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INTERNATIONAL TAX ISSUES RELATING TO GLOBALIZATION

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BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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INTERNATIONAL TAX ISSUES RELATING TO GLOBALIZATION

THURSDAY, MARCH 11, 1999

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

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, Murkowski, Nickles, Mack, Thompson, Moynihan, Baucus, Conrad, Graham, Kerrey, and Robb.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order. I am pleased to welcome everyone to what I consider a most important hearing, one that will examine an issue that is more important than ever, America's international tax policy.[1]

And today, capital investment, financial sales transactions, as well as communication travel as quickly as it takes to click a computer key. And American businesses no longer consist solely of American firms manufacturing on American soil, participating in the international market only through export sales.

Today, our firms buy components from overseas subsidiaries, they manufacture capital equipment, consumer goods from a multitude of areas around the world, and then depend on an overseas subsidiary to market their markets.

To stay at the cutting edge of a dynamic and promising international economy, we need to fundamentally rethink our tax code, Senator Moynihan, with a view to enhance America's competitiveness. And we need to make world commerce more accessible for our businesses.

We must eliminate unnecessary complexity in the international provisions of the tax code. We must maintain and develop export opportunities that exist in our tax policies and make sure that they are consistent with our international obligation. We must assure

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[1] For additional information on this subject, *see also* "Overview of Present-Law Rules and Economic Issues in International Taxation," Joint Committee on Taxation staff report, March 9, 1999 (JCX–13–99).

that whatever revisions we undertake strengthen the integrity of our tax system.

And finally, we must keep our eye on the long term when it comes to seeing the future changes in the global marketplace. We can only say that the past is prologue. The almost miraculous change of the last 10 years only hints at things to come.

And in order to ensure that American companies can effectively compete in the new global economy and provide jobs for our American workers, it is essential to have our country's pro-growth trade policies meld with our international tax rules. Today, more than ever, tax rules are playing a crucial role in business decisions.

This morning we will hear firsthand from DaimlerChrysler how the consideration of tax issues in that merger led to the company being based in Germany. We will hear dramatic testimony from Intel, a company that given the opportunity would locate their headquarters abroad. Our tax laws must encourage international businesses to come here and to strengthen American business overseas.

I ask that my full statement be included as if read.

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

The CHAIRMAN. I turn to you, my good friend, Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Once again you are so entirely right. We are in a new situation with a difference. Every day, there is $1.5 trillion traded in foreign exchange in the world—$1.5 trillion. And it comes down to $17.4 million per second.

The CHAIRMAN. It is unbelievable.

Senator MOYNIHAN. But we had a wonderful hearing about a month ago in which we heard from a representative from the Emergency Committee for American Trade which was established at a time when there was an emergency—we went through a long period when there was not. Now, we are back where there is.

He cited a study from Professor Matthew Slaughter who we will hear today which makes the point, and I will quote, the globalization in recent decades has largely just returned the world back to the level of integration before World War I, end quote. That is something to ponder. We are getting back to where we were in 1914.

You recall the representative from New York Life said, well, that is right, in 1914, we were in 72 countries. We are now in seven. The 20th century went through awful torments, but we are coming out. And I think you feel, let us keep going out and evolving in the way we have been doing.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator MOYNIHAN. And also, Mr. Chairman, as a grandfather, may I thank you for this little token from the—oh, no point in giving them any advertising, but they are always welcome. [Laughter.]

The CHAIRMAN. I have to tell you, Senator Moynihan, I was concerned when I saw this for two reasons, whether ethically we could keep it. I think we can. But secondly, whether this was a sign of our intellect. [Laughter.]

Senator MOYNIHAN. No, it is that we are grandparents.

The CHAIRMAN. It is my pleasure to call forward now Senator Dorgan. It is a pleasure to welcome you here. And we would ask you to keep your remarks short because we have a full schedule.

STATEMENT OF HON. BYRON DORGAN, A U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you very much. I will be brief. I appreciate the opportunity to come just for a few moments at the start of your hearing.

As you know and my colleague from North Dakota Senator Conrad knows, I served for 10 years on the House Ways and Means Committee, served prior to that in a job that Senator Conrad had after I did as State Tax Commissioner.

I have had an abiding and interesting time dealing with tax issues. I was Chairman of the Multi-State Tax Commission for 2 years and started their national joint auditing program and so on. So I was interested when you called this hearing, interested to come and to make a couple of brief comments.

You identified the five specific criteria, one of which is assuring that revisions strengthen the integrity of the tax system, another of which is dealing with unnecessary complexity. I fully agree with that. I think our tax code is horribly complicated and ought to be simplified.

I also think that the integrity of our tax system is something that we ought to be very concerned about especially in the context of global economics that you are talking about and increasing globalization. As you proceed through this hearing, I would ask you to do a couple of things.

Number one, be skeptical about claims that U.S. investments overseas have had much effect overall on U.S. employment and wage levels. I know that you will hear that. And you referenced it in your testimony. Also, consider the plight and the equity interests of the companies who produce here in this country as one talks about what we should with this tax system.

The Congress has in recent years in my judgment made some very significant mistakes that will not be viewed by those who testify following me. But in 1996, the repeal of 956A. You did not initiate that. That came from the House, but was accepted in conference. That was a $427 million tax reduction. In 1997, the repeal of the Controlled Foreign Corporation and PFIC overlap, that was a $250 million cut. You did not initiate that. That came from the House. In 1997 and 1998, the Active Finance Exception to subpart F at hundreds of millions of dollars.

Well, these things have been done. I stood on the floor and opposed them, but they were part of larger packages. And I could not get at them. I know many supported them.

But I want to make a couple of comments about facts. About 1.3 million of the 2.3 million U.S. companies pay no U.S. income taxes probably because a good many of them are not profitable, 40,000 of the 60,000 foreign-based companies doing business in the U.S. paid no U.S. income tax, zero. Some perhaps are not profitable.

I would doubt whether that would be the case with the automobile maker that most of you would know that sold $3.4 billion

worth of automobiles into the U.S. and in a 2-year period during those $3.4 billion worth of sales paid zero, not a penny, not a nickel, not a dime, not a dollar, just no U.S. income taxes at all.

The GAO is going to complete a report that will update much of this information. And it will likely show once again that a substantial portion of foreign corporations doing business in this country are paying no U.S. income taxes.

Now, one of the concerns that I have is that the complexity allows massive tax avoidance. We have what is called the "arm's length" pricing method of determining whether a foreign corporation selling to a wholly-owned U.S. sub is making money or not.

Well, when do they business with each other, we have auditors occasionally go out and try and connect the ends of two plates of spaghetti. You take each transaction and say, now, if that transaction were between corporations that were not related, would it had been a fair transaction at a fair price? It is nearly impossible. It is a buggy whip enforcement tool. You cannot do that. It does not work.

The result is safety pins being imported from Canada at $29 each, pianos sold to Brazil at $50, toothbrushes from France $18, exporting tractor tires to France for $7.69. What does all that mean? It means that related companies can price their product either too high or too low in order to move the profits wherever they want those profits go and therefore avoid paying taxes. And we cannot do much about it.

It is long past the time when we adopt a formulary approach to dealing with this issue. That would radically simply the system. It would say to a corporation when you are doing business around the world, that piece of the income pie that ought to be attributable to the United States marketplace and therefore your profit attributable for tax purposes just as a domestic corporation would should be determined by some very simple, two or three-factor formula.

We do that in this country between the States on income. It is called UDITPA, Uniformed Division for Income Tax Purposes Act. Now, why is there such a hue and cry by the multinationals against that? Because it will close the door to their ability to avoid paying any taxes.

I note the fellow from Intel that is here today is going to say that, gee, he wishes they had not even located their company in the United States. I happen to think Intel is a wonderful company. I am a customer of theirs and like their product. I was surprised when I read that comment last evening. Intel is a company that has done very well. Gosh, most companies should pray to do so well.

But part of that is that they have access to the best marketplace in the world. There is no better marketplace than the U.S. marketplace. There is no substitute for it on the face of this earth.

When accessing this marketplace, one would hope that any corporation doing business here would be required to pay their fair share. And, yes, taxes are a burden. It is a burden that we have for the purpose of paying for schools and roads and defense and the other things that are part of our lives.

It would be required to have the same burden that our domestic companies would have who sell and produce only in this country

and have no flexibility. They cannot transfer price. They cannot price a toothbrush at $7.50 to move profits away and therefore pay no tax.

I would support those who follow me today, Mr. Chairman, in conclusion, by saying, yes, by all means let us simply. Let us reduce the complexity and simply dramatically the requirement for complying with our tax laws for all the multinationals, including foreign companies doing business in this country. But let us do it in a way that closes the loopholes that allow many of them to do hundreds of billions of dollars of business in this country and then tell us they made zero in profits and intend to pay no U.S. income tax.

As I mentioned, in closing, another GAO report will be coming out that builds on previous information that has been given to this Congress about the amount of tax avoidance. And frankly, it is very substantial.

The percentage of U.S. and foreign-based companies, those with incomes of more than $250 million and those with total business receipts of at least $50 million that paid no tax is about 30 percent. So we have a very substantial problem with tax compliance in addition to the issue of complexity. Let us deal with both.

The CHAIRMAN. Thank you very much for being here today, Senator Dorgan. We look forward to working with you as we progress in this area.

The committee will now hear from four individuals representing different types of companies facing different international business and tax challenges. I am very pleased to welcome first Mr. Robin Beran, Caterpillar's Tax Director, who will highlight exciting international investment that has led to increased international competitiveness as well as increased employment.

Next testifying in her capacity as Chairman of the Organization for International Investment's Tax Committee, Ms. Guarino will talk about the hurdles companies face when they wish to do business in the U.S.

