

**UNITED STATES SENATE
COMMITTEE ON FINANCE
NOMINATIONS HEARING
NOVEMBER 4, 2009**

QUESTIONS FOR MR. MICHAEL MUNDACA

ANSWERS TO QUESTIONS FROM CHAIRMAN BAUCUS

Question 1

This Committee will be considering tax reform in the near future, and I expect we will work closely with you on this effort. To what extent do you believe our tax code is working well? To what extent do you believe tax reform is necessary? What changes would you make to the tax code so our country remains competitive in the global marketplace and the job market is strong? Should the emphasis be on domestic reform, international reform, or both?

The elements of a desirable tax system include: promoting economic growth; simplicity; fairness; and raising adequate revenue for the Federal government to meet its obligations. Our current tax system falls short of the ideal in several respects. It is too complex, too filled with special rules, and too susceptible of evasion and avoidance. We need to reform our tax system so that it effectively and fairly raises adequate revenue while enhancing the competitiveness of U.S. business and U.S. workers.

This reform should cover both international and domestic aspects of our tax system; given the increasingly global nature of our economy, we cannot ignore how we tax cross-border investment.

Question 2

Last week, I introduced the Foreign Account Tax Compliance Act, which will incent foreign financial institutions to tell the IRS who their US account holders are, and how much money is in their accounts. Do you think this is an effective way to clamp down on Americans who are hiding their money offshore to avoid or evade U.S. taxes? To what extent do you believe offshore noncompliance is a serious problem? What do you intend to do as Assistant Secretary to stop offshore scams and schemes? The IRS recently reached an agreement with UBS that requires UBS to turn over the records of many US account holders. The IRS also has been conducting a voluntary disclosure initiative encouraging US persons hiding money offshore to come forward. What will you do as Assistant Secretary to ensure this information doesn't go to waste – that it is reviewed in a timely, efficient and effective manner?

Noncompliance with our tax rules in general is a very serious issue, and offshore noncompliance is an especially serious issue. Non-compliance undermines confidence in the fairness of our tax system and fosters further non-compliance. It also results in a de facto tax increase on compliant taxpayers, who must pay more because others fail to pay what they owe. The Treasury Department has developed a multi-pronged approach to combat offshore tax evasion. Our comprehensive approach includes legislative proposals, a focus on bilateral tax information exchange agreements, multilateral initiatives to improve transparency and information exchange in tax matters, and Internal Revenue Service (IRS) enforcement actions.

The Foreign Account Tax Compliance Act incorporates the substance of many of the Administration's legislative proposals to curb the use of off-shore tax havens and close the international tax gap. The proposed legislation would enhance information reporting, increase tax withholding, strengthen penalties, and make it harder for foreign account-holders to evade U.S. taxes, while also providing the enforcement tools necessary to crack down on tax haven abuse. I believe that the Foreign Account Tax Compliance Act would be an important step in addressing offshore noncompliance, and if confirmed I look forward to working closely with you, other members of this Committee, and other members of Congress on this important issue.

In addition to legislative proposals, the Treasury Department is pursuing a number of other measures to improve offshore compliance. Since President Obama took office, the Treasury Department has made a high priority of negotiating international agreements to permit the IRS to obtain the information that it needs to enforce U.S. tax laws. Since January of this year, we've reached agreements on exchanging tax information with Switzerland, Luxembourg, Gibraltar, and Monaco.

The United States also is leading efforts in the G7, the G20, and the Global Forum on Transparency and Exchange of Information for Tax Purposes to make sure that countries meet international standards and are committed to preventing the facilitation of offshore tax evasion.

To augment all of these efforts, the Administration's Fiscal Year 2010 Budget would provide funds to add nearly 800 new IRS employees to combat offshore tax evasion and improve compliance with U.S. international tax laws by businesses and high-income individuals.

While I cannot comment on ongoing investigations involving UBS or the use of information received by the IRS under their voluntary compliance initiative, be assured we are aggressively pursuing those who evade U.S. taxes, and those who facilitate such evasion. We are working closely with Commissioner Shulman and Chief Counsel Wilkins of the Internal Revenue Service to be sure that they have the tools needed to pursue these important initiatives in a timely, efficient and effective manner.

Question 3

The IRS says the annual tax gap is \$345 billion. That figure is based on 2001 data and doesn't include all of the international tax gap. Taking into account that it is eight years later, and offshore tax evasion is a big problem, what do you think is the true size of the tax gap? In July, Treasury updated its Tax Gap Plan that originally was developed as a result of my insistence for a comprehensive plan with goals, measures and timelines to reduce the

gap. I believe it is important to improve compliance of the taxes already on the books – this doesn't raise taxes on anyone and it is fairer to Americans who pay what they owe. What was your role in updating the plan, and do I have your assurance that you are committed to improving voluntary compliance of the Tax Code?

As you know, the IRS estimated the gross tax gap for 2001 at \$345 billion. After enforcement action and receipt of late payments, the net tax gap was \$290 billion. The IRS arrived at these estimates of the tax gap in 2005 based on the best available data. The Treasury and IRS have initiated intensive efforts to update the estimate of the tax gap on an ongoing basis, to permit more regular and effective assessment.

As Acting Assistant Secretary (Tax Policy), I exercised oversight over the preparation of the updated tax gap plan. I share your concern with addressing the tax gap, and appreciate your leadership as we set forth goals, measures, and timelines. If I am confirmed, improving voluntary compliance will be a top priority of mine.

Currently, the Administration's Fiscal Year 2010 Budget contains seventeen domestic tax gap legislative proposals, relating to information reporting, business compliance, tax administration, and penalties. Enactment of these proposals will help to close the tax gap, but more needs to be done.

I am committed to addressing tax evasion in general and offshore tax evasion in particular, and if confirmed I look forward to working closely with your Committee to address this important issue.

Question 4

A GAO report came out last week that said the IRS collection notice process has a lot of problems – it lacks goals and measures, and some of the fundamental business rules, like debt thresholds, hadn't been revisited since the 1980s. Collecting taxes is a basic IRS function. To what extent can the IRS be doing more with the tools it already has to close the tax gap? How can you work with the IRS to ensure the agency is working smartly and efficiently? How will you ensure that Congress hears about all the good ideas to help close the tax gap, not just a few that seem to make the cut each year?

In 2008, the IRS collected over \$28 billion in tax debts through its collection activities, and the IRS continues to provide a very high return on each dollar spent on tax enforcement. Although the IRS's collection activities are substantial and effective, there remains room for improvement. In that regard, the recent GAO report raises a number of important issues and makes a number of very helpful recommendations regarding the IRS's collection process. The Administration's Fiscal Year 2010 Budget also contains a number of proposals focused on improving collections. It is also critical that the IRS receives the resources necessary to efficiently implement the collection tools provided to it. If confirmed, I will work with Commissioner Shulman and Chief Counsel Wilkins as well as the staff of the Committee to develop recommendations for narrowing the tax gap.

Question 5

Voluntary tax compliance is the most effective way to close the tax gap. Timely guidance from Treasury and the IRS helps taxpayers know how to report complex and controversial tax issues. The new credit card information reporting rules are a good example of this. When do you predict those regulations will be issued so that the industry and business owners know how to prepare for the new law?

Increased information reporting is unquestionably a vital tool for promoting voluntary compliance. Treasury and the IRS have invested significant resources over the last year in preparing proposed regulations to implement the new credit card information reporting rules, which go into effect in 2011. As part of this process, Treasury and IRS actively solicited input and feedback from taxpayers, banks, and credit card processors, and that input was taken into account in preparing the proposed regulations. The proposed regulations are nearly ready, and I expect they will be issued within the month.

Question 6

Congress is going to be passing health care reform this year. Treasury and the IRS are going to play an important role in the eligibility verification process and implementation of the tax credits that will make health care affordable for millions of Americans. Do I have your commitment that you will make implementation of health care reform a priority, with a particular emphasis on reducing the burden on individuals who are enrolling through the exchanges and receiving the credits?

The health reform proposals currently being considered would make use of the tax system as a means of verifying eligibility and delivering tax credits that will help make coverage affordable for millions of individuals and families. You have my personal commitment that if I am confirmed the Office of Tax Policy, working closely with the IRS, will make implementation of health care reform a high priority. In particular, we will give emphasis to the importance of implementing health care reform in a manner that minimizes any burdens on individuals and families (including those enrolling through exchanges and receiving credits) as well as on small businesses and other employers.

Question 7

For over 200 years, the Department of Treasury, through the former U.S. Customs Services, has carried out the important mission of collecting duties and enforcing U.S. trade laws. In 2002, the U.S. Customs Service, which became the Bureau of Customs and Border Protection (CBP) within the Department of Homeland Security, was given a new mandate of securing our nation's borders while carrying out its historical trade mission. The Department of Treasury, as part of this transition, retained authority over all customs revenue functions and commercial operations of CBP. In your role as Assistant Secretary of the Treasury for Tax Policy, you will play a leading role in ensuring CBP fulfills its historical trade mission. I have been concerned that trade facilitation and enforcement simply have not been a priority in recent years. And while the agency's security mission is

vitaly important, I believe CBP must do a better job of balancing their two missions. How will you address these concerns?

One of the most effective ways that Treasury helps CBP balance its security and trade processing mission is by ensuring that regulations involving customs revenue functions create no unnecessary burdens for business or for CBP and that regulations are as simple and clear as possible. This approach facilitates trade and also reduces the drain on CBP resources. I commit to you that if I am confirmed, both trade facilitation and enforcement will be my priorities with regard to customs revenue functions.

