job is obtained by dividing total program costs from the Joint Tax and Appropriations Committees by the number of WOTC and W-t-W placements for FY 1997-FY 2002.
11. Timothy Bartik, W.E. Upjohn Institute for Employment Research, “Poverty, Jobs, and Subsidized Employment”, *Challenge*, May-June, 2002. Bureau of Labor Statistics, “The Employment Situation”, monthly reports.
12. John H. Bishop and Mark Montgomery, “Does the Targeted Jobs Tax Credit Create Jobs at Subsidized Firms?” *Industrial Relations*, Vol. 32 No. 3 (Fall 1993), p. 299. See also Kevin Hollenbeck, The National Center for Research in Vocational Education, “Final Report on the Aggregate Employment Effects of the Targeted jobs Tax Credit (TJTC) Program”, prepared for Macro Systems, Inc. and the U.S. Department of Labor, September 1986; Sandra Christensen, Congressional Budget Office memo, “The Targeted Jobs Tax Credit”, May 1984; and Linda LeGrande, Congressional Research Service of the Library of Congress

memo, “Costs Under the Targeted Jobs Tax Credit and Other Job Creation and Training Programs for the Structurally Unemployed”, March 6, 1985. Both CBO and CRS concluded 34 jobs out of 100 using the jobs credit were *net new jobs*, contrasted to 3 out of 10 found by Bishop and Montgomery and Macro Systems. Put another way, in 7 out of 10 jobs eligible workers were substituted for ineligible workers; the remaining 3 jobs were new jobs, so there was no substitution. All 10 jobs achieve the congressional intent of giving disadvantaged and disabled workers the nod over others. Most windfall credits have been eliminated from WOTC by three activities: (1) worker eligibility for the tax credit is considered during the job application process, before hire; (2) about half of WOTC employers make active outreach efforts to draw eligible workers into their hiring streams (GAO-HRD-91-33); and (3) almost all employers have adjusted their hiring to increase their intake of eligible workers by receiving referrals from agencies in touch with disabled and disadvantaged groups. In view of these hiring practices, it is difficult to find cases of windfall credits being paid for workers who would have been hired without the tax credit.

13. GAO-01-329, “Work Opportunity Tax Credit”, March 2001 (Computation of number of firms participating in WOTC made by WOTC Coalition using GAO data). Brian Headd, “The Characteristics of Small-business Employees”, *Monthly Labor Review*, April 2000. Mr. Headd is economist, Office of Advocacy, Small Business Administration.
14. GAO-02-37, “Welfare Reform—More Coordinated Federal Effort Could Help States and Localities Move TANF Recipients With Impairments Toward Employment”, October 2001
15. Carlos Tejada, “No Recovery for Disabled?”, *Wall Street Journal*, April 16, 2002, p. B-1
16. GAO-02-224, “SSA Disability”, January 2002
17. Harry Holzer and Paul Offner, Brookings Institution Center on Urban and Metropolitan Policy and Georgetown University Public Policy Institute, “Welfare: What About The Men?”, *Washington Post*, January 3, 2002.
18. Bartik, *op. cit.*, p. 103
19. Elaine Sorensen and Robert Lerman, “Welfare Reform and Low-Income Noncustodial Fathers”, *Challenge*, July-August, 1998. U.S. Department of Labor, Bureau of Labor Statistics, “Work and Family: Turning Thirty—Job Mobility and Labor Market Attachment”, Report 862, December 1993. For a profile of a 31 year old man, a new father making \$7.50 an hour whose family is on welfare, see *Washington Post*, June 17, 2002, p. 1. See also report of Manpower Development Research Corporation, New York, on the 7-state Parents Fair Share Demonstration Project of 1994-1996 and *Washington Post*, “Support Program Helps Deadbeat Dads Find Jobs”, February 11, 1994, p.A3.
20. GAO-01-329, “Work Opportunity Tax Credit”, March 2001; and Bureau of Labor Statistics, “Work and Family: Turning Thirty”, *op. cit.*