Then, we will hear from Mr. Loffredo, Vice President for Taxes of the recently created DaimlerChrysler Corporation. He will discuss some of the factors that led to the structure of that merger and other international tax issues.

And finally, Mr. Bob Perlman, Intel's Vice President for Tax, Licensing and Customs, will address some of the challenges high-tech companies encounter as they compete in the global market.

Gentlemen, ladies, it is a pleasure to welcome you.

And we will start with you, Mr. Beran.

STATEMENT OF ROBIN D. BERAN, DIRECTOR, CORPORATE TAX AND ASSISTANT TREASURER, CATERPILLAR, INC., PEORIA, IL

Mr. BERAN. Thank you. Good morning, Mr. Chairman and members of the committee. I am Robin Beran. As Chief Tax Officer I have global responsibility for Caterpillar's tax planning and compliance. It is a pleasure to be here this morning and talk with you about international taxation.

Let me begin with a few facts about Cat. We are the world's largest manufacturer of construction and mining equipment, natural

gas and diesel engines and industrial turbines. We also have plans to become a leading manufacturer of agricultural equipment.

Our products are distributed and supported around the globe by a world-class network of almost 200 independently-owned dealers. We also operate subsidiaries that handle financing and leasing programs for our customers and logistics for other companies.

We employ 65,000 people worldwide and posted sales last year of nearly $21 billion, including $6 billion in exports. We expect sales to exceed $30 billion in the next decade. How well we achieve that goal depends on our ability to compete freely and fairly in the global marketplace.

Cat is particularly committed to free trade in large part because of our unique competitive position. We operate primarily from U.S. manufacturing base. And while we expect foreign sales to grow more rapidly than U.S. sales, the majority of our manufacturing assets, about 70 percent are and are going to remain in the U.S. as long as we have access to world markets from here.

Our facilities are capital-intensive and high-tech. It does not make economic sense to duplicate manufacturing operations for many of our larger products. And from political risk standpoint, we believe the U.S. remains the best place to invest.

We are one of this Nation's largest net exporters. Our exports last year supported about 45,000 U.S. jobs, 15,000 within Cat, and 30,000 jobs that are U.S. suppliers. By 2010, we expect that 75 percent of our sales will be outside the U.S.

Since we plan to maintain our U.S. base, we have the potential to provide thousands more export-related jobs for American workers in the future, but only if we can compete freely and effective in the world marketplace. That is a big if. And unfortunately, it is one that grows in direct proportion of protectionist sentiments.

More than 30 years ago, annual report warned that trade barriers could stifle companies like Cat which would otherwise compete effectively in world markets. And we emphasize that free trade is the driving force behind economic growth.

The world has come a long way since then eliminating some major barriers. While the U.S. has taken many steps to reduce trade barriers, many of our tax policies are still dated. Tax policies implemented in the 1960's and continually expanded in the years since do not reflect the current competitive environment facing companies like Cat.

There have been a few recent changes that are helpful, including the wise decision to extend deferral to active finance companies, but more is needed to keep companies like ours competitive. One good step would be a permanent extension of that provision.

Mr. Chairman, I salute you for your recent comments about preserving two very important features of our current law. Under attack both domestically and abroad, the export source rule and the foreign sales corporation provisions are extremely important to U.S. exporters.

I also thank you for your support in reducing complexity in the international provisions of a tax code we struggle with every single day.

In the last 5 years, my staff and I have managed Caterpillar's acquisition of 20 other companies, formation of 17 joint ventures,

and the establishment of numerous alliances with other global firms whose common thread from the foreign participants, disbelief as to the complexity of the U.S. tax reporting requirements. These are astute businessmen and women from substantial non-U.S. entities who are amazed at the level of detail required for U.S. tax purposes.

When a growing company acquires businesses with new technologies, not all will be in the U.S. Global companies operate globally. We service customers where they need us.

Since the fastest growing markets for infrastructure-related equipment are outside the U.S., you will find us there, but there are real benefits to U.S. workers from our foreign investments.

I will offer two recent examples. In 1985, we acquired the design for Articulated Trucks from the Brown Group in England which continued to manufacture the ATs for Cat. Those are the scale models of the ATs you have in front of you.

This innovative design helped Cat provide solutions that customers wanted. An interesting note here, once we obtained design rights, supply components to the Brown Group from our family of U.S.-based suppliers expanded.

In 1996, we purchased the Brown Group of companies, obtaining control of the manufacturing capacity. Now, Cat is starting a new facility in Texas to manufacture these ATs for the western hemisphere market, using U.S. labor, U.S. suppliers, and U.S. logistics for this expanded capacity. Without the original investment in England, we would not be introducing U.S. production for these vehicles.

Cat's association with Claus of Germany, a leading manufacturer of combines is another example. Cat and Claus formed joint ventures to manufacture a market, Claus combines in the U.S. and Cat AG tractors in Europe. Caterpillar Claus of America is a 50-50 joint venture that is producing state-of-the-art, high capacity combine harvesters in Nebraska. The same principles involved here. Without the foreign investment, we would not be adding to our U.S. production.

Unfortunately, I do not have scale models of the little combines for you, but the point is U.S.-based, multinational companies face burdens, such as aggressive anti-deferral regimes and complexity that most of our foreign competition does not.

To maintain our philosophy of build it here and sell it there, we need a modern tax policy with a globally competitive focus. U.S. tax rules must allow us to fairly to participate when opportunities arise rather than placing us at a competitive disadvantage.

True simplification would require major changes to the foreign tax credit provisions, including the various baskets woven into the system, also things like adopting GAAP for determining earnings and profits, treating the European Union as one entity, and somehow pulling together the various sanctions-related mandates and trying to make some sense of them all.

At the appropriate time, I would be happy to respond to any questions you have. Thank you.

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

The CHAIRMAN. Thank you, Mr. Beran.

And now, Ms. Guarino, please.

STATEMENT OF JULIETTA GUARINO, VICE PRESIDENT, TAXES & CUSTOMS, ABB, INC., STAMFORD, CT, ON BEHALF OF THE ORGANIZATION FOR INTERNATIONAL INVESTMENT

Ms. GUARINO. Good morning. My name is Julietta Guarino. I am the Vice President of Taxes and Customs for ABB, Inc, the American subsidiary of a Swiss global engineering and technology company. In the U.S. with revenues of $6 billion, ABB employs about 20,000 workers in 41 States.

I am testifying this morning on behalf of the Organization for International Investment, an organization made up of American subsidiaries of parent companies based abroad. Throughout this testimony, I will refer to them as American subsidiaries.

These companies are significant American stakeholders. According to the most recent government data, American subsidiaries employ 5 million workers in the U.S., paid a record high of $13.2 billion in Federal income taxes. That is a 30-percent increase from the prior year. They reinvested $20 billion into the U.S., up 40 percent from the prior year. And virtually in every year since 1980, they have accounted for more than 20 percent of exports from the U.S.

At ABB alone, exports from the U.S. amounted to 30 percent of exports from the U.S. in the past 2 years. Let me mention one other fact. More and more Americans are shareholders in companies like ABB. For example, Philips Electronics headquartered in the Netherlands and a significant player here in the United States is now owned by 40 percent by shareholders in this country.

As a multinational enterprise and a major exporter here in the U.S., my company's tax interests are very similar to those of my fellow panelists from Caterpillar or Intel. However, American subsidiaries face unique tax issues.

ABBI would like to submit for the record a list of detailed suggestions, but I will confine my oral remarks to four broad observations and recommendations.

Number one, promote nondiscrimination. U.S. law generally treats American subsidiaries the same as U.S.-based multinationals. However, there are tax provisions that discriminate against American subsidiaries. For example, in certain circumstances when an American subsidiary borrows from a related party or even U.S. bank, present tax law may disallow interest tax deductions.

My colleagues here from Intel and Caterpillar do not, as a practical matter, face the same restrictions on their ability to deduct interest payments on business borrowings. In addition, IRS field agents sometimes take inconsistent positions based on whether a taxpayer is inbound or outbound. We urge the committee to maintain a principle of nondiscrimination and ask you to consider rolling back exiting discriminatory provisions.

Number two, lessen excessive U.S. tax penalties. The U.S. has a system of punitive measures which is much harsher than those of virtually any of our trading partners and is not in harmony with multilateral guidelines. If other countries follow the United States' lead and adopt harsh penalties, multilateral or multinational companies will run into an escalating wall of penalties around the world.

I have included for the record an example of harsh punitive measures and some specific proposals for reevaluating the penalty

provisions that apply to inbound investors. We urge you to examine or reexamine the U.S. penalty regime.

Number three, reduce complexity. ABB does business in nearly every corner of the world. And nowhere else do we face the mountain of recordkeeping, documentation, and evidentiary requirements that we do here.

To comply with U.S. tax rules, my tax staff is three times larger than the parent company's tax department in Switzerland. My staff and I have to rely on more, more advisors and more economists than any other ABB tax function anywhere in our environment. Most OFII member companies tell a similar story. We urge the committee to examine ways to reduce complexity.

Number four, protect programs that enhance certainty and eliminate controversy. We share your view, Mr. Chairman, about the importance of allowing taxpayers to negotiate advance pricing agreements with the IRS to resolve transfer pricing disputes without costly and uncertain litigation.

The public disclosure issue raised by an ongoing BNA lawsuit may undermine the APA's program's effectiveness. Many taxpayers are very concerned about this development. And I know of several that are seriously considering withdrawing from or not entering the program. We urge the committee to actively monitor the developments in this current litigation. Congress may need to intervene to save this valuable program.