Question 8

CBP also plays an important role in administering and enforcing our trade laws. And CBP's policy decisions have a sweeping effect on the trade community. As such, Congress mandated that CBP fully consult with the trade community, other agencies, and Congress before making significant policy decisions. But CBP has persisted in making major decisions without proper consultation. And this results in policy changes that are not supported by the facts. Can you assure me that you will work closely with the Secretary of the Department of Homeland Security to conduct proper oversight of the customs revenue functions and commercial operations? Can you assure me to consult with all interested stakeholders, including the trade community and other agencies, before making such decisions? And can you assure me that you will consult closely with me and my staff as you consider any such changes?

I am a strong advocate of interagency cooperation and stakeholder consultation, and I commit to you that if confirmed I will promote cooperation with the Department of Homeland Security, as well as other interested agencies, stakeholders and the Committee and its staff with regard to the administration of customs revenue functions. I understand that there have been increased communications with Congress over the last few months. If confirmed, I promise to ensure that this communication continues and improves.

ANSWERS TO QUESTIONS FROM SENATOR GRASSLEY

Question 1: The Proper Priority for US Tax Policymakers

In the last weeks of the Clinton Administration, in December 2000, the US Treasury Department put out a 200-page report entitled “The Deferral of Income Earned Through U.S. Controlled Foreign Corporations.” The report stated:

“tax policies ... that maximize global welfare are considered first, because maximizing global welfare is probably the best way to maximize U.S. economic welfare. ... it is probably not advisable to establish policies that promote national short-term interests at the expense of global economic welfare, because establishing such policies is likely to encourage other nations to seek to advance their own short-term national interests at the expense of global economic welfare.”

This suggests that US tax policymakers should focus more on maximizing global economic welfare, than on maximizing US economic welfare.

- What was your role, if any, in the drafting of this report?
- Do you think that US tax policy-makers should focus on maximizing global economic welfare, or should we focus on maximizing US economic welfare? Which should take priority?

I did not participate in the preparation of the report sections you cite, although I am generally familiar with its findings, and did participate in the drafting of chapter 6 of the report, regarding the challenges to subpart F from electronic commerce.

You raise one of the most debated questions of international tax policy. Specifically, what is the role of our tax system in promoting national welfare and to what extent should our tax policies take account of the interaction between the U.S. economy and the larger global economy?

In my view, U.S. tax policy should advance the economic welfare of U.S. citizens and residents. While there is an ongoing debate as to which policies advance U.S. welfare, I believe our analysis of policies should focus on the long-term effects such policies have on the economic welfare of U.S. citizens and residents.

Question 2: Permanency of the Research & Development Tax Credit

The section 41 Research & Development Tax Credit has expired over a dozen times since its original creation as part of the Economic Recovery Tax Act of 1981. It has always been extended again, but one time (in the mid 1990s), a one-year period did not have the credit. Furthermore, many times it has been allowed to expire, and was retroactively patched back to the last expiration date. Furthermore, the various ways to calculate the R&D credit have changed numerous times.

The R&D credit, of course, is for the purpose of incentivizing Research and Development. However, given all this uncertainty associated with the credit, it is questionable if it can really achieve the intended incentive effect. To the extent a taxpayer takes into account the credit in determining its future R&D budget, presumably the taxpayer must discount the expected benefit to reflect the likelihood that the credit will not exist.

- **Would it be possible to achieve a greater incentive effect if we had a permanent and more stable credit? Or do you think the constant expiration and constant tinkering with it do not reduce its incentive effect very much?**
- **Thought of from a different angle, could the US government achieve the same incentive effect as under current law, but for less money, by merely making the credit permanent, but with less generous provisions?**
- **Does the frequent expiration and extension of the R&D credit increase the volatility of earnings reports as released on a quarterly and annual basis to the investing public of publicly-traded corporations, especially in the high-tech sector? If yes, to what extent is that undesirable?**

The research tax credit encourages technological developments that are an important component of economic growth. However, the Administration believes that the credit's temporary nature undermines its effectiveness. Uncertainty about the future availability of the research tax credit diminishes the incentive effect of the credit, because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. Therefore, the Administration's priority is to make the credit permanent, and a proposal to make it permanent was included in the Administration's Fiscal Year 2010 Budget. The Administration also agrees that the credit's structure could be simplified or updated in certain respects to maintain or improve its effectiveness. I look forward to working with Congress, if I am confirmed, on possible modifications to the credit.

The frequent expiration and extension of the research tax credit can affect the volatility of earnings reports. Companies are not permitted to anticipate the passage of legislation and thus have to prepare interim financial statements without regard to the effect of the credit during the period that the credit has not been extended. This is undesirable because interim financial statements and earnings reports are most effective when they closely reflect actual performance.

Question 3: Technological Progress and Elasticity of Response to Taxes

In one sense, there are only two types of taxes: "Benefits Received" taxes and "Ability to Pay" taxes. With a Benefits-Received tax, the amount of tax that the taxpayer receives is, at least roughly, equal to the benefit that same taxpayer receives from the government. With an Ability-to-Pay tax, there may be very little benefit received by the taxpayer. With this type of tax, the taxpayer simply has the resources, the ability, the deep-enough-pockets, to pay the tax.

In an earlier era, when capital and people were not very mobile, there would not be so many negative distortions caused by an Ability-to-Pay tax. Those subjected to high Ability-to-Pay taxes may not have liked it, but there was not so much they could do about it. In the modern era, however, capital and people are very mobile. A US telemarketer

being located in India was astonishing a decade ago, but not only are we used to that now, but we hear that US tax returns are even outsourced to return-preparers in India. As another example, 100 years ago, people rarely left his home state – today, they can and do easily leave the country. Governments that think they can impose an Ability-to-Pay tax are increasingly finding that taxpayers, and their investments, have an Ability-to-Move-Away.

Benefits-Received taxes do not have nearly as much the same type of problem: Taxpayers are not generally chased away by such taxes, as they usually will want to stick around to receive the worthwhile benefit the tax pays for.

It would seem that there are only two policy options to make in the face of this Ability-to-Move – especially as that Ability-to-Move only increases with the ongoing march of technological progress: i) transition away from Ability-to-Pay taxes and to Benefits-Received taxes; and/or ii) ever increase the grasp/scope of the US tax network, so that there is in fact no Ability-to-Move-Away.

What do you think are the long-term tax-policy implications? Do you see other alternatives to what I have suggested? How will your office lay the groundwork for addressing these implications?

The globalization of the American economy raises great opportunities for increasing the standard of living of Americans. It also raises challenges for the design and implementation of effective tax policy. Tying taxes more closely to benefits received is one way to attempt to deal with increased mobility, as you point out. However, the application of the benefits received approach can be limited. For example, it might not be feasible for many important government services, such as national defense, because the benefits are diffused over society in general.

I look forward to working with Congress, if I am confirmed, to develop effective and fair ways of raising the revenue required by the Federal government in an increasingly global economy.

Question 4: Notice 2008-83 and the Rule of Law

Section 382 of the Internal Revenue Code limits the ability of acquiring companies that acquire target companies to offset the taxable income of the acquiring company with the Net Operating Losses of the target. This provision was not enacted lightly by Congress, but rather after extensive scholarly reflection by the staffs of the Senate Finance Committee and the Joint Committee on Taxation, as well as after reflection by the House Ways & Means Committee. It has been an established part of the law ever since 1986.

This law was changed when Treasury issued Notice 2008-83. Many tax law scholars have opined that Treasury simply did not have authority to make this change. Although Congress subsequently prospectively overturned the Notice, I want to make sure that no such episode occurs again and that Congress remains the Federal lawmaker for these United States.

- What was your involvement, if any, in the drafting, analysis, or promulgation of this Notice?

I had no involvement in the drafting, analysis, or promulgation of Notice 2008-83. My position at that time was Deputy Assistant Secretary for International Tax Affairs, and the issues addressed in Notice 2008-83 were not within my area of responsibility.

- **Do you believe Treasury properly exercised its authority by issuing Notice 2008-83?**

In the American Recovery and Reinvestment Act, Congress provided that the Notice would be inapplicable to transactions occurring after the date of the Recovery Act's enactment. However, the Notice remains in effect for transactions occurring before that date. In light of my current position as the Acting Assistant Secretary (Tax Policy), I believe that it would be inappropriate for me to express a personal view on whether previously-issued guidance that remains in effect for at least some transactions was not a proper exercise of the Treasury Department's authority.

- **What steps has the Treasury made in 2009 to assure that all guidance the Treasury issues is within the authority granted to the Department by the Constitution and by Congress?**

Before any item of regulatory or other public guidance is issued, it is reviewed twice to determine whether authority for the guidance exists. First, the Chief Counsel of the Internal Revenue Service must review and approve the guidance. Second, the lawyers in the Office of Tax Policy at Treasury also undertake a review of whether authority exists for the issuance of the guidance. In conducting this review, Treasury takes into account the Chief Counsel's views concerning whether the guidance is within the authority granted to the Department. A regulation or other item of published guidance is issued only if the Treasury concludes, upon the completion of these reviews, that there is authority for the issuance of the guidance.

- **What assurances can you offer that Treasury will comply with the Congressional Review Act of 1996?**

Treasury is committed to complying with all applicable laws, including those that govern the process we must follow in issuing guidance. You have my assurance that Treasury will continue to meet its obligations under the Congressional Review Act of 1996.

Question 5: Corporate Tax Rate

In your testimony to the Committee, you mentioned that according to some measures, the US has the second highest statutory marginal corporate income tax rate of OECD countries.

Do you think having a low corporate tax rate is important in assuring that US multinational corporations are competitive?

