STATEMENT OF DAVID BULLINGTON
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ON BEHALF OF
THE INTERNATIONAL MASS RETAIL ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

July 30, 2002

Mr. Chairman and members of the Committee, I am David Bullington, Vice-President for Tax at Wal-Mart Stores, Inc. Based in Bentonville, Arkansas, Wal-Mart is the nation's largest retailer, with facilities in all 50 States and in 10 foreign countries. As of June 30, 2002, the Company had 1,617 Wal-Mart stores, 1,140 Supercenters, 512 SAM'S CLUBS and 33 Neighborhood Markets in the United States. Internationally, the Company operates units in Argentina (11), Brazil (22), Canada (196), China (19), Germany (96), Korea (12), Mexico (572), Puerto Rico (17) and the United Kingdom (255). Wal-Mart also owns a 6.1% interest in Seiyu, Ltd. with options to purchase up to 66.7% of that company. Seiyu operates over 400 stores located throughout Japan. Wal-Mart employs more than 1 million associates in the United States and more than 300,000 internationally.

I appear before you today on behalf of the International Mass Retail Association ("IMRA") – the world's leading alliance of retailers and their product and service suppliers. IMRA members represent over $1 trillion in sales annually and operate over 100,000 stores, manufacturing facilities, and distribution centers nationwide. Our member retailers and suppliers have facilities in all 50 states, as well as internationally, and employ millions of Americans. As a full-service trade association, IMRA provides industry research and education, government advocacy, and a unique forum for its members to establish relationships, solve problems, and work together for the benefit of the consumer and the mass retail industry.

Introduction and Summary

I welcome the opportunity to participate in this hearing, which focuses on the role of the Extraterritorial Income ("ETI") Exclusion Act on the international competitiveness of U.S. companies. As IMRA member operations have expanded into the European Union ("EU") and other countries such as China and Mexico, there has been an unleashing of pent-up demand for U.S. goods. U.S. retailers and our vendors are clearly the largest employers in the U.S., and to the extent we are able to compete successfully worldwide, we generate employment opportunities in the United States, create additional markets and enhance economic growth in our country. Of course, many of the U.S. vendors that supply the retail products we sell overseas export through and realize the meaningful benefits of foreign sales corporations ("FSCs"). Because the U.S. tax that retailers and vendors pay directly impact the price we pay for goods and, thus, charge our customers world-wide, we have a direct interest in FSC and FSC alternatives that Congress will be inclined to develop as a result of the World Trade Organization ("WTO") ruling that the FSC/ETI regime constitutes a prohibited export subsidy.

There is an emerging consensus that, in light of the WTO decision, it is not feasible for Congress to enact new legislation that simply replicates the benefits of the FSC/ETI regime. Consistent with this emerging consensus, many in Congress have begun to focus on proposals designed to increase the international competitive position of American companies in a manner consistent with the obligations of the United States under the international agreements to which it is a party. For the reasons summarized in this statement, we share the view that it is vitally important for Congress to develop legislation that will not only assist those sectors of the U.S. economy that currently benefit from the FSC provisions of the Code, but which will enhance the competitive position of *all* American businesses in the global marketplace.

The most effective action that Congress could take, within the context of the current structure of the U.S. tax system, would be to enact a significant reduction in the corporate tax rate. This would improve American competitiveness internationally as well as at home. Moreover, and whether or not a significant reduction is enacted, if foreign source income continues to be subject to U.S. tax, Congress should revise the subpart F and foreign tax credit provisions of the Code in a manner that will both enhance American competitiveness and simplify the operation of those provisions.

Taxes and International Competitiveness

The international competitive position of American businesses is an integral factor in the health of our economy and the well being of our citizens. The U.S. federal income tax system has a significant impact on the international competitiveness of American businesses. Unfortunately, however, our current system frequently functions in ways that undermine, rather than strengthen, American competitiveness at home and abroad.