In conclusion, I would like to you, Mr. Chairman, and the committee for holding this hearing. And we look forward to working with you in the future. And we would like you to keep in mind that American subsidiaries are major contributors to the U.S. economy. Thank you.

[The prepared statement of Ms. Guarino appears in the appendix.]

The CHAIRMAN. Well, thank you, Ms. Guarino.

And now, we will turn to Mr. Loffredo.

STATEMENT OF JOHN L. LOFFREDO, VICE PRESIDENT, TAXES/NAFTA, DAIMLERCHRYSLER CORPORATION, AUBURN HILLS, MI

Mr. LOFFREDO. Good morning. My name is John Loffredo. And I am Vice President and Chief Tax Counsel for DaimlerChrysler Corporation, the U.S. arm of DaimlerChrysler A.G. The merger of Chrysler and Daimler Benz A.G. was billed as a merger of equals. This was a marriage of two global manufacturing companies, one with its core operations in North America and the other headquartered in Europe with operations around the world.

I thought I would share with you today some of the tax considerations that went into determining the country of incorporation of this new dynamic company. Both companies, Chrysler and Daimler Benz, knew that after the merger these companies would continue to pay their fair share of taxes to the country in which they operate. Therefore, the merger would not reduce or eliminate the companies' taxes in the U.S. or Germany on the operations in those countries.

However, the new company was concerned that, one, it only paid taxes in a country where income was earned and not a second time

on dividends repatriated from its foreign subsidiaries and, two, that it would not be subject to immediate taxation on normal, active business income earned outside of the country of its incorporation. There is a clear distinction, the distinct choice to be made between the U.S. and Germany.

The German tax system is based on a territorial theory. By contrast, the U.S. tax system follows the philosophy of taxing the worldwide income of U.S. companies while allowing tax credits for taxes paid to foreign governments.

Under the German territorial tax system, qualified dividends received from foreign subsidiaries are not taxed in Germany. When DaimlerChrysler Corporation earns money in the U.S. and after it pays its taxes, it may elect to dividend some of this after-tax earnings from the U.S. to Germany. It will be subject to a 5 percent penalty. And these dividends then when they arrive in Germany are not subject to tax.

The U.S. operations of DaimlerChrysler will only be taxed once in the U.S. There is, however, potential legislation in Germany to change that.

However, under the U.S. worldwide tax system, a U.S. parent company receiving dividends from its foreign affiliates must include the dividends and corresponding foreign taxes paid on its U.S. taxable income.

Under certain restrictions, putting the tax laws over the past several decades, the U.S. taxpayer may never be certain that these dividends would not be taxed by the U.S. The result could be taxation of at least a portion of these earnings twice by two different countries.

Under these circumstances, the German territorial tax system provides a greater degree of certainty than normal active business income earned outside the country of incorporation of the new DaimlerChrysler will only be taxed once.

Why does the U.S. company have a problem utilizing all of its foreign tax credits if foreign-source income is only taxed once? The main reason for this problem is that a U.S. company has to apportion many of its domestic business expenses, especially interest expense against its for foreign-source income, thus reducing the amount of foreign income that can be taken into account in meeting the limitations. This would create unused foreign tax credits.

In DaimlerChrysler Corporation's case, if we were the parent of the new company, more than 50 percent of the interest incurred in the U.S. to finance the sale and leases of vehicles in the U.S. would have been apportioned to foreign-source income. This would have certainly resulted in double taxation of significant amounts of repatriated foreign earnings.

Other areas of concern on the U.S. tax laws were the treatment of our foreign finance subs, investment income earned by foreign subsidiaries and foreign-based company sales. The problem of the immediate taxing active foreign finance business income by the U.S. has been alleviated by recent legislation that has given taxpayers temporary relief to exclude such active business income from U.S. tax.

The German tax system would not tax such inactive business. And DaimlerChrysler would continue to own finance subsidiaries in

Canada, Mexico, and strongly support a continuation of the exclusion in the U.S.

The U.S. would tax in the year earned passive foreign income earned at our foreign subsidiaries. And this especially is a problem with respect to interest on working capitals. This would not be taxed by the Germans.

Lastly, there are certain base company income where if we manufacture it in the U.S., sold to a distribution company in the second country, and then sold on to a third company, that income in the distribution company could be subject to tax in the U.S.

By becoming a subsidiary of a German company, DaimlerChrysler has minimized the possibility of paying additional tax on its foreign operations. However, a lot of my friends who are in U.S. companies still face these problems. Thank you.

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

The CHAIRMAN. Thank you, Mr. Loffredo.

And now, Mr. Perlman.

STATEMENT OF ROBERT H. PERLMAN, VICE PRESIDENT, TAX, LICENSING & CUSTOMS, INTEL CORPORATION, SANTA CLARA, CA

Mr. PERLMAN. Thank you, Mr. Chairman. I am Bob Perlman, Vice President of Tax, Licensing and Customs for Intel Corporation. Intel is the world's largest manufacturer of integrated circuits. We perform most of research and wafer fabrication in the United States and sell over 50 percent of our products outside the United States.

We have been one of the top U.S. exporters as a percentage of revenue for the last 5 years. Our industry is acutely capital intensive and the ability to sell our products on a worldwide basis enables us to achieve a level of profitability which will support our ever increasing research and capital requirements.

I would point that we believe we are in the top five taxpayers in the United States. Let me begin by stating that if Intel were to be founded today, I would strongly advise that the parent company be incorporate outside the United States. Our tax code competitively disadvantages multinationals simply because the parent company is incorporated in the United States.

U.S. international tax policy does not acknowledge global competition and puts a high price on the consequences of the actions of U.S. companies creating a competitive disadvantage. Frequent changes in the tax code and administrative rules create uncertainty which is highly disruptive to sound business planning.

An example of this is the recent experience with hybrid entities. The Treasury Department issued regulatory rules which greatly simplified entity classification and then attempted to revoke them. After Congressional concern was expressed, Treasury withdrew the revocation, but announced its intention to issue similar rules in the future.

Businesses that have acted upon these regulations cannot simply unwind their restructuring and thus may suffer adverse U.S. tax consequences.

In contrast to foreign competitors, U.S. companies cannot proceed with sound business planning without checking numerous, non-intuitive potential international tax consequences.

The degree to which our tax code intrudes upon business decision making is unparalleled in the world. Complex rules relating to numerous foreign tax credit baskets, extensive expense allocations, and detailed earnings and profit calculations are some examples. Other countries do not have such complex rules.

Given the global business reality of needing to secure market access and service international customers, U.S. multinationals such as Intel need to locate production and other facilities in foreign countries. Our international competitors line the streets in these same locations.

If an international competitor's home country's tax system is based upon territoriality, income generated by the foreign facility is not taxed currently or upon repatriation. A U.S. company will only $.65 in the U.S. with which to do research and otherwise invest while the foreign competitor will have a full dollar in his home country.

Taxpayer provisions found in many treaties produce similar results. One areas of our international tax rules particularly ripe for reform is subpart F. The anti-deferral rules were intended to be a back stop to the transfer pricing rules which were yet to be fully developed in 1962. Today, strict enforcement of transfer pricing rules is occurring on a worldwide basis.

Accordingly, manufacturing sales and services income should not be taxed until remitted. The foreign-based company's sales and services income provisions should be repealed.

The U.S. tax consequence of an activity should depend upon whether the activity occurred within the U.S. taxing authority and not upon whether sales or the service activities occurred within the country in which a foreign company happens to be incorporated.

Minimization of foreign taxes through a base company should not concern the United States. Many of our foreign competitors tax jurisdictions do not currently tax such earnings and reserve their anti-deferrals rules only for passive income.

This reduction of foreign taxes through the use of base companies ultimately benefits the Unites States Treasury through reduced foreign tax credits upon remittance.

Another troubling outcome of the current subpart F rules occurs when U.S. companies attempt to cope with difficult exchange control and customs issues. For example, the U.S. company desires to sell into China. It can establish a corporation in China where it would be exposed to currency controls and very difficult customs issues.

If instead, the U.S. company chooses to sell into China by use of a Hong Kong subsidiary, it would avoid these aspects of business. However, by doing so, it would suffer the loss of deferral on such income.

It is difficult to understand why avoiding adverse, non-business risks should cause an adverse U.S. tax impact. This Hobson's Choice is not suffered by foreign competitors. Similarly, if faced with a high dividend withholding tax and no branch profits tax in a foreign country, doing business through a branch would minimize

tax costs. However, subpart F would apply even though the withholding tax ultimately would be borne by the U.S. Treasury through foreign tax credits.

In 1992, the European Common Community created a single market, now 15 countries. This action enables business to be operated on a consolidated basis, but not by U.S. companies.

I have two other points. And I will briefly outline them. One is the alternative minimum tax, 90 percent limitation on foreign tax credits which is a provision that absolutely guarantees 10 percent double taxation.

And the final one is the carryover period for foreign tax credits which since this is not an incentive but a relief from double taxation, in my view, should be unlimited forward. Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you, Mr. Perlman.

Generally, what would you each say are the biggest challenges companies face today as they compete in the global marketplace? Are they related to trade or tax or both areas?

Mr. Beran.

Mr. BERAN. Mr. Chairman, trade and tax is so interrelated, I am not sure you can separate the two. A point I would make is that as we open up and reduce the trade barriers, it tends to make tax even more important because it becomes one of the true distinguishing factors in the competitive market. And so I believe we need to give emphasis to both and recognize a competitive environment we deal in.

The CHAIRMAN. Ms. Guarino.

Ms. GUARINO. I agree with that, Chairman. As a matter of fact, as you know, we have the FISC right now that is under attack. And we being an American subsidiary feel very strongly that the FISC should survive. And we are completely against the WTO position.