Which of the following do you think is more important in keeping US multinational corporations competitive: The average tax rate, or the marginal tax rate? In answering this question, please clarify your understanding of those terms "average tax rate", "marginal tax rate," or any other similar terms you may use in discussing this question.

All of these measures provide important insights into the effects of the corporate tax system on multinational corporations.

Both the statutory and marginal effective tax rates influence international economic decisions. The statutory corporate income tax rate in combination with other features of the tax code determines the “marginal effective tax rate,” which measures the effect of the corporate income tax (and other taxes) on investment decisions. Marginal effective tax rates show the total percentage of capital costs, excluding economic depreciation, needed to pay taxes over the lifetime of a marginal investment (i.e., an investment assumed to just break even). The statutory tax rate also is important because it influences the extent of the incentive to shift income into or out of the United States. In some cases, the decision on where to locate the production of a particular highly profitable good or service is based not only on the marginal effective tax rate, but also the taxation of infra-marginal returns (returns above those needed for the investment to just break even) which are taxed at the statutory tax rate.

Neither the statutory nor the marginal tax rate measures the overall portion of corporate income that is paid in taxes. For that purpose, the average corporate income tax rate, i.e., the ratio of corporate taxes to corporate capital income, is the appropriate measure. It can differ from the marginal tax rate for several reasons, including the existence of substantial economic profits. It could also differ from the statutory rate, depending upon the level of tax compliance and enforcement.

Compared to the statutory rate, the marginal effective tax rate may give a more accurate picture of the incentive for corporations to invest at the margin. Statutory rates, however, influence decisions regarding both income shifting, as well as the investment location with respect to highly profitable goods and services. As such, a high statutory rate can act as a disincentive to certain investment and an incentive to income shifting.

Question 6: Bonus Tax Legislation

Legislation that passed earlier this year in the House of Representatives (H.R. 1586) would tax bonuses paid on or after January 1, 2009, to employees of companies that received TARP funds. Similar legislation (S. 651) has been introduced in the Senate.

The legislation was triggered by the justifiable outrage last Spring over the revelation that the employees of AIG Financial Products were being paid bonuses totaling \$165 million. AIG Financial Products is the very AIG Division whose reckless risk taking would have brought down AIG but for the U.S. taxpayer rescue. Many believed, I among them, that the bonuses were absolutely indefensible.

Despite the public outcry, the bonuses were paid in March, 2009. At the time we were told that the Treasury Secretary learned of the bonuses only days before they were due to be paid and that nothing could be done to stop the payments.

Eight months have passed since those bonuses were paid. Incredibly, the Special Inspector General for TARP reported last month that the employees of AIG Financial Products are

due to receive another round of bonuses in March, 2010. This time the payout will be \$198 million. No one at Treasury can claim that they are unaware of the bonuses this time.

The Special Inspector General also reports that efforts by Treasury to recoup the 2009 bonuses have yielded negotiations, but no bonus repayments. Worse still, the 2010 bonuses of \$198 million are still on track to be paid next March.

Do you support the bonus tax legislation to the extent that it would tax the 2009 bonuses already paid to employees of TARP recipients? If not, why not?

Do you support the bonus tax legislation to the extent that it would tax future bonuses to be paid to employees of TARP recipients? If not, why not?

Secretary Geithner's statement of June 10, 2009, which was issued in connection with legislative proposals for strengthening compensation committee independence and providing shareholders with a "say on pay," sets forth quite clearly the Treasury's view that pay should reflect long-term value creation and financial soundness that benefits corporate stakeholders and the economy at large.

TARP recipients differ from other private-sector companies because of the government's ownership interest and because taxpayers are substantial stakeholders. Representing those stakeholders, it is important that the Treasury exercise an oversight role. Mr. Kenneth R. Feinberg was designated as the Special Master to review and approve executive compensation for top executives at the seven firms (including AIG) receiving exceptional assistance. His job is to help ensure that companies strike the right balance around their need to retain talent, reward performance, and protect the taxpayers' investment. We all have a shared interest in ensuring that those companies can return to profitability as soon as possible so that taxpayers can recoup their investment.

Question 7: Use of TARP Funds

The Special Inspector General for TARP has repeatedly asked Treasury to require quarterly reports from TARP recipients regarding their use of TARP funds. Treasury always refuses, saying that money is fungible and such reports would not provide useful information. However, the Special Inspector General conducted a survey of every TARP recipient last summer and found a wealth of useful information for the asking. The Special Inspector General found that, rather than lending to businesses, many TARP recipients were using TARP funds to pay down debt, build up reserves, and acquire other banks. This is useful information and the Special Inspector General continues to recommend that Treasury require all TARP recipients to report their use of funds. Treasury has begun requiring such reports from AIG, Bank of America and Citigroup. And on November 2, 2009, a GAO report on the auto industry bailout stated that Treasury requires Chrysler and GM to report quarterly on their use of TARP funds. Obviously these reports provide useful information.

Will Treasury promise to begin requiring that all TARP recipients file quarterly reports on their use of taxpayer TARP funds and that the reports be made transparent for Congress and the public? If not, why not? Given that Treasury requires use of funds reports by

AIG, Bank of America, Citigroup, Chrysler and GM, why not require those reports of all TARP recipients?

While TARP matters are outside my area and authority, I understand from my colleagues that Treasury is committed to issuing reports that adequately address the transparency issues raised by SIGTARP. As my colleagues have previously indicated to you, Treasury will be issuing an expanded quarterly report that will cover, on both an aggregate basis and for each bank participating in CPP, all of the significant categories of uses reported in SIGTARP's Use of Funds Survey Responses, including lending, investments, capital cushion, repayment of debt and acquisitions. Moreover, the report will be based upon detailed financial information collected by bank regulators, and will specify the actual levels and changes of assets and liabilities related to each use of funds rather than simply identifying categories. Further, the Treasury report will be updated each quarter and will show how uses of capital by each CPP bank and by all CPP banks in the aggregate are changing over time. Finally, Treasury will continue to consider, evaluate and discuss with SIGTARP additional ways to collect and report information about how banks are using TARP funds.

Question 8: Historical Trends of Federal Taxes

Mr. Mundaca, the Treasury Assistant Secretary for Tax Policy plays an important role in setting tax policy in any administration. As Finance Committee members, we'd like to get your views on the trends in revenues. CBO reports that, over the past 40 years, taxes as a percent of GDP averaged 18.3 percent. In the year 2000, Federal taxes took 20.9% of GDP, a record Post World War II level. Individual income taxes were at even more dramatic levels. CBO reported individual income taxes were at 10.3% of GDP.

CBO has also indicated that revenues hit a trough, at about 16.3% for 2004. But in 2005, revenues increased to 17.5 percent, in 2006, revenues were up to 18.5 percent, and in 2007, revenues jumped to 18.8 percent – that's higher than the historical average – all with the AMT patch and the 2001 and 2003 tax cuts in place. In 2008, according to the Treasury, revenues declined slightly to 17.5 percent. Because of the recession, Treasury has determined revenues further declined to 14.8% in 2009.

Now, we hear a lot of criticisms from those who opposed the bipartisan plan. One of the main criticisms is that we cut income taxes too much. That is, the allegation is that the bipartisan tax relief plan gutted the Federal revenue base. I was pleased to see Drs. Furman and Goolsbee indicated in their Wall Street Journal op-ed of August 14, 2008, that an Obama Administration would seek to keep the revenue base at or close to historic averages of GDP.

Do you agree with Drs. Furman and Goolsbee? Do you disagree with those who argue the only path to fiscal discipline is to maintain record levels of Federal taxation as a percentage of the economy? Do you recognize that there is a downside to future economic growth if we return to record levels of Federal taxation?

I recognize that tax rates that are too high can dampen economic growth, as can unsustainable deficits. Effective tax policy balances the goals of revenue sustainability, fairness, simplicity, efficiency, and growth. I look forward to working with the Congress, if I am confirmed, to develop tax proposals that meet the Federal government's revenue needs while simultaneously being as fair, as simple, as efficient, and as pro-growth as possible. Once the economy recovers, it will be important to restore fiscal discipline, in order to avoid an unchecked rise in federal debt, which would pose a threat to the U.S. economy in the long term.

Question 9: Capital Gains Tax Rate

The House of Representatives has proposed imposing a surtax of 5.4% on singles with income over \$500,000 and couples making over \$1 million. This surtax would be imposed on a taxpayer's modified adjusted gross income (MAGI). Under the House bill's definition of MAGI, the surtax would be imposed on income that is not currently subject to ordinary income tax rates, including capital gains income.

The current top capital gains tax rate of 15% is scheduled to expire at the end of 2010. In the President's budget he proposes allowing the 15% rate to increase to 20% for singles making over \$200,000 and couples making over \$250,000.

If the House 5.4% surtax is enacted into law and the 15% cap gains rate is allowed to expire for singles making over \$200,000 and couples over \$250,000 this effectively results in a top long-term capital gains rate of 25.4%. Do you agree?

Raising the rates from 15% to 25.4% represents a 70% swing in the top rate. Do you envision any adverse consequences to equity markets as a result of this swing in the top rate?

As you point out, the President has proposed keeping the current capital gains tax rates for 2009 and 2010, and permanently extending the zero and 15 percent rates for single taxpayers with incomes under \$200,000 and joint filers making less than \$250,000. This proposal would return the top capital gains rate to what it was prior to 2003, but it would apply to fewer taxpayers. Under the President's proposals, overall tax rates on capital gains income would remain lower than prior to 2003, and those same low rates would apply to dividends as well.

