

PRESIDENT'S ADVISORY
BOARD
ON FEDERAL TAX REFORM
2005 FEB 29 A 9 4

Comments in Response to Request for Comments #1 (February 16, 2005)

From: Cornelius C. Shields, Individually
650 Timber Lane
Devon, PA 19333

To: President's Advisory Panel on Federal Tax Reform

Date: February 18, 2005

[Cornelius C. Shields, Individually]

This is to offer comments in response to the Advisory Panel's Request for Comments #1, posted February 16, 2005. I write individually, as an adjunct professor teaching law school courses in tax policy and corporate and international taxation, and from experience with the federal government, a multinational corporation, and law firms.

Goals That the Panel Should Try to Achieve

- Revenue neutrality. Because the relation between taxes and increased gross domestic product is almost always inverse, the Commission will face a difficult challenge if its recommendations are to be revenue neutral. Nonetheless, the Advisory Panel should not forego favorable consideration of sound changes. For revenue neutrality the Advisory Panel will have, first, the GDP benefit of changes that make the tax code less wasteful of taxpayer and government time and money and, second, the revenue benefit of changes that increase the ability of the IRS efficiently to collect taxes due. If, at the end, there is a revenue shortfall, the Advisory Panel has two possibilities that will not limit its ability to make tax recommendations that will enhance national prosperity. One is to recommend counterbalancing reductions in future Medicare and Medicaid expenditures by capping them at a percentage of GDP. The other is to recommend a counterbalancing, single-rate surtax applied to all taxable income. These approaches will enable the Advisory Panel to consider and recommend the fullest set of tax changes and will leave to the President and Congress the ultimate political decisions.

- Entitlements and a national value added tax or sales and use tax. These taxes should be left to the states. Adoption of them at the federal level, without simultaneous repeal of the Sixteenth Amendment, will put the U.S. on the high tax, low growth path of many of the European Union countries. Reserving broad consumption taxes to the states limits the size of the federal tax and expenditure budget, and tax competition among the states operates as a salutary brake at that level. A federal VAT will not resolve the Medicare and Medicaid budget problem. Medical entitlement programs will expand without limit until capped at a percentage of GDP because near-infinite amounts of money can be expended to prolong lives and reduce pain.

- Alternative minimum tax. Policy for the individual alternative minimum tax cannot properly be designed without seeing how it articulates with policy for lower income individuals, including policy toward how many income recipients, if any, should be excused from paying at least some federal income tax. However, because of information deficiencies there is no effective, present way to consider interactions among tax policies such as personal exemptions, standard deduction, earned income tax credit, and child tax credit and non-tax policies such as temporary assistance for needy families, food stamps, public and section 8 housing, and Medicaid. Before appropriate changes to the AMT can be identified, a thorough study should be made and published that addresses these information deficiencies. Only then can transparent and coherent recommendations be proposed and evaluated. The Advisory Panel should recommend deferring decisions on the AMT until this study has been completed and released.

[Cornelius C. Shields, Individually]

- Top ordinary income tax rate. The top ordinary income tax bracket for individuals and corporations is of key practical importance, swamping the theoretical question whether tax schedules should be proportionate or progressive. Federal tax policy should be clear, to continue gradual lowering of the top rate for ordinary income to some as yet un-agreed upon number (possibly the twenty-eight percent legislated in 1986 but never reached).

- Tax rate for shareholder dividends and capital gains. Policy should be to achieve effective equality between the tax burden imposed on partnership and sole proprietor income and the tax burden imposed on corporate ordinary income plus shareholder stock dividends and capital gains. Effective equality is close enough; theory need not get in the way of a practical solution. Treasury and the IRS should periodically estimate, compare, and publish the effective tax rate paid on the worldwide incomes of large samples of high income U.S. resident partners and proprietors and of publically held U.S. multinational corporations. From this information Congress can determine whether an increase or decrease in the section 1(h)(11) rate is appropriate.

Unnecessary Complexity and Burdens

- Tax return disclosure. The IRS does not have, and should not have, enough resources to hunt through all larger business tax returns looking for hidden issues that should be challenged rather than passed over. At present, businesses need not specially disclose on their tax returns more-likely-than-not positions. The Code should be amended to provide for explicit, highlighted disclosure of all positions taken on larger business tax returns where either the taxpayer or its advisor cannot reasonably conclude in writing that the probability is 75 percent or greater that the position will be sustained if challenged and litigated to resolution. Positive revenue estimates for this change are likely to be substantial, and will be greater if the amendment is applicable to tax years still open under the statute of limitations, e.g., for at least one full year after the date the amendment is passed.

- Territorial system for U.S. multinational corporations. The current deferral-subpart F-foreign tax credit system for taxing U.S. multinational corporations is premised on a supposed need for the federal government to intervene in domestic versus foreign investment decisions. This 1962 premise has been overtaken by the elimination of U.S. capital export controls in the 1970s, by the adoption of freely floating currency exchange rates, and by the increasingly obvious benefits to the U.S. and to the rest of the world from full U.S. participation in free global trade and investment. The current U.S. system is “staggeringly complex” and can and should be replaced with a much simpler, more easily administered and enforced territorial system.

A specific proposal addressing this problem will be submitted in response to a subsequent Advisory Panel Request for Comments.

[Cornelius C. Shields, Individually]

● Taxing inbound foreign investment. Foreign direct corporate investment in the U.S. is taxed essentially the same as U.S. corporate investment in the U.S. However, in addition to the section 11 tax of up to 35 percent, a 30 percent withholding tax is imposed on dividends (and on interest and royalties) paid to the foreign owner. Clearly, a combination of a 35 percent tax on business earnings plus another 30 percent tax on dividends is not competitive. The 30 percent dividend tax also is imposed on dividends received by non-resident alien portfolio investors from U.S. stocks, and, in addition, these foreign portfolio investors are subject to U.S. estate tax on the value of their U.S. stocks. The current system requires a U.S. tax treaty to reduce the 30 percent withholding tax to a low or zero rate on dividends and to zero on interest and royalties. All of this is inconsistent with an open capital and trade regime in which the U.S. runs a substantial current account deficit that necessarily requires foreign investment in U.S. assets.

A specific proposal addressing this problem will be submitted in response to a subsequent Advisory Panel Request for Comments.

● "Earnings stripping" – section 163(j). Currently, foreign multinational corporations investing in the U.S. can be discriminated against in their debt-equity capitalization structures compared to U.S. corporations. This is inconsistent with an open capital and trade regime, where foreign direct investment in the U.S. is needed and beneficial.

A specific proposal addressing this problem will be submitted in response to a subsequent Advisory Panel Request for Comments.

● Corporate taxation. Corporate reorganizations are an important part of a large, competitive, dynamic economy. Currently, some types of reorganizations are subject to much more limiting rules than others, creating traps and resulting in unproductive expenditure of taxpayer time and money. In addition, tailoring of corporations frequently is a desirable part of reorganizing them, but current law is needlessly restrictive.

Specific proposals addressing these problems will be submitted in response to a subsequent Advisory Panel Request for Comments.

Thank you for your attention to these comments.

Very truly yours,



Cornelius C. Shields