We need to increase exports. Trade is critical to our economy. And I think you could even notice by Mr. Perlman's and my title, customs is even a part of it. Tax and customs come together. I think most organizations have more discussions from the business people of how to incorporate all of this.

The CHAIRMAN. Thank you.

Mr. Loffredo.

Mr. LOFFREDO. Yes. When we were just Chrysler, we tried to compete worldwide just from the United States, North American base. And what we found is a lot of protectionist restrictions in the local countries, such as percentage of local content and tremendous duties. If you would believe that if you were shipping a U.S. car into Finland, you would pay over 100 percent duty on that car or 70 percent going into Brazil at one time or 35 percent going to Argentina.

It forced us to start looking and moving some of those operations outside of the U.S. Those costs made it impossible for us to sell the vehicles. It is a combination of protectionists in the countries we operated and the tremendous high duties automobiles face around the world.

The CHAIRMAN. Mr. Perlman.

Mr. PERLMAN. Mr. Chairman, I think trade, I would agree with Mr. Beran that tax and trade are integrally related. I am not sure that the U.S. Government's tax and trade police are integrally related.

One of the biggest problems we have in competing is not so much our competitors because we will be willing to get into the ring with them any time.

It is the problems we have with the U.S. Government and particularly in the tax area, some of the provisions I talked about which would take more from us than other governments take from their companies not on the income earned in the home country, but on the income earned in other countries.

And again, if we have only $.65 and our Japanese or German competitor has $1 to spend on research, you do not have to be a rocket scientist to figure out in the long term who is going to win that battle.

The CHAIRMAN. Speaking of territorial, you said Japan has a territorial tax, but what about the EU, the European Union?

Mr. PERLMAN. That is country by country, but in most countries in EU, you can avoid home country taxation either through because there is a treaty with the other country or because they have a territorial system. A classic territorial system in the world is France which is completely and totally territorial.

The CHAIRMAN. As you know, one of the major concerns about world trade is the impact on American workers. In what ways can international trade and tax policy working together create a win-win combination, increasing international competitiveness, as well as more jobs here at home?

Mr. Beran.

Mr. BERAN. Mr. Chairman, at the end of the day, it is going to depend upon the competitiveness of our companies, the competitiveness of our workers. Our experience is that in general, U.S. workers are very competitive. We create a knowledgeable workforce in general. Now, it is tied to the education system. It is tied to research spending.

I am not sure I have a simple answer to that obviously as you can kind of tell, but we need to be competitive and be able to generate the economies of scale to compete in the global marketplace. The U.S. economy, as large as it is and as important as it is, is not enough to make you a global competitor.

The CHAIRMAN. Ms. Guarino.

Ms. GUARINO. Well, Mr. Chairman, I think perhaps one way to have the two integrated, tax and trade is to promote each in our system, including tax laws. As I pointed out before, the American subsidiaries contribute to the workforce by 5 million workers.

By discriminating or having tax laws that are slanted against these types of companies, we are not encouraging our economy in that sense. We are not encouraging workers. We are not encouraging, I think I also pointed out, how much we have reinvested in plants and equipment.

So we should be looking at this with this new global market not as in a vacuum, not as the U.S. and U.S. companies, but rather the U.S. economy having an open market, trying to encourage free

market, trying to encourage in our treaties a lowering of withholding taxes, having dividends and interest without withholding taxes, also trying to encourage in trade in Latin America.

Latin America, South America is probably one of our biggest trading partners, having a free market with South America I think would be extremely positive to the U.S. economy.

The CHAIRMAN. Thank you.

Now, Mr. Loffredo, you said our tax system really encouraged a merger to have the foreign company buy the American company. And I suppose that in turn means the headquarters will be abroad?

Mr. LOFFREDO. Well, at the current time, we have two headquarters, Senator. We have a headquarters in Stuttgart. And we continue to have a headquarters in Auburn Hills. And we are shuttling planes back and forth.

Senator MOYNIHAN. Are all headquarters equal?

Mr. LOFFREDO. I would rather not answer that question. [Laughter.]

Mr. LOFFREDO. But to answer the question you asked before, it is very interesting. The merger has created a tremendous incentive in the United States for us to continue to manufacture in the United States and to continue to sell from the United States.

And when I do my transfer price study that Senator Dorgan mentioned earlier, I try to determine what the proper price of the vehicles are coming outside of the U.S. for foreign subsidiaries.

And when I look at our studies and where we operate around the world, the most efficient place for us to operate is in the United States, our assembly plants in Detroit and in Delaware and in Illinois.

The CHAIRMAN. We are happy you are there.

Mr. LOFFREDO. They are the most efficient in the world. But now, when I shift from the United States out to our subsidiaries outside the United States, those subsidiaries will be owned by our German parent. And I do not have to worry about paying double taxation on that income that we earn overseas unlike some of the others who have to worry about that.

The CHAIRMAN. Thank you, Mr. Loffredo.

Mr. Perlman.

Mr. PERLMAN. Senator, there are several things I would like to point out in the trade area that I think can be analogized to the tax area. We do 90 plus percent of our research in the United States. And it as cutting edge, advanced research as anywhere in the world.

There are not enough people in the United States to do this research. So we had to battle last year on H-1B visas. I do not believe there is any other country in the world that would have a visa restriction on Ph.Ds. from MIT, but we had to face that issue here.

We are facing an issue now in both encryption and hardware exports that are going to make it very administratively difficult for us to ship products that are available in Comp USA to the People's Republic of China which is going to become the second largest market in the world very shortly.

These are trade problems. They are not tax problems, but they are the type of problem that subpart F creates. As Mr. Loffredo just pointed out, when you are a foreign company doing business

in two other countries, you do not have to worry about U.S. taxation.

When you are a U.S. parent, you have to worry about everything that happens offshore because if you are not very careful it is going to become immediately taxable in the United States, even though there was not one iota of energy expended in the United States to generate that income.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. Could I thank Mr. Beran and Ms. Guarino for the thought that we had better begin thinking of making the EU a single unit for tax purposes.

I would like to thank Mr. Loffredo for mentioning the interest expense allocation rules. That was put in the code in 1986. We were here and we did it. And I think it should be revisited and I hope we can do.

I would like to ask Mr. Perlman a question, on pages 3 and 4. If I could just read at the bottom of page 3, you say "For example, for U.S. wanting to sell in China, if it located a corporation there it would be exposed to currency controls and customs issues."

Mr. PERLMAN. Yes, sir.

Senator MOYNIHAN. "If, instead, the U.S. Company sells into China through a Hong Kong subsidiary it would avoid the foreign currency and customs exposures. However, by doing so, it would suffer the loss of deferral on the sales income. It is difficult to understand why avoiding adverse business risks of currency controls, harsh customs rules and foreign taxation should also cause an adverse U.S. tax impact. This 'Hobson's Choice' is not suffered by foreign competitors."

Mr. PERLMAN. Yes, sir.

Senator MOYNIHAN. Now, you say the Hobson's Choice is that you can do this or you can do that.

Mr. PERLMAN. Either way you have adverse consequences.

Senator MOYNIHAN. Either way you have adverse consequences. Sir, are you aware that a Hobson's Choice is no choice?

Mr. PERLMAN. That's basically right, yes, sir.

Senator MOYNIHAN. Now, you said there is a choice here and a choice there. Hobson was an innkeeper. [Laughter.]

Senator MOYNIHAN. He rented horses, but you couldn't take your pick of the horses. You had to take the horse nearest the door. A Hobson's Choice is no choice. Check that out with your speech writers, will you? [Laughter.]

Mr. PERLMAN. Yes, sir. I will chastise my speech writer.

Senator MOYNIHAN. Now, one other question, sir. You testified, "Let me begin by stating that if I known at Intel's founding over 30 years ago what I know today about the international tax rules, I would have advised that the parent company be established outside the U.S."

Mr. PERLMAN. Yes, sir.

Senator MOYNIHAN. I do not think we have heard that before in this committee. Perhaps you can suggest where you would have advised?

Mr. PERLMAN. I would have advised——

Senator MOYNIHAN. Pinochet was in charge in Chile. That was a pretty friendly country at that time.

Mr. PERLMAN. I would have advised the Cayman Islands, sir.
Senator MOYNIHAN. The Cayman Islands?
Mr. PERLMAN. Yes, sir.
Senator MOYNIHAN. For the climate?
Mr. PERLMAN. No. Well, for their business climate, yes.
Senator MOYNIHAN. Their business climate. So you would have left the United States for the tax shelters of the Cayman Islands. Do you think that the Marines are still down there if you need them?
Mr. PERLMAN. That was Barbados.
Senator MOYNIHAN. Supposing you had trouble in the Cayman Islands, where would you turn, to their fleet?
Mr. PERLMAN. It's hard for me to imagine there would be any trouble in the Cayman Islands. And in fact, the classic story——
Senator MOYNIHAN. Well, you are always welcome to go there, sir. I do not think you should come before the United States Committee on Finance, which is trying to help, and say you wish you were in another country.
Mr. PERLMAN. Sir, what I was trying to point out was that by being in another country, you do not suffer adverse consequences that the U.S. Government and this committee in particular should remove from the Internal Revenue Code so a statement like that would not have to be made.
Senator MOYNIHAN. So money matters more to you than country?
Mr. PERLMAN. Not money, sir, the——
Senator MOYNIHAN. Enough. I will not pursue this, Mr. Perlman. I just regret that you made that remark. I am sure you will reconsider it, but if you do move, well, just keep in check with the American consul. You might never know.
And thank you, Mr. Chairman.
The CHAIRMAN. Senator Grassley.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. And he will be followed by, well, we will wait and see. [Laughter.]