While capital gains tax rates can affect stock prices, the effects are generally thought to be outweighed by other factors, such as the strength of the overall economy. The President's Budget proposals reflect the view that in 2011, when our economy is back on track, it is critical to focus on restoring fiscal discipline and reducing the deficit, to promote long-term economic growth.

Question 10: Delinquent Debt Collection/Tax Gap

According to a GAO report from last year, the amount of delinquent tax debt is almost \$300 billion of which over \$100 billion was deemed collectible.

In letter dated March 6, 2009, I expressed my disappointment about killing the private debt collection program to Secretary Geithner and Commissioner Shulman and requested that Treasury and IRS develop a strategic plan to reduce the amount of delinquent tax debt and provide regular progress reports. I have not yet received any updates since my March letter. I ask for your commitment to work on that strategic plan and that you ask IRS to provide the updates requested immediately.

Congress and the Administration have many ideas for new and complex ways to tax individuals and small businesses to fund all sorts of new spending. It would seem wise to make sure people are paying what they owe before we tax them even more. What has been your involvement in both tax gap reports Treasury provided to the Committee? What recommendations do you have to improve tax collections and the tax gap overall?

If confirmed, I will work with Commissioner Shulman to ensure that the Internal Revenue Service has in place a plan, as well as the resources, necessary to collect tax debts, and that you are updated on progress. In regard to a strategy to improve collections, the Administration's Budget proposals for Fiscal Year 2010 contain a number of proposals focused on improving collections, including increasing the ability of the IRS to levy payments made to federal contractors and expanding the scope of payments that could be subject to a 100-percent levy by the IRS.

In my prior position as Deputy Assistant Secretary for International Tax Affairs, I did not prepare the 2007 tax gap report, which focused largely on domestic issues. However, as Acting Assistant Secretary (Tax Policy), I exercised oversight over the preparation of the more recent tax gap report. This report highlighted, among other points, the levy proposals in the Administration's Budget proposals which would help address the tax gap, as would a number of other proposals dealing with expanded information reporting, improved compliance by businesses, strengthened tax administration, and increased penalties. In addition, simplification of the tax laws and reducing compliance burdens (by, for example, making e-filing easier and more accessible) will help to narrow the tax gap.

Question 11: Use of Third Party Data

In your response to Chairman Baucus's question about the combating the tax gap, you mentioned information reporting. However, one GAO report after another highlights that IRS is not utilizing the information it already receives. Why do you think additional information will help? How will you help insure that any new information provided to IRS from 3rd parties will be used effectively and efficiently by the IRS?

Although compliance generally increases significantly for amounts that a third party reports to the IRS, excessive reporting of unnecessary information not only burdens taxpayers and third parties, but may also hinder the IRS's ability to process and use necessary information. It is therefore critical that the information requested by the IRS from taxpayers and third parties meets specific tax compliance and enforcement needs. There are many important information reporting programs already in place that provide critical information to the IRS. However, there remain additional sources of information that could potentially improve tax compliance if made

available to the IRS. The Administration's Budget proposals for Fiscal Year 2010 contain a number of proposals addressing those additional sources of information, including increased information reporting by foreign financial institutions, domestic corporations, and insurance companies. The Treasury Department is also actively working to implement recent legislation providing for increased information reporting related to credit card payments and the tax basis of securities. If confirmed, I will work to ensure that the information reporting required by the IRS does not overly burden taxpayers and focuses on meeting specific tax compliance and enforcement goals of the IRS.

Question 12: Offshore Tax Abuse

There are at least two different Senate proposals to curb off-shore tax shelters. In addition to the Chairman's proposal, Senator Levin has proposed creating a blacklist of countries. What do you think of this approach?

The Administration appreciates Sen. Levin's leadership in highlighting the importance of combating offshore tax abuse and seeking ways to address the issue. Senator Levin's proposal would base imposition of negative consequences with respect to entities, transactions, and financial accounts on their association with countries on a list of "offshore secrecy jurisdictions." The Chairman's proposal and the Administration's Budget proposals, however, take a different approach. Because foreign financial institutions are in the best position to provide the IRS with the information it needs to enforce U.S. tax laws, the Administration's Budget proposals, like the Chairman's proposal, focus on financial institutions instead of countries, and impose negative tax consequences on foreign financial institutions (including offshore investment vehicles), wherever located, that do not agree to collect and provide information to the IRS with respect to U.S. accountholders.

Question 13: Update on Studies Mandated by the Pension Protection Act

In August 2009, Treasury tax staff briefed Finance Committee on the studies required by the Pension Protection Act. I understood that both the study on supporting organizations and donor advised funds and the study on investments in life insurance by tax-exempts would be completed by the end of the year. Please provide an update on the status of these studies.

Completion of these reports is a high priority. We intend to deliver the report on charity-owned life insurance by the end of this year. We are also in the final stages of completing our report on donor-advised funds and supporting organizations, which we now intend to deliver by the end of February 2010.

Question 14: Return Preparer Regulation

Regulation of return preparers is of concern to both me and Chairman Baucus and Commissioner Shulman has made this a priority. Since it can be a key tool in combating the tax gap and you have extensive experience as a practitioner, please provide your thoughts on what standards should apply to do paid and unpaid preparers. Should those

subject to Circular 230 be subject to additional standards? Should those not currently regulated be subject to tests and other standards? What should the role of the IRS be compared to the role of private sectors, e.g., professional associations?

I fully support Commissioner Shulman's recent initiative to study the regulation of tax return preparers. Based on the public comments received in connection with that initiative, there appears to be broad based public support for ensuring that all tax return preparers meet certain standards of professional competency. I look forward to reviewing the Commissioner's recommendations in this area.

Question 15: Customs and Border Protection

Are you aware of the important role that the Treasury Department has in working with Customs and Border Protection on customs regulations? Do you have any recommendations for improving the operation of the delegation of customs authority by Treasury to the Department of Homeland Security?

I am aware of the important responsibility that Treasury has for customs revenue functions. I believe that a critical step in promoting effective operation of the delegation of customs authority to the Department of Homeland Security is through close cooperation with that Department, and other parties with an interest in the process, including, of course, the Committee.

Question 16: Interagency Consultation/Coordination

The Department of the Treasury, in coordination with the Department of Homeland Security, promulgated regulations in 2008 and 2009 that proposed to alter longstanding administrative customs practices before consulting with this Committee or other appropriate federal agencies. For example, Treasury promulgated a notice of proposed rulemaking on heading "9802" of our tariff schedule before consulting with the Office of the United States Trade Representative. The "9802" proposal was subsequently withdrawn because of concerns over its consistency with our international trade obligations.

Senator Baucus and I recently introduced a customs reauthorization bill. Section 102 of our bill establishes an interagency review board comprised of officials from Customs, the Departments of Homeland Security, Treasury and Commerce, and the Office of the United States Trade Representative, to review regulations before they are promulgated to determine whether they conform to our international trade obligations. Do you think such a review board will improve the coordination among these agencies with respect to the development and administration of our domestic customs laws and regulations? Do you have other ideas for improving coordination among these agencies?

I am a firm believer in interagency coordination. As a matter of practice, Treasury now consults with USTR on all customs regulations prior to publication. I am open to proposals that would ensure comprehensive review in appropriate circumstances.

Another example I would cite is the so-called “first sale” rule. Treasury promulgated a notice of proposed interpretation on “first sale” before consulting this Committee. The rule elicited a strong response from the business community and Congress, which passed a sense of Congress stating that Customs should delay implementation of the rule until further information is known about the impact on international trade flows.

Do you consider it part of your agency’s mission to keep the Finance Committee fully informed of such matters? If confirmed, will you recommit your agency to regularly engage this Committee in advance of proposing or finalizing any significant changes to the administration of U.S. customs laws?

I believe it is important to keep the Committee fully informed about significant matters in customs administration and will regularly inform the Committee of significant changes in customs administration that are subject to Treasury review.

Question 17: International Trade Data System

Congress vested the Treasury Department with the authority to develop the International Trade Data System. Are you aware of the importance of this system? If confirmed, will you devote the necessary resources to complete the development of the ITDS and to coordinate integration of ITDS capability into the Automated Commercial Environment with CBP?

ITDS can significantly reduce the burden of complying with import formalities by eliminating redundant import filing requirements. Treasury chairs the interagency ITDS Board of Directors and coordinates interagency participation in ITDS, and is a strong supporter of the ITDS program. Currently, building ITDS functionality is the responsibility of Customs and Border Protection and is funded by appropriations for DHS.

ANSWERS TO QUESTIONS FROM SENATOR ROCKEFELLER

Question

A number of companies have suffered greatly due to last year's unprecedented economic crisis and sudden drop in stock value. This unforeseen event created unintended consequences in the application of some tax laws.

One area where this has occurred is in the measurement of whether there has been a 50% or greater "change in control" of a company for purposes of IRC section 382. If a "change of control" is deemed to occur, a company can lose significant tax assets (through the elimination and limitation on the use of losses it has incurred over time). This technical operation of a complicated rule has serious, practical consequences for companies. When tax assets are lost, a company has a harder time generating capital, thereby reducing its ability to expand capacity to create jobs.

The question of how to determine a "change of control" in an economic downturn creates a number of issues, including: (1) how to account for dramatic changes in stock prices that create "5% owners" whose holdings need to be monitored and accounted for; (2) how to deal with changes when a company has different classes of stock; and (3) how to apply the existing "segregation" rules in the current IRC section 382 regulations.