There are several fundamental points about our current tax system that the Committee should keep in mind. First, as discussed more fully below, when compared to EU member countries and other members of the Organization of Economic Cooperation and Development ("OECD"), the United States is not a low tax country for corporations. Because the United States, unlike a number of other countries, taxes corporations on their worldwide income, these comparatively higher rates of taxation have effects on international as well as domestic competitiveness. Second, while the foreign tax credit provisions of the Code aim to avoid double taxation of foreign source income, these provisions have been amended in such a manner that full relief from double taxation frequently does not actually occur.[1] Third, while the U.S. tax on foreign source income earned through controlled foreign corporations (CFCs) generally is deferred until those earnings are distributed as a dividend to the U.S. Parent corporation, the limitations on deferral contained in the subpart F provisions of the Code are broader than those of many other countries with whose businesses we compete around the world.[2] As a result of all of these factors, "a U.S. multinational frequently pays a greater share of its income in foreign and U.S. tax than does a competing multinational company headquartered outside the United States."[3]

In hearings conducted by this Committee in recent years, others have quite properly emphasized that it is essential for Congress to address the adverse effects of the current tax system on American competitiveness in a comprehensive manner. The revenue that would be generated by the repeal of the ETI provisions of the Code provides Congress with the resources to do so. The competitive position of American exporters

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[1] International Tax Policy for the 21st Century, National Foreign Trade Council, Vol. 1 at p.3.(NFTC Study)
[2] Id.
[3] Statement of Peter Merrill Before the Committee on Ways and Means, United States House of Representatives (February 27, 2002).

should of course not be ignored, but Congress should also take this opportunity to improve the international competitive position of all American businesses.

Wal-Mart is an excellent example of how success internationally generates jobs and economic growth in the United States. As we increase our number of stores overseas, we provide additional markets for the U.S. products we sell. Agricultural products from the United States are sold in our stores internationally. We support our international operations at our headquarters in Bentonville, Arkansas where we employ over 15,000 people. Fifteen hundred associates in our Information Systems Division are responsible for coordinating our worldwide distribution systems that move product anywhere in the world to the shopping carts of our customers. In addition, our numerous suppliers employ people throughout the country to support our overseas efforts. Several thousand of these employees reside in Arkansas – for example, Proctor and Gamble has 200 employees and Coca-Cola has 100 employees at our Bentonville headquarters supporting their worldwide sales to Wal-Mart.

As Congress considers reform of the tax system to enhance international competitiveness, there are a number of approaches that merit consideration. The balance of this statement outlines a series of tax law changes that Congress should consider as part of the process of maintaining and strengthening the position of American businesses in the global economy.

Corporate Tax Rate Reductions

As noted earlier in this statement, the United States is not a "low tax" country for corporations. The U.S. corporate tax rate of 35 percent is higher than that of the home countries of corporations that directly compete with U.S.-based multinational firms and many of these countries have lowered their rates in recent years. For example, the corporate tax rates imposed by the U.K. and Australia are 30 percent while France has a 33.3 percent rate. Mexico has joined this increasingly global trend and provided for a stepped rate reduction from the current 35 percent to 32 percent by 2005 and Canada has likewise enacted similar stepped rate reductions. More generally, "the average central government corporate tax rate in OECD member states has fallen since 1986 to 30.5 percent in 2001 – 4.5 percentage points less than the U.S. rate."[4]

[4] Id.

Because the United States taxes the worldwide income of American businesses, these high rates affect the international competitive position of those businesses. For example, if an American corporation, a French corporation and a U.K. corporation compete for business in the U.K., the American corporation will generally have the highest tax burden of the three, which will be triggered if it repatriates the earnings to the U.S. as a dividend. This rate disparity has an adverse effect on American competitiveness internationally and it would exist even if the foreign tax credit provisions of the Code functioned properly. Moreover, because the subpart F provisions of the Code are so broad the adverse effect of the rate disparity is all too frequently felt before repatriation of a CFC's earnings.

For these reasons, the reduction of the U.S. federal corporate income tax rate would be the most effective means to increase American business competitiveness, both at home and abroad. It would reduce the adverse impact of continued U.S. taxation of foreign source income and produce the following additional benefits. First, it would promote U.S. exports in particular, and the international operations of American businesses in general, in a way that is beyond challenge before the WTO or elsewhere as a violation of the international agreements to which the United States is a party. Second, it would be simple. Unlike many of the changes in the taxation of foreign source income enacted since the mid-1980s, there would not be yet another maze of new rules that would puzzle both taxpayers and the Internal Revenue Service. Finally, the results of a tax rate reduction would be predictable. In contrast to many of the complex recent tax law changes, Congress and the Treasury could more readily determine the immediate and ongoing impact of a rate reduction on tax receipts. Likewise, U.S. companies would be better able to plan for their future needs (e.g., for capital investment and the hiring of new personnel).

Targeted Revisions to the Taxation of Foreign Source Income

Some in Congress and in the Administration have suggested that the U.S. move away from taxing the worldwide income of American companies, and instead adopt a territorial tax regime. We believe that such fundamental tax reform issues are beyond the scope of this hearing, and that immediate, practical solutions are what this Committee seeks. Therefore, assuming that Congress chooses to continue to tax foreign source income, there are numerous changes that could and should be made to the subpart F and foreign tax credit provisions of the Code in a manner that will both enhance American competitiveness and simplify the operation of those provisions.