I would hope what our meeting is about so that we have a tax code so that those choices do not have to be made. And I appreciate this meeting for that reason.

I guess I have questions of three of the panelists. I would start with you, Mr. Perlman. Besides describing the huge problem that we have with tax code complexity, you also suggest I believe a more serious problem biased against investment and capital formation. And you use an example of subpart F rules that certain profits of U.S. multinationals lose deferral when the profits are invested back in the United States when at the same time foreign competitors like Japan do not have the same penalty when they make the same type of investment.

You also described how the alternative minimum tax rules relieve double taxation only to the extent of 90 percent when the foreign tax credit is used in circumstances unless you have a situation where you are guaranteed 10 percent double taxation.

So a very simple question, but maybe one that gets at the heart of this meeting, how would you suggest that we deal with this anti-investment bias that seems to permeate the tax code?

Mr. PERLMAN. Well, I think, Senator, that it requires let us say a scalpel rather than a bludgeon. I think things have to be removed from the Internal Revenue Code. And it follows very much on the question Senator Moynihan was just asking me about why we would be—why I would recommend personally we incorporate outside the United States.

And it comes back to that very example. We have a factory in Pe Nang, Malaysia. Right across the street from us is a Japanese company. They are doing exactly the same thing we are with exactly the same economics of that factory.

If we both repatriate the money back to our home country, they will have a dollar, we will have $.65. We have both made arrangements with the Malaysian government not to pay tax there. They will be able to spend a full dollar on research in Japan. We will only be able to spend $.65 in the United States. So I think that is part of the problem.

Another part of that problem is we cannot even spend the money in Malaysia because the interest income of the Malaysian factory is taxed immediately in the United States. So we are at a disadvantage in the capital formation.

Now, in no way did anything I say about leaving the United States is something you cannot do once you are established mean any of the operations would leave the United States.

This is still the right place to have all of our factories. It is just the seat of the corporation that would be outside the United States so you would not have to suffer that loss of 35 percent of what you have earned even if it were earned outside the United States. That is really the issue.

I think another scalpel should be taken to the alternative minimum tax which I believe that my opinion in 1986 when it was passed was overkill at that time. And it is now becoming dramatic overkill, but particularly a provision that is intended to relieve double taxation.

This is not an incentive. This is a relief provision. Limiting it makes no tax policy sense to me whatsoever. And that 90 percent should be raised to 100 in response to those issues, sir.

Senator GRASSLEY. Thank you.

Mr. Beran, you focused your testimony on two issues that concern me, the complexity of the tax code and the need to have a modern tax structure that is consistent with a global focus.

Now, obviously, you know every time we in Congress or even on this committee talk about simplifying the tax code, we tend to make it more complicated by requiring through our legislation complicated Treasury Department rules and etcetera.

Do you have any general advise on how we should approach simplification of our international tax rules that will not make the problem of complexity worse?

Mr. BERAN. Senator, one of the most complicated areas deals with the foreign tax credit. And absent of going to more of a territorial system, a simplification of the baskets or elimination of the

baskets and creating one overall basket would go a long way to simplifying the complexity we deal with.

We have to track various elements of income through systems that need that income for—or that information for no other reason. So it creates a lot of computer effort, accounting effort purely to track information that in the end does not end up making—often does not end up making that much difference in our tax bill. So I think that would be the area I would focus on.

Senator GRASSLEY. All right. And Mr. Loffredo, you made a persuasive argument that many U.S. companies that have foreign operations are put at a competitive disadvantage because they compete in a global marketplace against other companies that do not follow the way that the U.S. tax system taxes foreign operations.

Other than making permanent the recent legislation that gives U.S. taxpayers relief by excluding certain active business income from U.S. taxation, how would you recommend that we make other international tax rules less complex and ending the unfair treatment of American business?

Mr. LOFFREDO. Well, first of all, at the minimum, U.S. companies should be able to use all of its foreign tax credits that it generates overseas. It should not have to be asked to do some unnatural acts to generate foreign-source income so that it has enough income to be able to use all of its foreign tax credits so it does not pay a double taxation. So at the minimum, the rules should be recognized in the U.S. that once a company does pay tax on its income, it should get credit for it in the U.S.

Now, whether or not you want to have that company taxed at 35 percent, because there are opportunities in the world to earn income at less than 35 percent just as you could earn above, it is a policy decision. If you want everything taxed at 35, you know, that is a decision that Congress has to make.

But at the minimum, if we can curve withholding tax on a dividend coming in from Mexico or a dividend coming in from some country in the UK, we should not have to go through hoops to figure out a way to get a credit for that.

We have paid the tax. We should get a credit for it. And we should pay double income on it by this allocation of expenses that we are forced to do and where I sell in Iowa and that interest expense is allocated to my UK dividend. It does not make any sense to me.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Kerrey then Senator Nickles.

OPENING STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Mr. Chairman, first of all, I want to thank you and Senator Moynihan for holding this hearing. I do think that international taxation is hand and glove with international trade issues. And we typically spend a lot of time talking about trade and insufficient amount of time talking about these issues of international taxes.

And I appreciate very much some of the details of the witnesses, but I must say that I had a flashback as I was listening to the tes-

timony to a moment when I was Governor of Nebraska interviewing a candidate for judge. And in the first 15 minutes I listened to this candidate, I decided I would appoint him. And the next 15 minutes, he talked me out of it. I associate myself with what Senator Moynihan said. The rules in the United States of America are not just taxes.

And, Mr. Loffredo, you talked about the disadvantages that Daimler Benz faces looking at U.S. tax situations, but U.S. law is a law that says that we want to encourage entrepreneurials. So we have many minimal restrictions on labor. We have minimal restrictions on health care. We have minimal restrictions on what businesses can do when they are treating their employees.

I mean, we have some problem areas we continue to work on. It is not just our tax law. Now, here you are focusing on tax and not focusing on other areas where there is a tremendous advantage for a U.S. corporation. We would not be experiencing the kind of economic growth were there not tremendous advantages in the United States of America, both to locate, build, and develop and grow. I mean, it is not by accident that we have the strongest economy on earth.

So I say to you that if you are trying to persuade us, I think you do have to broaden your attack and broaden your focus as you come and present testimony to us because we live in an environment where trade has become unpopular.

This committee passed I think with all but one vote normal trade authority to the floor. We are not going to pass it in the House. We are not going to pass that in the House of Representatives because the people have become skeptical about trade even in my Sta' that benefits enormously from trade.

So I just urge you as you present to the people's representatives to consider what the people themselves are thinking both about trade and multinational corporations. As you heard from Senator Dorgan, there is a stigma attached to the name all by itself.

And you do not have to look any further than what is likely to occur over the next year about our debate over China. We are apt to knee jerk and do some very bad things in regard to China just because it is really easy to demagogue that issue. It is very easy to demagogue on China because there is deep suspicions about what the Chinese are trying to do.

I spent a great deal of time on the tax code on the IRS Commission. And one of the conclusions that I have reached is as long as you tax income, a, you are going to have a very difficult time keeping the tax code simple just because, as Senator Grassley and others have already said, we cannot help ourselves. People want tax credits for all of sorts of things.

Secondly, as long as you tax income, it is going to be very difficult not to have an evasive system. I have to prove what my income is. I have to face a challenge. And thirdly, it seems to me as long as you tax income, it is going to be very difficult to meet the international challenge of trying to make certain that our tax code is competitive.

And so I would ask each of you now how you feel about replacing our income tax code with a consumption tax, progressive or other-

wise? I would favor progressive, but to replace the income tax with a consumption tax.

I would appreciate from those of you especially that are domiciled in the United States and in manufacturing, how you feel about that kind of change in law. Would that be something that would provide you with a competitive advantage as a U.S. manufacturer?

Yes, sir.

Mr. LOFFREDO. Yes. In my prior life when I was working with Chrysler in 1985, we worked very closely with Senator Roth to develop a single business tax equivalent at the national level which had a border adjustable feature to it which as a U.S. manufacturer was extremely important for us to compete both in the U.S. with our foreign competition basically coming in tax free and internationally when we were selling outside the U.S., as I mentioned the tremendous burden of tax U.S. products has as it is leaving the U.S.

Recently, we have worked with former Senator Nunn and Senator Dominici on the USA tax. And we had supported that. And I think many U.S. manufacturers support a consumption tax that had a border adjustability. In my new life, I am not as sure if I agree with that. As to the U.S. products leaving the U.S., I definitely agree to that.

Just to clarify one point, I do not know if my testimony was clear or not. I think as being a subsidiary of a German company, we will be stronger in the U.S. because now we do not have to worry about the adverse features of the U.S. We take advantage of having a fine workforce in the U.S. and a fine place in safety and——

Senator KERREY. Well, I will put you on the spot, Mr. Loffredo, by observing that there are many other laws besides taxes in Germany that are adverse to corporations that I hear about all the time.

Thank God I am in the United States, I hear people say, rather than trying to start up in Germany. They have very high unemployment rates there and in France. And I hear constantly that there is said that one of the reasons is that they have very restrictive laws on businesses.

Mr. LOFFREDO. But the U.S. operation will still be under the U.S. laws and have the benefits of the U.S. law. And we should flourish because we can avoid some of the concerns we have mentioned in the tax area.

Senator KERREY. Well, if I could, just a simple yes or no and perhaps follow up later on an answer, Mr. Perlman, you have strong feelings about almost everything else. You must have a——
[Laughter.]

Senator KERREY. You can blunt with me on this one, all right.