I understand that the Treasury Department is looking at developing additional guidance under IRC section 382 to address the questions raised by the recent economic downturn. Last year, Treasury used its authority under IRC section 382 to address the impact of the rules on a very small number of affected taxpayers. I believe that it is beneficial to provide guidance to a much larger segment of impacted taxpayers. As you develop your new guidance, we strongly urge you to consider an application of the "change of control" rules that takes into account last year's dramatic and sudden downturn in the stock market and to address all the issues raised by this unforeseen change of events.

Can you specifically look at issuing guidance under IRC section 382 that addresses the three issues mentioned above? Can you provide me with a timeline for when guidance will be issued?

I look forward to working with you on sensible rules that interpret our tax laws in a way that allows companies to grow and create jobs during these challenging economic times.

I recognize that Internal Revenue Code section 382 is a concern to a broad cross-section of this nation's business community, and that it can have a significant effect on a company. The Guidance Priority List for 2008-2009 included an item for guidance addressing fluctuations in value described in Code section 382(l)(3)(C), and we are actively developing that guidance, and hope to issue that guidance within the next few months. In addition, I fully support reviewing and developing additional broad-based public guidance under section 382, which may include re-examining the issues you describe.

ANSWERS TO QUESTIONS FROM SENATOR SCHUMER

Question

In 2003, the Bush Administration delegated a significant amount of authority to the Deputy Assistant Secretary for Tax, Trade and Tariff Policy, a career position in the Office of Tax Policy that you will manage. This delegation appears to have resulted in issuance of proposed rules that seek to set policies that neither reflect the political position of the administration, nor reflect any sensitivity to the role of Congress in these matters. Recent examples include the proposed rules on "first sale" and on duty drawback.

As Assistant Secretary for Tax Policy, will you take an active role in reviewing trade policy issues and proposed rules?

What steps will you take to ensure that proposed rules reflect authority delegated to the agency by Congress?

If confirmed, I will ensure that proposed rules involving customs revenue functions are scrutinized with regard to their relationship to our trade policies and our international obligations. In addition, I will ensure that significant regulatory proposals involving customs revenue functions are brought to the attention of the Committee.

ANSWERS TO QUESTIONS FROM SENATOR NELSON

Question 1

In a couple of years, we expect large job losses at the Kennedy Space Center in Florida. The Clinton Administration was effective at designing regional tax incentives for economically distressed areas, such as Empowerment Zones and Renewal Communities. It makes sense to focus resources on areas most in need. As Assistant Secretary, will you work with us to develop a similar proposal for areas, such as the Cape, that need help?

I share your concern for those who have lost their jobs, such as those at the Kennedy Space Center. If confirmed, I would be happy to work with you on this issue.

Question 2

The President's budget would impose an excise tax on drilling in the Gulf of Mexico in the case of companies with windfall profits from poorly drafted leases. I have a strong interest in preventing drilling off the Florida coast. What is the status of this proposal?

I understand the Government Accountability Office has reported that the return to the taxpayer from drilling in the Gulf of Mexico is among the lowest in the world, despite other factors that make the United States a comparatively good place to invest in oil and gas development. I also understand that an excise tax on Gulf of Mexico production would advance important policy objectives, such as providing a more level playing field among producers, raising the return to the taxpayer, and encouraging sustainable domestic oil and gas production. The Administration's Fiscal Year 2010 Budget committed the Administration to working with Congress to develop a proposal to impose an excise tax on certain oil and gas produced offshore in the future. If confirmed, I will work with Congress to develop such a proposal.

Question 3

Early next year, the Senate should consider financial regulatory reform. Financial derivatives used by AIG and others played a significant role in the financial crisis. Are the tax rules related to financial derivatives part of the problem? Do they need reform?

Most financial institutions mark to market their securities, including their derivatives positions, for both financial accounting and tax purposes, thereby ensuring that book and tax income are closely aligned. This book-tax conformity should minimize the role that tax rules alone play in influencing behavior. Moreover, although derivatives may have concentrated risk and thereby contributed to the financial crisis, it does not appear that that concentration was influenced by the tax treatment of derivatives. As Congress considers financial market reforms, and as the market for derivatives becomes more standardized and more contracts move to exchanges and clearinghouses, Treasury will monitor the situation to determine whether existing tax rules should be revised to reflect those changes.

Question 4

The public is understandably outraged with Wall Street bonuses. Are the tax rules related to executive compensation unfair? For example, an average worker is limited in how much he can put in a 401(k) account. But the tax law allows corporate executives to defer unlimited compensation as long as certain requirements are met. Is reform needed?

As you know, the Federal income tax treatment of section 401(k) plans – which are tax-qualified – is different from the tax treatment of executive deferred compensation, which, for the most part, is not tax-qualified. The limits on contributions by employees to 401(k) plans are part of this structure, which accords tax-favored treatment to those plans, largely by allowing employees to defer recognition of income on the contributions until amounts are paid from the plan, even though the benefits are held in trust for the employee, protected from the employer's creditors, and the employer can claim a current tax deduction for contributions. Contributions to tax-qualified plans such as 401(k)s are limited in view of this favorable treatment. By contrast, the tax law generally does not accord nonqualified deferred compensation this same combination of advantages (including the fact that employers receive no current deduction for amounts deferred and are taxed on any earnings on assets not paid out as current pay); accordingly, Congress to date has not imposed dollar limits on nonqualified deferred compensation.

The Code section 409A rules that Congress enacted in 2004 also help constrain executive deferrals by ensuring that the amounts deferred really do remain subject to the claims of a company's creditors in the event of bankruptcy and by placing stringent limitations on the ability of executives to control the timing of distributions from nonqualified deferred compensation plans.

Question 5

What is the status of the U.S. Treasury's negotiations with the Government of Panama on reform of their tax laws?

For a number of years, the Treasury actively pursued a Tax Information Exchange Agreement (TIEA) with Panama. Negotiations have been stalled for the past several years, however. In May 2009 the Government of Panama publicly committed to negotiating an agreement with the United States that would provide for full exchange of information related to tax matters. We hope to make progress on this matter in the near future.

Question 6

What would be the minimum commitment you would require from Panama on its tax reform before the administration will send this agreement to Congress?

The Treasury would require Panama to commit to a TIEA that complied with international standards, in particular the OECD and US Model TIEAs. This would include the obligation to

obtain and exchange information held by financial institutions in response to a request for information that was made pursuant to the TIEA.

Question 7

Are you aware of any provisions in the U.S.-Panama trade agreement that would remove key policy tools used to combat financial crimes and would conflict with U.S. government efforts to combat the global economic crisis by re-regulating finance?

No, I am not aware of any such provisions.

ANSWERS TO QUESTIONS FROM SENATOR HATCH

Question 1

I am very concerned about some of the proposals in the Treasury's Green Book for this year that are designed to discourage "U.S. businesses to shift their investments and jobs overseas." You are an experienced international tax expert. Do you believe the current U.S. tax law creates any disadvantages for U.S.-based multinational corporations in competing against their non-U.S.-based counterpart companies? Do you think there is a danger that by making our international tax rules even less friendly to U.S. businesses that we discourage such firms from forming in the United States or even providing an incentive for them to leave this nation?

The academic literature is replete with evidence that U.S. foreign direct investment is a positive thing for the United States, both in terms of domestic employment and in terms of global competitiveness. How would making U.S. companies even less competitive through more onerous tax rules help achieve the President's goal of encouraging growth and recovery and creating jobs?

The Administration is concerned about the competitiveness of both U.S. businesses and U.S. workers. Numerous academic studies have considered the relationship of foreign investment to domestic employment. Some of those studies have found a positive relationship and others a negative relationship. Some forms of foreign investment are associated with a decrease in domestic employment, while others are associated with an increase in domestic employment. For example, there are two potential effects on domestic employment if a U.S. multinational corporation shifts some of its production activities overseas to take advantage of lower foreign production costs—a substitution effect and a scale effect. The lower foreign production costs may cause a substitution of foreign for domestic workers (the substitution effect). However, if the lower foreign production costs cause an increase in demand for the U.S. multinational corporation's products, the corporation may then increase output, which could raise investment and employment both in the United States and abroad (the scale effect). The net effect on domestic employment could be either negative or positive depending on the relative strengths of the two offsetting effects.

The process of considering whether and how to tax the active foreign income earned by the foreign subsidiaries of U.S. multinational corporations, in my view, should begin with a comparison of the domestic employment gains and increased domestic business activity known to result from domestic investments (for example, in education or infrastructure) with the net domestic employment gains or increased domestic business activity that result from reducing the U.S. taxation of U.S. multinational corporations' overseas income.

If confirmed, I commit to work with Congress to create rules that maximize the economic welfare of U.S. citizens and residents.

Question 2

Do you think that fundamental and wholesale reform of the tax code is politically possible in the next two years? Or, do you believe that it might make more sense from a practicality standpoint for the Administration and Congress to pursue a series of incremental reforms that simplify the code and improve incentives for both households and firms?

Given the need to reduce the budget deficit, we should consider comprehensive tax reform that promotes growth, simplifies our current rules, and fairly raises adequate revenue for the Federal government to meet its obligations. If I am confirmed, I will work with Congress to help enact tax reforms that achieve those goals.

Question 3

Mr. Mundaca, as you know, in the Finance Committee's health care bill there is a provision that requires individuals to obtain health insurance or else face a penalty of \$750. The bill also includes various "annual sector fees" on several parts of the health care industry. During the markup of this bill, there was quite a disagreement as to what is and is not a tax. What is your definition of a tax and would you consider the excise tax and the annual sector fees in the health care bill to be taxes?

The House and the Finance Committee health care bills provide different means to offset the cost of health care reform. The Finance Committee bill imposes a penalty on individuals who fail to obtain coverage and imposes fees on certain sectors of the health care industry. In general, a penalty is exacted when proscribed behavior is engaged in. A fee is generally imposed in return for a benefit, such as access to a larger market.