With respect to subpart F, Congress should reduce the number of instances where deferral is inappropriately denied, particularly in the case of active businesses. In the case of the foreign tax credit provisions, Congress should eliminate, or at least reduce substantially, situations that can result in double taxation (including situations where credits for foreign taxes actually paid cannot in fact be used). The four specific proposals discussed below are illustrative rather than comprehensive, but they are both critically important in their own right and demonstrate the manner in which the current foreign source income provisions of the Code inappropriately compromise American international competitiveness.

1. <u>Subpart F: Working Capital for Active Businesses</u>

Under subpart F, deferral generally is denied for passive investment income earned by a CFC and such income is taxed to the U.S. shareholders of the CFC on a current basis as if it had been distributed to those shareholders as a dividend. Such passive investment income generally is classified as "foreign base company income" and is not eligible for deferral. There is a so-called de minimis exception, which is applicable if the CFC's foreign base company income and insurance income (computed on a gross basis) is less than the *lesser* of five percent of gross income or $1 million.[5]

Notwithstanding this de minimis rule, the incremental investment income attributable to the working capital of a CFC engaged in an active business can still be subject to U.S. tax on a current basis. The dollar limitation contained in section 954(b)(3)(A)(ii) should be eliminated for working capital. A specific dollar threshold (such as the $1 million in current law) discriminates against successful CFCs which, given the nature of their active business (e.g., cyclical retailers), require relatively large amounts of working capital in the ordinary course of business. It is inappropriate as a matter of policy when, solely as a result of its size and the working capital needs of its active business, a CFC is treated as generating subpart F income. There is broad

[5] Section 954(b)(3)(A). Unless otherwise specifically indicated, all references are to sections of the Internal Revenue Code of 1986, as amended.

agreement within the private sector that the application of subpart F in such a case is inappropriate.[6]

For these reasons, section 954(b)(3)(A) should be amended to preserve deferral for working capital of a CFC attributable to active business operations. This could be accomplished in one of two ways. First, the current threshold could be returned to its original 1962 level (gross foreign base company income of the CFC cannot exceed 30 percent of its gross income with no dollar limitation). While such a change would reflect the operating needs of active businesses for working capital, it would also encompass other forms of foreign base company income. As an alternative, Congress could limit the change to investment income attributable to working capital by excluding such income from the computation of the de minimis rule (i.e., in applying section 954(b)(3)(A)(ii), investment income attributable to working capital maintained in connection with an active business would be disregarded). We believe a suitable definition of "working capital" could be developed and that such an exception could be readily applied to taxpayers and administered by the Internal Revenue Service.

2. Subpart F: Repeal of Foreign Base Company Sales and Services Income Rules or Same Country Exception

Under subpart F, certain sales and services income of a CFC is classified as foreign base company income and is thus not eligible for deferral even though the income is generated in the active conduct of a trade or business. Under section 954(d), foreign base company income generally includes *sales* income earned by a CFC located in a country that is neither the origin nor destination of property it either purchases from or sells to a related person. Under section 954(e), foreign base company income generally includes income earned by the CFC from *services* performed outside the country in which it is incorporated if the services are performed for or on behalf of a related party.

Many countries that have anti-deferral regimes comparable to subpart F have not included provisions such as those that deny deferral for foreign base company sales and services income. In our view, Congress should repeal the foreign base company sales and services income rules. As noted, the income encompassed by the foreign base company sales and services income rules is active business income of the type frequently not taxed

[6] International Tax Policy for the 21st Century, National Foreign Trade Council, Vol. 1 at p9.

on a current basis by other countries that have enacted anti-deferral regimes. Such income should not be subject to current U.S. tax.

If deferral continues to be denied in the case of these types of sales and services income, the "same country" exceptions (which permit deferral) should be revised to treat the member countries of the EU as a single country and comparable treatment should be provided with respect to China/Hong Kong. Such a change would merely reflect the current political reality of those regions. Thus, the subsidiaries of a U.S. corporation located within the EU or China/Hong Kong would no longer be characterized as having tainted income (i.e., income subject to an immediate U.S. tax) upon the receipt of certain payments from other subsidiaries located within these locales. The member countries of the EU and China/Hong Kong are not "tax havens" and there is no reason to defer action on this targeted modification to subpart F.