Mr. PERLMAN. I noticed you picked right up on that, sir. First of all, let me state publicly so I do not get in trouble again that what I am about to say is my position not Intel's. Intel has no position whatsoever on whether we ought to change to——

Senator KERREY. Are you answering Senator Moynihan's question or mine?

Mr. PERLMAN. Both. [Laughter.]

Mr. PERLMAN. But in response to your question, Senator, I am not yet convinced that a consumption tax can be that much simpler than the income tax. If you look at the Nunn-Dominici tax, the bare bones of it, the equivalent of our Internal Revenue Code of 1913 is already something like 300 pages long.

If you speak to the VAT people in Europe who actually administer the VAT for companies like ours, they will tell you it is quite complicated because the only VAT that is completely simple is one that taxes everybody and everything at exactly the same rate.

And I think you will suffer the same issues, the same political and rational economic issues, such as removing prescription drugs. We had a snack tax in California. I do not know if you heard about that. But if you bought Oreos and a six-pack, it was a snack. You paid sales tax. But if you bought a box of 50, it was a food. And you did not have to pay the sales tax.

Senator KERREY. Oreos is a meal, not a snack. [Laughter.]

Mr. PERLMAN. Only in a box of 50, not in a pack of six. And that was an issue that was driving the supermarkets crazy in charging the sales tax.

So if I ever see one that is simple enough, then I think it would deserve serious consideration, but I am not sure we can get there.

Senator KERREY. Mr. Chairman, the red light is on. I will just ask the other witnesses on non-committee if you could give me an answer, I would appreciate it.

Ms. GUARINO. Sure, I would love to, Senator. First of all, I would say 20 years ago, my early days in tax, I remember lots of discussion about consumption tax, a VAT tax. I think overall, the idea could be a good idea, but there is always the concept of is it really replacing the income tax or is it along side the income tax?

As you know, in Europe, they have a VAT tax, but it is a VAT tax in addition to income tax. And then, how do you coordinate that with our sales tax? There are many issues. If we can work through the issues, I would very much support it. We need to work through those issues, not spend another 20 years discussing it.

The CHAIRMAN. Thank you, Senator Kerrey.

And now, it is Senator Nickles.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you very much. I want to say to Mr. Perlman maybe I will come to your rescue, but I appreciate your honest assessment. I want to have an environment that a company, a new company, the Intels of tomorrow or the Microsofts of tomorrow determine that it is very much their advantage to be in the United States for tax and other purposes. And I do not want tax to be such a concern that it might even make it a close call.

We want—you mentioned, I think you said that Intel was, what, the fifth largest taxpayer?

Mr. PERLMAN. I believe we are in the top five. For all I know, we could be number one. We pay a heck of a lot of Federal income tax.

Senator NICKLES. I understand. So it is my point being is that I do not want the tax code to be an encouragement for upstart com-

panies or new companies that are coming out any day or all the time to be thinking, well, maybe we should be for tax purposes have our headquarters offshore. I think that would be a serious mistake. We had that happen. And I do not, we do not want that to happen. And so we need to make sure that our tax code is not certainly disadvantaging. And I would like to think that we would create the environment.

And I might also add when some of the comments were made, I am concerned about the Justice Department in this administration going after Intel, going after Microsoft to such an extent, and some in Congress as well, that also might have other factors that might people think, well, maybe we should be located in Great Britain or maybe we should be located in Hong Kong or some other place. So I just mentioned those couple of comments.

You did mention a couple of specific things I think were interesting. One, you said an AMT, if a person is an AMT player pair, that right now, you are limited to 90 percent of foreign tax credits. And you said it should be 100 percent.

Does the rest of the panel agree with that, you should be able to deduct 100 percent of your foreign tax credit?

Mr. BERAN. Yes, Senator, I would agree.

Senator NICKLES. Anybody else, is that agreed?

[No response.]

Senator NICKLES. All right. Also, I think you mentioned that you should be able to carry it forward unlimited in 4 years. Right now, I think it is limited to 5 years going forward.

Mr. PERLMAN. Yes, sir.

Senator NICKLES. This committee recently passed a bill that would increase that to seven, but also reduced the look-back from 2 years from 1 year. So what is your thought on reducing the look-back?

Mr. BERAN. Well, Senator, generally when you have the need for a carry-back it is because your cash flow is not very good, your income has fallen off. And so the carry-back period is extremely important to the company that gets in that situation.

Cash flow is what drives all of our businesses, the R&D, the production, etcetera. So cutting back the carry back period can be very detrimental. And in some cases, it could almost put companies out of business, depending upon the severity.

Senator NICKLES. Could it not in effect really hurt the companies that are really hurting? I mean, those maybe for whatever reason. And some industries are quite cyclical and have very good years, very bad years. And if they have a very bad year, not being able to get the carry-back would be pretty punitive?

Mr. BERAN. Yes, Senator. And then, you have a combination that both the shortening of the carry-back period plus the alternative minimum tax is going to work together to really hurt a company that is in a cyclical industry that is especially a capital-intensive company. The AMT works especially severely against the capital-intensive company in a cyclical industry.

We are hoping to have solved that problem through better operations, but it is a concern of mine for our business.

Senator NICKLES. Well, recently this committee passed a bill that did limit the carry-back. And I had some reservations about that

and have mentioned it to a couple of our colleagues. I appreciate. Maybe, we should have had you all testify a few weeks ago.

I very much appreciate the comments that were made. Foreign taxes is one of the more complicated. Any comments?

It is one of the more complicated and less understood or least understood provisions of the tax code. And most people's eyes glaze over when you start talking about foreign tax credits and so on.

Senator Dorgan made some rather strong statements. Do any of you care to comment on those?

Ms. GUARINO. I would like to jump in.

Senator NICKLES. Please.

Ms. GUARINO. Mr. Dorgan has for many years talked about his formulary apportionment. And he basically views it as simplicity versus the system we have now as complex.

Many years ago, I worked for a franchise tax board as a tax auditor for California. So I am very familiar with the unitary concept. And it is not really all that simple as he leads people to believe.

Right here in the United States, there are many—there will be many controversies over how you get the measurements. Right within the States, there are different views on whether you have a three factor formula or double weighting, etcetera, etcetera.

Senator NICKLES. Right.

Ms. GUARINO. But in the international arena, that becomes even more complicated because our treaty partners which we have spent many years developing these treaties, they do not accept the formulary method.

So what he is taking us down the road to is down the road to certainty of double taxation or probability of double taxation. And that is exactly what the Treasury and the Congress have spent many years trying to help taxpayers avoid.

So I would suggest that if we are looking for simplicity, we look within the avenue that we are working towards right now and trying to simply that rather than go to another avenue which will be more complex and cause even more dollars to people like Mr. Perlman.

Senator NICKLES. Mr. Perlman, do you want to comment on it?

Mr. PERLMAN. Yes, sir. I would agree 100 percent with what Julie just said. I would come at it in a more positive way. And I would say that it is probably the right idea, but the U.S. Congress is not the right place. You would have to take it to the U.N. because if the whole world adopts exactly the same formula, you will get simplicity.

But as Julie said, the minute one country has a hard, fast formulary rule and the other countries do not, you are guaranteeing double taxation. You are guaranteeing an overload on a competent authority mechanism which really is not even that effective until today.

Senator NICKLES. Thank you.

Did you want to add something?

Mr. LOFFREDO. Yes. Just the point, even the U.S. law, when we have imports coming into this country, say that the amount of that transfer price which is very difficult to calculate also has to be used for customs duties.

What do we do on an apportionment type of basis for customs duties? Does the rest of the world has to follow a transfer price and play by the rules because we have a law that says you have to show the customs duties your transfer price, but we do not have to do that to another country?

We spend a lot of time at Chrysler trying to come up with the correct transfer price so that it not only satisfies the income tax rules, but satisfies the customs rules in the various countries we ship to. I know it is difficult, but it is, you know, we are facing difficult laws that are different in hundreds of countries throughout the world.

Senator KERREY. Thank you.

The CHAIRMAN. Senator Murkowski.

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Thank you, Mr. Chairman. I think this is one of the most important hearings that this committee is going to have this year. And I do want to commend you. I think that, you know, as we look at the overall issue of the complexity and yearn for simplicity and talk about U.S. corporations and mergers and the opportunity to go overseas and yet I think Senator Kerrey's enlightenment, if you will, deserves some further examination relative to your role collectively.

You are tax people. You have an obligation to your management team to obviously represent them in the most efficient manner. And that includes trying to reduce the tax obligation that your individual corporations have. And I appreciate that. And the issue of worker's conditions in the U.S. and advantages in the U.S. vis-a-vis overseas are part of your overall corporate responsibilities, but you are in the tax business. And you want to limit that tax liability. And I understand and appreciate that. That is your expertise. And that is your goal.

The fact that Mr. Perlman has not already gone over—Intel has not already gone over to the Cayman Islands speaks for itself. Yet, you point out had you known what you know today, you probably would have been there.

Mr. Loffredo, his position I think is enlightening to us because it is recent, we are seeing a U.S. corporation that as a consequence of a merger overseas.

My concern, Mr. Chairman, is this likely to be continued drift, if you will, out of necessity, recognizing the elimination of the dual tax? At what point does it become a drain on the U.S. Treasury, if any? I do not know that we have these answers, but somebody might be capable of beginning to put them together.

And then, the other factor that bothers me is, you know, one country or another is going to from the standpoint of competitiveness be encouraged to offer certain tax incentives or advantages in the tax law to attract that headquarters or that corporation to come in. So you are going to have a constant evolution in the process.

My question to you collectively is, how do you suggest that we as the Finance Committee address this dilemma of considerations, competition from other countries to attract capital headquarters by

reducing taxation, offshore activity? How do we do the simplification? How do we encourage that revenue is not lost in the United States as a consequence of moving like Chrysler did?