Question 4

As you probably know, Chairman Baucus and I have introduced a bill to extend permanently the research tax credit. I am aware that the Treasury's Green Book for this year once again includes the proposal to make the research credit permanent. My question, however, is whether the Treasury supports expanding the credit as well, by strengthening the alternative simplified credit, as we propose in the Baucus-Hatch bill?

The Administration appreciates your efforts and the efforts of Chairman Baucus to extend the research credit permanently. The research tax credit encourages technological developments that are an important component of economic growth. However, the Administration believes that the credit's temporary nature undermines its effectiveness. Uncertainty about the future availability of the research tax credit diminishes the incentive effect of the credit, because it is difficult for taxpayers to factor the credit into decisions to invest in research projects that will not be initiated and completed prior to the credit's expiration. Therefore, the Administration's priority is to make the credit permanent, and a proposal to make it permanent was included in the Administration's FY 2010 Budget. The Administration also agrees that the credit's structure could be simplified or updated in certain respects to improve its effectiveness. I look forward to working with Congress, if I am confirmed, on possible modifications to the credit.

Question 5

Mr. Mundaca, as you know, our tax law contains a provision that temporarily provides an exemption from subpart F for active financing income. This provision is very important for U.S.-based companies competing globally in insurance, banking, and other financial services sectors. Does the Treasury Department support a permanent extension of this provision?

The Administration supports extending the active finance exception for one year as described in its Fiscal Year 2010 Budget. If confirmed, I look forward to working with Congress to consider whether this section should be extended beyond 2010.

ANSWERS TO QUESTIONS FROM SENATOR SNOWE

Question 1

Mr. Mundaca, as you are well aware, the House is considering offsetting the cost of health care reform with a surtax on high-income individuals. In particular, the House bill would apply a surtax of 5.4 percent on single filers with over \$500,000 in income and married couples with over \$1 million in income. Given the fact that the 2001 tax cuts are expiring at the end of 2010, the impact of this tax increase will be to take the top marginal income tax rate from 35 percent today to 45 percent, a staggering 29 percent increase. Given that small businesses often pay taxes through the individual income tax system, as Ranking Member of the Senate Committee on Small Business and Entrepreneurship, I am extremely concerned about the potential impact of these surtaxes on small enterprises and their ability to continue generating the 64 percent of net new jobs that will lead us out of this devastating recession.

Mr. Mundaca, could you comment where the Administration stands on the surtax? Would you agree with me that health care reform should be financed within health care? Why or why not? Would you also agree with me that the House surtax could have a devastating economic effect, especially when combined with the expiration of the 2001 tax cuts, by impeding small business' ability to create jobs and drive economic growth? Additionally, would you not also concur that the surtax contemplated by the House would harm a small business' ability to provide quality, affordable health insurance?

One of the Administration's principal goals of health care reform is to relieve the burden on small businesses. Each of the bills making their way through Congress includes several important measures, including health insurance exchanges and a small business tax credit, that will make it more affordable for small businesses to provide health insurance to their workers.

As your question indicates, the House and the Finance Committee health care bills provide different means to offset the cost of health care reform. If confirmed, I look forward to working with Congress on those proposals.

Question 2

Mr. Mundaca, employees are able to exclude from taxation health insurance benefits provided by their employer. This is true not just for income taxes, but for payroll taxes also. Self employed people are not permitted to exclude their health insurance premiums from payroll taxes for Social Security and Medicare. This is a double burden for the self-employed because they pay both the employer and employee share of the tax, known as the Self-Employed Contributions Act - or SECA tax. For a family insurance policy in the individual market that costs \$20,000, the SECA tax burden of 15.3 percent would be another \$3,060 of tax.

There is currently a surplus in the Finance Committee bill that is credited toward the Social Security trust fund. This surplus arises from the excise tax on high cost health insurance from people making a rational choice to take higher wages instead of non-taxable health benefits and those higher wages result in enhanced payroll tax collections. Mr. Mundaca, given that the excess funds in the bill are directed to the Social Security Trust Fund and that there is no policy reason to differentiate between employees and the self-employed regarding the exclusion for health benefits, will the Administration support addressing the inequity of the SECA tax problem?

Your question correctly states that health care expenses incurred by a self-employed individual are deductible for federal income tax, but not for self-employment tax (SECA) purposes, whereas health care costs are excluded from an employee's income for both federal income tax and FICA tax purposes. It is difficult to compare the equities of the deductibility of health care expenses for self-employed individuals versus employees because the taxation of self-employment earnings differs in a number of fundamental ways from the taxation of employee wages. For example, self-employed individuals may deduct the full amount of their business expenses against their self-employment income, while an employee's business expenses are itemized deductions that are generally subject to a 2% of income floor. Because of these differences, any consideration of a change in the deductibility of health care cost for SECA purposes should be considered in context of the overall taxation of self-employment earnings.

ANSWERS TO QUESTIONS FROM SENATOR KYL

Question:

A number of commentators have suggested the adoption of a securities transaction tax, or so-called Tobin tax, as a means, in part, to reduce excessive speculation in the financial sector. The Tobin tax has been proposed in various forms since the early 1970s.

A securities transaction tax would have a significantly negative impact on the financial markets - at precisely the worst time possible. President Obama and Secretary Geithner have spent much time and effort in working to repair the U.S. financial markets given that the economic recovery we are beginning to witness depends in no small measure on a well-functioning capital market.

Can you provide to the Committee your thinking on the effects that a securities transaction tax would have on the U.S. capital markets? In particular, I would be very interested to learn of your views on how the U.S. financial market could retain its preeminent global position, along with the hundreds of thousands of jobs associated with that sector, by adopting a Tobin tax.

Many countries have experimented with different versions of a transaction tax or a Tobin tax. There is no disagreement that we need to create a more stable system where taxpayers are not exposed to the risk of loss from financial institutions and where those institutions do not operate with the expectation that the government will be there in the future to bail them out. Our approach is focused on how we build a system in which taxpayers do not have to absorb the costs in the future and financial institutions are responsible for the risks they take and the consequences of their mistakes.

ANSWERS TO QUESTIONS FROM SENATOR ROBERTS

Question 1

The America's Healthy Future Act imposes an individual mandate penalty on those who do not purchase health insurance. Under the bill, the Internal Revenue Service (IRS) is tasked with collecting this penalty. There are millions of individuals and families who are not required to file tax returns. What processes will the IRS have to develop and implement in order to verify that this group has obtained health insurance? What will be the cost to develop and implement these measures?

Under the Committee's bill the IRS is responsible for enforcing the penalty on individuals who fail to obtain coverage. The bill also limits collection to withholding from federal payments, and prohibits the IRS from imposing criminal or civil penalties on individuals for non-compliance. Although the IRS has begun analysis of the implementation needs, no cost estimates have been prepared.

As I understand the Committee's bill, individuals and families whose income level is below the threshold for filing a tax return will likely either be exempt from the penalty or will have coverage through Medicaid or Medicare. Certain of these individuals may purchase coverage with the tax credit provided in the bill, in which case they will be required to file a tax return in order to retain the credit.

Question 2

The America's Healthy Future Act imposes a penalty on employers that do not provide affordable health care coverage. In order to accurately calculate and pay this penalty, the employer will have to obtain information from each employee about their income, including income from other employers. Employers will also have to collect information about whether the employee has purchased health insurance through an exchange, and information about whether the employee is eligible for the premium credit.

This seems like a significant increase in the scope of information that employees will have to provide to their employers. What privacy provisions will apply to the collection and use of this information? How will this information be collected? Will penalties be assessed for noncompliance with these additional information requirements?

As I understand the Finance Committee bill, the details regarding how employers will collect necessary information are not specified. If confirmed, I look forward to working with Congress to ensure that the use of individuals' private financial and health care information is maintained

in strict confidence and protected as appropriate by the provisions of section 6103 of the Internal Revenue Code and the HIPAA privacy provisions.

Question 3

The America's Healthy Future Act imposes an excise tax to fund the Patient-Outcomes Research Trust Fund. Does the IRS currently have the ability to determine which entities will be required to pay these excise taxes? If not, how will the IRS make such a determination?

The Finance Committee's bill calls for a Patient-Centered Outcomes Research Trust Fund that would be funded in part by a fee for each individual covered under insured and self-insured health plans. For insured plans the bill calls for the fee to be collected from the issuer of the insurance policy. For self-insured plans, the fee would be collected from the plan sponsor. Since this would be a new fee, the IRS does not currently have in place forms and processes for collecting it, but I believe that the IRS will be able to determine which entity – insurance carrier or plan sponsor – will be responsible for paying the fee depending on the nature of the plan and should have no special difficulty in developing the necessary forms and procedures.

ANSWERS TO QUESTIONS FROM SENATOR ENSIGN

Question 1

Sixty-seven Senators are cosponsors of legislation introduced by Senator Kerry and myself, S. 144, which would remove cell phones from the definition of listed property. I understand that both business and the IRS recognize the difficulty of keeping cell phone records. Related to this issue, Commissioner Shulman issued a statement asking Congress to act “...to make clear that there will be no tax consequences to employers or employees for personal use of work-related devices such as cell phone provided by employers.” That is precisely what we hope to do, and this is the kind of tax simplification that the Congress and the Administration should be cooperating on. Since Congress is quickly moving to legislate on this matter, what can the Treasury do to minimize administrative burdens on taxpayers during the interim?