3. Foreign Tax Credit: Ordering Rules and Carryover Periods

Because U.S. corporations (and other U.S. based taxpayers) are subject to U.S. tax on their worldwide income, the income they earn from their international operations potentially can be taxed twice – once by the foreign country in which it is earned and a second time by the U.S. The foreign tax credit is intended to reduce the incidence of double taxation by permitting most foreign income taxes to be credited against the U.S. tax on foreign source income. These credits are generally allowable in the year they are "triggered" (e.g., by the payment of a dividend by a CFC to its U.S. Parent or by the imposition by a foreign country of withholding taxes on the U.S. Parent's receipt of foreign source income such as royalties paid by a CFC to the U.S. Parent).

Even if triggered, foreign tax credits may be used only to offset the U.S. tax on foreign source income. If, in any year, the full amount of otherwise creditable foreign taxes cannot be used, the resulting "excess" credits may be carried back to the two preceding taxable years and then forward to the five succeeding taxable years. If not used within those carryover periods, the foreign tax credits expire and can no longer be used to offset U.S. taxes on foreign source income. In prior years, Congress has enacted legislation that reduces the likelihood that foreign tax credits may be used promptly (e.g., requiring that various categories of foreign source income be placed in separate "baskets" and prohibiting the use of credits attributable to foreign source income assigned to one basket to reduce the U.S. tax on foreign source income assigned to a different basket).

Furthermore, there are certain additional rules (such as the interest allocation rules discussed below) that artificially reduce the portion of a taxpayer's income that is treated as foreign source income. Since foreign taxes may only be credited against the U.S. tax on foreign source income, such artificial reductions reduce the ability to use foreign tax credits.

These and other provisions of the Code operate to reduce the effectiveness of the foreign tax credit as a tool to prevent double taxation. This is unfortunate since it is generally acknowledged that the foreign tax credit is critical to American international competitiveness. While Congress should address the underlying causes for the ineffectiveness of the foreign tax credit, it can and should take two immediate steps: (1) revise the ordering rules for applying credits; and (2) extend the carryover periods.

The current ordering (or "stacking") rules contained in section 904(c) permit foreign tax credits triggered in one year to be used in a carryover year only *after* the foreign tax credits triggered in the current year have been fully utilized. This rule increases the likelihood that otherwise valid credits for foreign taxes actually paid on foreign source income that has been subject to U.S. tax will nevertheless not be used during the carryover period and will thus expire.

The proposed "International Tax Simplification for American Competitiveness Act", introduced in 1998 (H.R. 4173 and S. 2231) sought to remedy this problem directly. Specifically, section 206 of that proposed legislation would have amended section 904(c) to provide that, with respect to any taxable year, foreign tax credits would be applied in the following order: (1) credits from carryforwards to that taxable year; (2) credits triggered in that taxable year; and (3) credits from carrybacks to that taxable year. This sensible result would make it more likely that U.S. corporations could in fact fully use the credits they earn for foreign taxes actually paid. This would increase the likelihood that the foreign tax credit would effectively serve its intended purpose and reduce the incentive that American businesses now have to engage in transactions designed principally to enable them to use excess foreign tax credits before they expire.

4. Foreign Tax Credit: Interest Allocations

As discussed above, current law contains a number of provisions that artificially reduce the portion of a taxpayer's total income that is treated as foreign source income. One of the most notable of these provisions requires the apportionment of U.S. interest expense between U.S. and foreign source income based on the asset values of members of the group (including the stock of CFCs and other foreign assets). Interest paid by a CFC is ignored. As a result, an excessive portion of domestic interest expense is apportioned to foreign source income. This reduces the portion of the group's income that is treated as foreign source income and means that U.S. tax may in fact be imposed on foreign source income that has already been subject to foreign tax at rates equal to or in excess of the 35 percent U.S. corporate tax rate.

Congress should address this problem by providing an election to allocate interest expense on a worldwide basis. Such a change is highly desirable. American companies should be able to include the interest expense of their CFCs, and thus achieve a truly worldwide or global apportionment.

Conclusion

When Congress began consideration of a legislative response to the decision of the World Trade Organization concerning foreign sales corporations and exterritorial income, we frequently saw the term "non-exporter" in the press. However, we feel that a better term for a company such as Wal-Mart with growing international operations is "wealth and jobs creator." As I explained earlier, our success internationally fuels economic growth, creates jobs in the United States and creates markets for U.S. products around the world.

Wal-Mart and IMRA appreciate this opportunity to present our views. We are prepared to assist the Committee in any manner as it continues to consider the important issue of the adverse effects of the current U.S. tax regime on the international competitive position of American businesses.