I will be very general. And I am troubled by one other thing. I do not know which of my 11 grandchildren I am going to give that to. [Laughter.]

Senator MURKOWSKI. That troubles me as well. But let us start with Mr. Beran.

Mr. BERAN. Thank you, Senator. I am afraid if we gave you another 10, we would violate the rule.

Senator MURKOWSKI. You would. There is no question about that. And while it may imply that I was hitting to that, I would agree with you it would put you over the letter of the limit today. [Laughter.]

Mr. BERAN. We do sell them in our gift shops, however.

Senator MURKOWSKI. I see. Well, that is fair enough. Well, I am not going to lead you into where your gift shop is. [Laughter.]

Mr. BERAN. Senator, that is a very difficult question. There are no simple answers. Most countries have their own approach to taxing business and their residents. In my mind, and this is speaking more from my point of view not necessarily the company's position, but as I try and evaluate where tax fits in a global economy and how economies function, I think recognition has to go back that you really—individuals are the ones who are really the focus, end up being the focus of the tax.

The corporate tax tends to distort that. A consumption tax has been discussed, I think could be a very good simplification approach, but it has to be the one tax. You cannot continue with an income tax on top of it because then you will just be back to the same problem. You need one rate. You cannot have a lot of exemptions or you will lose the benefit.

As a matter of fact, when I first started up our European group of tax advisors within caterpillar, the first person I hired was a VAT person because that was the biggest problems we were having.

The VAT in and of itself is not exactly simple, but it can be if you do not create a lot of exemptions. That is where most of the complexity in the law comes from.

But the consumption would be a possibility to reduce a lot of the detailed recordkeeping we have to do. It would certainly improve the complexity if not necessarily the clear flow of income on taxation. I think we really have to focus on that the individuals are the ones who pay taxes. And by taxing business, you distort the flow of money.

Senator MURKOWSKI. Ms. Guarino.

Ms. GUARINO. Senator, I think as this hearing was put together, there were five criteria for it. And I think if the committee can stay with that agenda, I think it will take it a long way. And I think for us, two of the biggest issues would be to expand exports and to reduce the complexity.

And I think even from today's hearing, we are hearing ways of doing that. I think if you take the big ticket items and in the international area for the foreign tax credit, the computation of the foreign tax credit.

If we can just, you know—we do not have to change the world, if we could take a few items and simplify the big ticket items that mean a lot to a multinational. It does not matter if you arc a U.S.-based or an American subsidiaries.

Take the big ticket items where everybody is spending lots of their time and so that we can be more competitive, where we can perhaps reduce the effective tax rate and be more in line, especially now in this global world now that you have the EU and now there is so much discussion about unfair competition and harmonization of their tax laws.

We need, you need to really monitor that and stay focused, keep the rates low, keep people enthused about the economy, and really expand the exports.

Senator MURKOWSKI. Thank you.

Mr. Loffredo, the first moments to wind up.

Mr. LOFFREDO. Senator, Chrysler has not moved. DaimlerChrysler is still a U.S. company with 100,000 employees in the U.S. It makes fine vehicles in plants all throughout the U.S.

The change at DaimlerChrysler is that our parent, it is now a German company. And now, under the U.S. tax laws, the way we are viewed is differently. And as a subsidiary of a foreign company, I have advantages that General Motors do not have. And that is the point, I should not have these advantages.

I mean, I enjoy having them, but I should not have them. And all business should be able to compete equally worldwide. We are not looking for any special advantages. We are just looking to be treated for the U.S. to recognize we are in a global economy now and that we should not be——

Senator MURKOWSKI. And you would theoretically come back if you were not taxed twice?

Mr. LOFFREDO. Right. Well——

Senator MURKOWSKI. Mr. Perlman.

Mr. PERLMAN. I would echo those sentiments by saying, you know, the seat of incorporation is probably two people in a file box. It is not factories. It is not the corporate staff. It is not the headquarters. It is just simply the seat of incorporation of the parent that I was talking about and I think John was just talking about.

I think if we do not do massive tax reform and go to a consumption tax or something else, the international provisions need to be looked at in a very fine way, provision by provision.

I think today, we have all given you both in oral and written testimony certain things to look at. There has also been a bill percolating on the hill. I think the first time I heard the bill it was called the Roskinkowski-Gradison bill. It goes back about eight or 10 years.

There is still about 10 or 12 non-terribly expensive provisions in that bill that can take an awful lot of complexity out of the international provisions of the code. If you couple that with some of the things you have heard, I do not think it is going to be a massive drain on the Treasury because if you look at the international portion of the whole corporate income tax, if you just did not take any of it, it would not be that big a number.

So I do not think it is a major drain, but the complexity, the work. I have 100 people doing taxes at our company. And we are

a very simple company. We have just a couple of products and a couple of ways of doing business. And we have 100 people doing taxes.

Senator MURKOWSKI. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Loffredo, just do not move your plant from Delaware. [Laughter.]

Mr. LOFFREDO. We make a very fine product there.

The CHAIRMAN. Senator Graham.

OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA

Senator GRAHAM. Thank you, Mr. Chairman. I would like to start by asking some questions about tax treaties. The United States has tax treaties with most of our major trading partners with the principal exception being in Latin America where we have relatively few tax treaties. What is the effect on business and commerce because of the existence or in the case of Latin America the absence of tax treaties?

Mr. PERLMAN. Let me take a small shot at that. It is not only Latin America, it is southeast Asia as well. I would indicate that Malaysia and Singapore which are two major countries in the high-tech industry, there are no treaties.

There are basically two effects at least that I see. And again, in a relatively simple company, we do not do a lot of reorganizations and mergers. We just make our products and try to sell them. Number one is the withholding tax rates which are very high in most countries in the absence of a treaty. And since we are not in foreign tax credit limitation, it will borne by the U.S. Treasury not by Intel Corporation in any event.

Secondly, it is the lack of certainty. By doing a certain thing within a country, when you have a treaty, you are certain or relatively certain as to whether or not you are subjecting yourself to that country's tax jurisdiction. In the absence of a treaty, you do not have that certainty.

And I would indicate that engineers have a habit of flying wherever they want to go and doing whatever they want to do without calling the tax department first. So sometimes, you can get into a pretty sticky situation, particularly if there is no certainty. If there is certainty, you can set up corporations in advance if necessary.

And to our company, those would be the two reasons, certainty and withholding tax rates.

Mr. LOFFREDO. I echo what Bob has said. The main advantages would be in lower withholding taxes on dividends or interest coming from those countries so that it minimizes the possibility of not being able to use those taxes and credits in the U.S.

Also, the fact where we are shipping vehicles around the world, that we are protected against being subject to local income taxes in those countries because our vehicles are being used. And a lot of times, we have to use local subsidiaries and intermediate subsidiaries to avoid that problem.

But I agree, treaties are very important. But the network that we are getting under as being a subsidiary of a German company is more broader. They have more treaties out there that we will be able to use.

Ms. GUARINO. Being an American subsidiary also, we have the same opportunities as was just discussed where some of our affiliates in some of the jobs that we do, some of our affiliates might do the jobs with a company in South America rather than the U.S. company.

Now, having said that, we do have much exports right here from the U.S. with Latin America and South America, but we do that mostly with tangible products to selling, as opposed to the construction jobs because once it gets into major construction jobs, it is the certainty that we do not have. And more often than that from the business perspective, predictability is a critical issue.

Mr. BERAN. I generally second the points made. Certainty is important and a better mechanism to resolve disputes at the margins. The treaties certainly help us access markets for products made in the U.S. And on occasion, it is for components. We might make components that we sell to an OEM, say, in Latin America or southeast Asia. And the treaties certainly help in those regards.

Senator GRAHAM. I might say, Mr. Chairman, I appreciate these comments. It has been befuddling to me why the Treasury which has the responsibility of initiating negotiations for a tax treaty has been I think the word "lackadaisical" would not be inappropriate, particularly vis-a-vis Latin America which is the region given my State of Florida that I am the most familiar with.

And I would hope that as part of this overall consideration of international tax issues that we might give some encouragement to the Treasury to be more assertive in initiating these.

I might also say that in most cases, the tax treaty is a precursor to expanded trade relationships because it clears out some of the typical impediments that have to be dealt with in expanded trade. So it is an important step in its own, but it also is a step in a chain of steps that lead to expanded U.S. commercial relationships.

While the yellow light, well, just went off.

The CHAIRMAN. Just in time. [Laughter.]

The CHAIRMAN. We do have another panel.

Senator GRAHAM. If I could maybe just make a quick statement.

The CHAIRMAN. Sure, sure.

Senator GRAHAM. I also share the accommodation for having this hearing. It has been my belief that when you ask the question of tax simplification against the entire United States Internal Revenue Code, it is like asking to level Mt. Everest. But that it is possible to ask the question of tax simplification against individual components of the code that are more or less freestanding, that is they are subject to a set of parameters that do not leak out into the rest of the code, then it becomes a manageable project.

It would seem to me that one of those areas would be the international tax area. And I will hope that we might identify it as a discrete component of the code and an important one for our economic interests and undertake the issue of tax simplification there. And success there may breed confidence to take on other components of the code for a similar effort at simplification.

The CHAIRMAN. Well, I agree with the Senator. I am eager that we do something about tax simplification, but addressing the entire code is just impractical. And so what we are trying to do is pick out key areas that I think are particularly tied to our future pros-

perity and competitiveness. And that certainly includes the international tax picture.

I want to thank all four of you for being here today. This is the opening shot on this matter. And we will be dealing with it for some time. So we will continue to look forward to consulting with you. Thank you very much for being here today.