I agree with the Commissioner that the laws related to the tax treatment of the personal use of employer-provided cell phones are out of date, and should be updated. Until that happens, the treatment of employer-provided cell phones as ‘listed property’ under current law is established by statute. I understand your question to be directed to the IRS’s administrative approach in examinations related to that issue. While enforcement is fundamentally a matter within IRS jurisdiction, we at Treasury are also aware of the problem and will continue to work with the IRS in crafting a reasonable solution to it. The Treasury and IRS have expressed their interest in suggestions on how to minimize administrative burdens within existing law and are reviewing public comments already received in an effort to develop ways to assist taxpayers. For example, approaches being considered to address the current substantiation rules include a method under which minimal personal use would be deemed allowable, a safe harbor substantiation method under which a stipulated percentage of cellular telephone use would be deemed to be business use, or a statistical sampling method to allocate personal and business use.

Question 2

The President has repeatedly promised not to raise taxes on lower and middle income families (i.e., those making less than \$250,000 per year). Yet, there are many new taxes being proposed in the healthcare and cap-and-trade legislation under discussion in the Congress. Specifically, there is an individual mandate excise tax, a “high cost insurance plan” tax, an insurance company tax, a medical device maker tax, a clinical laboratory tax, an employer mandate tax, a pharmaceutical maker tax, and a small business surtax.

- a. Do you agree that the healthcare legislation now under consideration by the House and Senate (H.R. 3962 and S. 1796) would impose new or higher taxes on middle income families who make less than \$250,000 per year? If not, why not?**
- b. According to the Congressional Budget Office and the Joint Committee on Taxation, some of these new taxes or “fees” will be passed through to consumers.**

Do you agree, and do you have any analysis that relates to the impact on consumers of any of these healthcare taxes?

- c. Do you agree that new taxes that increase taxpayer costs for healthcare, such as insurance, pharmaceuticals, lab tests, and medical devices, violate the President's promise not to raise taxes on families making less than \$250,000 per year? If not, why not?**
- d. Do you maintain that imposing taxes on businesses in the amount of hundreds of billions of dollars would not violate the President's promise not to raise taxes on middle income families even when it can be conclusively demonstrated that these taxes will ultimately be borne by middle income families as consumers?**
- e. Will you definitively and without qualification guarantee that not "one dime" in new taxes or new tax liability will be imposed on middle income families as a result of the healthcare bill the President ultimately signs?**
- f. As an acting official of the Treasury department, have you seen or prepared a Treasury analysis on the impact of any of these new healthcare taxes, as embodied in the current House and Senate bills, on middle income families and whether and how much this group will ultimately pay in higher costs, either directly or indirectly? If so, please provide that analysis.**

As your question indicates, various versions of health care reform legislation are currently under consideration in Congress. A variety of ways to offset costs, in addition to those the Administration suggested, have been proposed and are still being considered. As you know, the characteristics of those offsets, the amounts they would raise, and the overall economic effects of the various proposals have been the subject of extensive analysis and discussion by the Committees, their staffs, and the Congressional Budget Office. I have not seen or prepared a Treasury analysis on the impact of the proposed healthcare offsets embodied in the current House and Senate bills. Once Congress determines the appropriate direction forward, Treasury looks forward to working diligently to evaluate any tax implications that may result.

The President has outlined three key goals that the final health care bill must meet: to provide security and stability for those with insurance, to bend the cost curve for American families and businesses, and to provide insurance for those who cannot afford it. I share and support the President's vision for what successful health care reform should achieve.

The President also has pledged not to raise taxes on families with incomes below \$250,000. If confirmed, I will support the President and Congress as they work to pass health care reform legislation that is consistent with that pledge.

Question 3

According to many charitable organizations, placing restrictions on taxpayers' itemized deductions would negatively impact the incentives to contribute to charities. For that reason, many charitable organizations oppose these restrictions especially during this

economic downturn in which charitable giving is down but charitable services are sorely needed. What is your view of the impact of cuts in charitable giving? Do you agree that cuts in charitable giving are likely if the deduction is restricted? If you agree with the Administration budget proposal to restrict charitable deductions, why do you believe such charitable work is relatively less important compared to the new spending the Administration proposes to make with the new revenue generated from restricting charitable deductions?

The evidence suggests that many factors affect charitable contributions, including public desire to help the charity and overall economic conditions. For example, between 2002 and 2003, the highest income tax deduction for charitable contributions was reduced from 38.6 percent to 35 percent – and yet individual charitable contributions rose, presumably because other factors were a more important influence on giving than the change in the income tax rate.

Furthermore, the restriction on itemized deductions would affect less than 1.5 percent of taxpayers. About 75 percent of overall contributions would not be affected by the proposed restriction, because those contributions come from individuals who would not be affected or from corporations or foundations not subject to the individual income tax. Finally, even to the extent that charitable contributions are affected by tax considerations, the Administration's Budget contains other proposed changes (including retaining an estate tax) that will create stronger incentives for giving.

Question 4

There has been some concern on the part of Congress about a few recent high profile bankruptcies by qualified intermediaries in IRC section 1031 transactions leading to defalcations and failed IRC section 1031 transactions when funds held by qualified intermediaries were not available to purchase the replacement property. This result causes taxpayers hardship resulting from taxation on gains on income that has disappeared.

I understand that the IRS has plans to issue guidance on this matter. Specifically, in the 2008-2009 Priority Guidance Plan or 'Business Plan' the IRS included a reference to "[g]uidance under §1031 regarding the treatment of accounts held jointly by the taxpayer and a qualified intermediary."

As you know, the IRS can issue rules or regulations covering the requirements for qualified intermediaries under IRC section 1031. Most regulatory guidance by the IRS falls under the General Counsel's general responsibilities. Can you update the Committee on the guidance on this issue and whether the IRS will issue rules to help better ensure that taxpayers' funds held by qualified intermediaries are available when the replacement property is scheduled to close?

Treasury and the IRS are aware that the failures of several large qualified intermediaries (QIs) have resulted in taxpayers who initiated a section 1031 transaction being unable to complete an exchange, because the QI filed for bankruptcy or defaulted on its obligations. As you note, the

2008-2009 Priority Guidance Plan includes a project to address the status of accounts held by QIs. The published guidance should address the tax consequences to taxpayers who lost money or property, or who were unable to complete an exchange, due to a QI failure.

In general, a taxpayer considering a section 1031 exchange transaction is free to determine whether to utilize the services of a QI, and if so, to negotiate with the QI regarding how the taxpayer's funds – including proceeds from the sale of relinquished property – are held by the QI pending completion of the exchange. For example, a taxpayer and a QI may agree that sale proceeds of relinquished property must be placed in a trust or escrow account. Section 1031 and the regulations thereunder do not prescribe any particular arrangement or requirement regarding how funds are held.

Question 5

In the Homeland Security Act, Congress created the Homeland Security Department but clearly laid out that the U.S. Treasury Department retained authority over customs revenue functions. That authority is largely exercised out of your office. Can you confirm and elaborate on your intentions to implement this law by vigorously exercising these customs revenue functions and overseeing Customs and Border Protection to ensure that trade facilitation remains a priority? What steps will you take to ensure that CBP evaluates the impact on trade facilitation and consults with your office and the public prior to publishing new regulations?

Treasury considers trade facilitation to be an important part of its role in exercising Treasury's customs revenue function authority. All CBP regulations involving customs revenue functions are subject to Treasury review, and if confirmed I will ensure that promoting trade facilitation is a top priority.

Question 6

I am a strong supporter of “Free File” software which allows free electronic tax filing services to taxpayers through a partnership between the IRS and a group of private sector tax software companies. Most taxpayers are eligible to use this software service, and it does not cost taxpayers any money to provide the service. In contrast, I and many Members of Congress do not support the development by the government of a tax preparation system. What is your view of this?

In 2009, approximately two out of every three taxpayers e-filed their returns with the IRS. The e-filed returns included approximately three million taxpayers who used the IRS Free File program. If confirmed, I will continue to pursue ways to increase e-filing, including increased participation in the Free File program.

Increased participation in Free File is one of many ways to relieve the compliance burden on taxpayers. If confirmed, I would work closely with all interested parties to ensure that any new programs meet the common goals of increased tax compliance and reduced taxpayer burden.

ANSWERS TO QUESTIONS FROM SENATOR ENZI

Question 1: Estate Tax

If Congress doesn't act soon, the death tax will disappear in 2010 only to resurrect itself in 2011 to pre-2001 levels, making it very difficult for Wyomingites to keep the family ranch or the family business "in the family." President Obama recognized the economic imperative of a permanent fix and included a proposal of his own in his FY 2010 budget submission.

Citing the current focus on health care reform, however, some senators have floated the idea of a one-year extension of current law as a temporary patch until the Senate can learn to walk and chew gum at the same time.

Your background includes extensive experience providing tax advice to corporate clients - a group for whom tax planning and the ability to look ahead is critical to global competitiveness.

*** Do you agree the same is true for family-owned and operated businesses? Aren't small businesses as equally disadvantaged by the inability to plan ahead and make timely and efficient investment decisions as corporations are?**

Tax planning under current law regarding the estate and generation-skipping transfer (GST) taxes is particularly difficult, because the changes in law currently scheduled to take effect in 2010, and then in 2011, are more fundamental than mere changes in the applicable estate and GST tax rates and exemptions. As you appropriately point out, tax planning, whether personal or business, and whether for large corporations or smaller family-owned businesses, is more effective and efficient when there is stability and consistency in the applicable law. This is particularly true in the case of estate planning where the date of death (the future time when the plan must be implemented) is unknown, and the taxpayer may lose the capacity to change the plan in response to intervening changes in the law. Permanence in our transfer tax laws would allow resources otherwise expended on repetitive planning costs, or set aside to pay indeterminate amounts of potential tax liabilities, to be redirected into the expansion of these businesses and increased job creation.

*** Both the House and the Senate approved budget resolutions that allowed for a permanent fix to the death tax - not a temporary band-aid but a permanent fix. If for economic reasons we all agree it is prudent to act, if a bipartisan majority of lawmakers believe we should act, and if it can be done in a manner that is deficit-neutral, do you see any reason the Administration would object?**

In its Budget proposals for Fiscal Year 2010, the Administration has already endorsed a permanent fix by assuming a baseline that incorporates the permanent extension of the estate and

GST provisions as in effect in 2009. The Administration supports such a permanent resolution in this area.

*** If a majority of both chambers agree we ought to pursue a permanent fix, and President Obama agrees we should pursue a permanent fix, then why should Administration officials even entertain the notion of a one-year band-aid?**

The Administration has proposed and supports a permanent fix.

Question 2: International Taxation

President Obama's economic team proposed significant changes to international tax law in their FY 2010 budget submission to Congress. Specifically, the Administration proposed to defer expense deductions related to foreign-source income, eliminate the "check the box" rules, and revise the determination and use of foreign tax credits.

In a puzzling and unnecessarily antagonistic move, the Administration looped these proposed changes under the umbrella term "loophole closers" suggesting that corporations who exercise these legal allowances are somehow cheating on their taxes. I think the distinction between shell corporations that headquarter in tax-free banana republics to avoid U.S. taxation and U.S. multinationals like Caterpillar, Exxon, Merck and Federal Express is very bright. Grouping the two together was simply inflammatory and besmirched the important contribution these legitimate businesses make to our economy.

*** Do you believe that the Administration's proposed changes to deferral, "check the box" and foreign tax credit rules are appropriately named "loophole closers?"**

The proposals by President Obama to existing international tax law that you identify are designed to reform existing tax rules and remove inappropriate incentives to shift business activity and income offshore. The changes proposed do not address illicit or illegal activities undertaken by U.S. multinational corporations to reduce their U.S. tax liabilities.

*** Do you believe, as many other tax experts believe, that the appropriate venue to examine and debate these provisions is within the broader context of corporate income tax reform?**

It would be appropriate to examine and debate these provisions in the broader context of corporate tax reform. However, if consideration of corporate income tax reform is not undertaken at this time, it is nevertheless appropriate to examine and debate the provisions that you identify to eliminate in a more targeted way inappropriate incentives under current rules.

*** Do you think it is wise to retrench our worldwide-based international tax structure at a time when most other industrialized nations are moving towards a territorial-based system?**

It is difficult to draw definitive insights from tax law comparisons between the United States and other industrialized nations. For example, our major trading partners rely less on the corporate tax and more on value-added taxes as a source of revenue than does the United States. As a result, our major trading partners may be less sensitive, from a revenue perspective, to provisions in their tax regimes that permit the erosion of the corporate tax base.

Many proponents of the adoption of a territorial-based system similar to what many European countries have adopted assert that such a system would promote the free flow of capital cross-border by eliminating the tax on repatriation of foreign earnings. Opponents of a territorial-based system, however, assert that a significant cost of adopting such a system is increasing the effective subsidy for foreign investment made by U.S. multinational corporations that exists today, which could provide a larger incentive for U.S. multinational corporations to invest overseas and not in the United States.

The Administration has received numerous comments on these important issues, and if confirmed, I look forward to working with Congress and this Committee on proposals that would advance the economic welfare of United States citizens and residents.

*** What obstacles do you see in moving towards a territorial-based international tax system?**

There are many factors to be considered in determining whether the United States should move towards a territorial-based system similar to one of the different models that have been adopted by our trading partners. Among the factors to consider are, first, that the revenue effects of a territorial-based system are uncertain and, second, that a territorial-based system would place significant additional pressure on transfer pricing rules. The revenue effects of a territorial-based system would depend in significant part on the presence (or absence) of meaningful expense disallowance provisions; the effectiveness of transfer pricing rules; and the definition of exempt foreign income.

These, and other, concerns and issues would need to be thoroughly considered before moving towards a territorial-based system.

*** What are the disadvantages of maintaining our current worldwide-based system?**

The current U.S. worldwide tax system with deferral of tax for most foreign business income is complex and provides incentives for U.S. multinational corporations to locate new investments overseas potentially at the expense of investments within the United States. It would be appropriate to reduce existing complexity and eliminate the features of the current system that encourage shifting of investments and profits overseas. These are, by most measures, disadvantages of the current system that should not be replicated in any successor regime.

Question 3: Cap and Trade Legislation

The Administration has proposed implementation of a carbon management regime to limit greenhouse gas emissions to combat climate change. Earlier this year, at the time of the President's proposal to reduce emissions by 14 percent below 2005 levels by 2020, unemployment was around 8 percent. Today, unemployment is 9.8 percent and rising. Additionally, the legislation that is being considered in the Senate requires even greater emissions reductions - 20 percent below 2005 levels by 2020 - than the President proposed.

In testimony before the Finance Committee, economists have made clear that the only way for such a program to reduce emissions is to change behavior and the only way to change behavior is to see energy prices increase. How does the Administration justify support for more stringent programs that will raise energy prices and burden middle and lower income families with unemployment nearing 10 percent?

It is my understanding that the Administration supports a cap-and-trade program because it is a proven, flexible policy that can harness market forces to help redirect the U.S. toward a clean energy economy. It is widely recognized that flexible market-based policies such as a cap-and-trade program for greenhouse gas (GHG) emissions can offer substantial cost savings relative to traditional emission regulations. Changing the relative price of GHG intensive goods and activities through market based incentives is critical to reducing our greenhouse gas emissions in a cost effective manner. The Congressional Budget Office (CBO) has estimated that the costs of the American Clean Energy and Security Act of 2009 (ACESA), which uses a cap-and-trade policy to reduce GHG emissions, would be relatively modest. Household purchasing power would decrease by an estimated \$160 in 2020 when analyzed using 2010 income levels.

The Administration's Fiscal Year 2010 Budget proposes to use the value of allowances created under a cap-and-trade program to help vulnerable households, businesses, and communities transition to a clean energy economy. ACESA also uses the value of allowances to aid vulnerable households and businesses, and CBO estimates that households in the lowest income quintile in 2020 would see an average *gain* in annual purchasing power of about \$125 under this proposal. The Administration's Budget for Fiscal Year 2010 also proposes to use a portion of the value of allowances to fund the clean energy research, development, and deployment that will be necessary to lower households' energy costs in the future. The Administration has already made a down payment on transitioning to the clean energy economy and lowering the energy costs of American families through the American Recovery and Reinvestment Act (ARRA). For instance, the weatherization program provided for in ARRA will lower energy bills by improving the energy efficiency of low-income residences.

I understand that the Administration projects that the economy will emerge from the current recession well before the enactment of any climate change policy. I also understand that the Administration believes that uncertainty about future climate legislation has had the effect of hindering a number of important investments in our energy infrastructure. Consequently, enacting a cap-and-trade system that provides clear long-run price signals could play an important role in supporting those needed investments.

ANSWER TO QUESTION FROM SENATOR CORNYN

Question

For almost two years, Treasury has had under consideration revisions to Treasury Regulations relating to the amount of tax-exempt bonds permitted to be guaranteed by the Texas Permanent School Fund (PSF). The Texas Congressional delegation has written two letters indicating its strong support for these revisions.

The PSF has existed since 1854 and in 1983 Texas voters approved a constitutional amendment that created a bond guarantee program. The PSF guarantee program allows Texas school districts to receive an "AAA" rating on their bonds, thereby lowering their borrowing costs and eliminating the need to pay for bond insurance. While Texas law currently allows the PSF guarantee-capacity limit to be up to five times the cost value of the assets in the PSF, the applicable Treasury Regulation restricts the guarantee capacity to two and one half times the lower of the cost or market value.

The current economic downturn pushed the PSF beyond the limits permitted under the existing Treasury Regulation, and the Texas Education Agency has stopped accepting applications from school districts to guarantee their bonds. Texas school districts, many of which are packing school children into trailers, are left with the option of postponing the financing of needed facilities in hopes of revisions to the Regulation, or going ahead and paying significantly higher borrowing costs. Needless to say, neither option is attractive. Continued delay in announcing a decision on these revisions will continue to hinder the creation of jobs and the improvement of educational opportunities for Texas students.

How quickly do you think Treasury's Office of Tax Policy can act on this matter, so that the Administration can announce a decision which will allow the PSF guarantee program to resume?

The Treasury Department and the IRS are fully aware and appreciative of the recommendations for regulatory changes to Treasury Regulations on the arbitrage investment restrictions that affect tax-exempt bonds guaranteed by the Texas Permanent University Fund. These recommendations generally urge an expansion of an existing regulatory exception to the arbitrage investment restrictions to increase the amount of tax-exempt bonds permitted to be guaranteed by this fund. We understand that recent state law changes have increased the capacity of this fund to guarantee tax-exempt bonds issued by Texas local public school districts. The guaranteed bonds generally are used for capital infrastructure projects for local public elementary and secondary schools.

The Treasury Department and the IRS are giving very careful consideration to the recommended regulatory changes to the arbitrage investment restrictions that affect this fund. Representatives of Treasury's Office of Tax Policy are scheduled to meet with representatives of the IRS and Texas counsel to this fund on Friday November 13, 2009 to discuss the recommendations

further. We plan to provide further public guidance to address this matter as expeditiously as reasonably possible consistent with legal requirements.