Mr. BERAN. Thank you, Senator.

Mr. LOFFREDO. Thank you, Senator.

The CHAIRMAN. It is now my pleasure to introduce our second panel. First, we will hear from Professor Mutti from the Economics Department at Grinnell College and then from Professor Slaughter who will highlight some of the findings of the Mainstay III Study on globalization sponsored by the Emergency Committee for American Trade.

Gentlemen, it is a pleasure to have both of you here. We would ask you to keep your comments to 5 minutes. Your full statement, of course, will be included as if read.

Mr. Mutti.

STATEMENT OF PROFESSOR JOHN H. MUTTI, PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, GRINNELL COLLEGE, GRINNELL, IA

Professor MUTTI. Thank you, Chairman Roth and distinguished members of the committee. I am pleased to have the opportunity to testify as you open these hearings to assess how well the U.S. tax system is suited to the rapidly changing global economy. And I particularly appreciate the broad agenda you have set, that you are looking at the philosophy of our tax system as a whole and not a set of problems that an individual industry might face in isolation.

Globalization certainly means that more U.S. firms face competitions from more firms internationally than was true in the past. That description aptly characterizes sales in foreign markets, but it also applies to sales to domestic markets, too.

Designing policies to take into account the new realities of international competition requires that we look both outward to foreign markets and inward to domestic markets.

My comments today address two broad issues. One that we have talked about this morning already and that is the question of worldwide taxation of income. And the second one that Senator Roth raised in the general speech that he had made to the International Finance Association, and that dealt with integration of the corporate and individual income tax system.

With respect to taxation of worldwide income, some claim that to promote high tech, R&D-intensive industries, it would be desirable to move away from this worldwide standard. An alternative advocated by many is the territorial approach that we have heard discussed where essentially the final tax on U.S. corporations operating abroad would simply be the corporate income tax collected in those countries where the income is earned.

As a result, U.S. multinationals would not be subject to a residual U.S. tax once they have paid repatriated income to the United States. And they could compete more readily with corporations that did not face such a residual tax.

Furthermore, if we look at those additional profits they would earn, we could say that could lead to greater research and development effort and enhance the competitiveness of domestic producers as well.

This reasoning is quite plausible as far as it goes, but it ignores a key question. That is, would favorable tax treatment of domestic production also lead to higher profits and greater research and development?

Asking that second question is particularly important when we explicitly recognize that governments face budget constraints. And favorable treatment of one sector implies less favorable treatment for others.

Does a compelling case exist then for favoring foreign production over domestic production? I think that the record is somewhat ambiguous because globalization competition seems to hit just as much U.S. production at home as it does U.S. production controlled abroad.

In addition, measures that improve the after-tax profitability of domestic measures appear to have a bigger effect in promoting R&D effort because it is in the domestic market that those new ideas seem to have their greatest immediate impact.

This reasoning suggests that the heightened importance of research and development in determining U.S. competitiveness may be best addressed with broader provisions, such as an R&D tax credit which improves the competitive position of both those who sell in foreign markets and those who sell in domestic markets as well.

The second issue I would like to address is the integration of the corporate and individual income tax systems. Such a change would avoid tax in capital income at both the corporate and the individual level and thereby improve the efficiency of capital allocation. It is an idea that European countries have long since adopted.

I comment today though only on the way that international factors affect the way we should judge whether this idea turns out to be successful. Normally, we expect reduction in taxation of equity capital to result in a lower cost of capital to U.S. producers. We expect that to reduce U.S. prices relative to foreign prices. And therefore, we would think that that should raise exports and reduce imports. And by that outcome, we might conclude that American competitiveness would be improved.

Because of international capital flows, however, those predicted effects may not necessarily occur. Depending upon the way foreign investment is treated under an integration scheme, it may result in U.S. investors holding more equity and foreigners holding more debt in world capital markets.

As a consequence, net foreign investment income would rise for U.S. investors. And that would tend to strengthen the value of the U.S. dollar. Appreciation of the dollar would end up reducing U.S. exports and increasing imports.

So in general, we might end up thinking that it looks like this policy does not have a strong effect on the trade balance, but nevertheless, it would be a policy that would end up improving the operation of the economy as a whole.

I would favor an integration of the two tax systems, personal and corporate, but I would urge us not to judge whether that is a successful policy on the basis of whether it improves the trade balance. I think it is the wrong expectation in that particular reform.

In summary, for my comments today, I would like to underscore that heightened international competition occurs both in foreign and domestic markets. And therefore, tax policy needs to address both of those situations.

And also, the changes you are considering are going to affect capital flows and investment income not just the cost of capital that we might look at that could effect prices of goods traded internationally.

As a result, I think that we often find policies that are desirable from the standpoint of efficiency and growth are not necessarily policies that simultaneously improve the U.S. trade balance. Thank you.

[The prepared statement of Professor Mutti appears in the appendix.]

The CHAIRMAN. Thank you, Professor Mutti.

And now, it is my pleasure to call on Professor Slaughter.

STATEMENT OF PROFESSOR MATTHEW J. SLAUGHTER, ASSISTANT PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, DARTMOUTH COLLEGE, HANOVER, NH

Professor SLAUGHTER. Thank you, Mr. Chairman. My name is Matt Slaughter. And I am an Assistant Professor of Economics at Dartmouth, a Faculty Research Fellow at the National Bureau of Economic Research, and a Visiting Scholar at the Institute for International Economics. I am pleased to have the opportunity to speak to your committee this morning regarding the ongoing globalization of the world economy.

My testimony will make three points: first, that it is very important to have clear facts about this process; second, that greater international trade and foreign direct investment (FDI) help raise U.S. living standards; and finally, that policy aimed at liberalization should account for how trade and FDI are interconnected.

A good deal of my testimony draws on a recent study, "Global Investments, American Returns" which I help produce for the Emergency Committee on American Trade (ECAT).

The first point I would like to make is that a lot of the ongoing discussion about globalization is full of hyperbole. Yes, international product markets definitely are integrating, thanks to declining natural and political barriers, but the process is not complete. The world has been here before. And policy can reverse it.

An important goal of the ECAT study was to present a set of facts about American companies with global operations, i.e. multinational enterprises. For example, these companies are not simply footloose enterprises which have been massively exporting U.S. jobs. In fact, their employment patterns are quite stable. From 1977 to 1994, total U.S. parent employment to these firms increased slightly from just under to just over 19 million.

At the same time, total foreign employment actually declined slightly from just over to just under 7 million. Thus, U.S. parents account for a large and growing share of total employment in these

companies. It is essential that facts like these rather than incorrect perceptions inform the policy discussion.

As for the claim that we have never been here before, we have. The decades leading up to World War I were a period of extensive globalization. Like today, much of it was driven by advances in technology in railroads, telegraphs, and the like.

During the period from 1914 until just after the end of World War II, however, international markets fragmented. Much of this was due to inward looking policies which raised barriers, such as large increases in tariffs. Thus, the recent globalization has largely just returned the world back to the level of integration before World War I. On some measures, world markets are still less integrated than they were.

The relevance of all of this for policy is that globalization is not inevitable. Policy can foster the process, but it can also reverse it quite dramatically.

As globalization goes on, there is much concern about its effect. My second main point is that increased trade and FDI raise average U.S. living standards.

On the role of American companies with global operations, there two important points. First, these companies help raise U.S. living standards by performing the majority of U.S. investment in physical capital and manufacturing, by undertaking the majority of total U.S. research and development, and by shipping the majority of U.S. exports and receiving a sizable share of U.S. imports. All of these activities contribute to U.S. productivity, the single best measure of a country's standard of living.

The second important point about living standard is that the U.S. and foreign activities of U.S. multinationals tend to compliment each other not substitute for each other.

Here is an example of the evidence on complimentarity. When classified by the industry of their U.S. parents, the majority of all U.S. foreign affiliates is in the manufacturing sector. But when classified by their own industry, the majority of these affiliates is in the service's sector. In fact, of the roughly 20,000 affiliates worldwide in 1994, in fully 25 percent, the mainline of business, was wholesale trade.

A big part of what affiliates do is perform services like wholesale trade which cannot be done efficiently from the United States. Accordingly, affiliate expansion generally triggers in U.S. parents additional investment, R&D, and trade. This means that the ability of these companies to raise U.S. living standards depends a lot on their ability to undertake FDI. Accordingly, policy restrictions on FDI and trade tend to reduce U.S. living standards.

In closing, I would like to offer three personal opinions on some current policy issues. First, U.S. trade and investment policies should recognize that restrictions on the one are likely to entail restrictions on the other. This policy harmonization should apply not just to U.S. laws, but also to U.S. efforts to open foreign markets.

It is important to work towards greater access to foreign markets for U.S. exporters, but access for host country sales by U.S. multinationals is at least as important. In 1996, total U.S. exports were $851 billion, but that year host country sales by affiliates of Amer-

ican companies with global operations were more than double that at $2.2 trillion.

Second, the success of reduced tariffs in recent decades forces trade policy today to deal increasingly with more subtle trade barriers, such as voluntary export restraints and product standards.

As tariffs have declined, what largely remains are a myriad of non-trade barriers. Trade policy today needs to consider what policy institutions can best address these different kinds of barriers.

And finally, in the wake of recent international turmoil, I think the need for commitment to trade and investment liberalization has increased not reduced. This is particular relevant for FDI. Discussions on how better to regulate international capital flows are very important, but these discussions should not sidetrack FDI flows which generally benefit source and host countries alike.

By its very nature, FDI is relatively immune to lots of the problems that portfolio investment can generate. In particular, it is not as prone to contagion and panics in part because its long-term nature means FDI cannot be as quickly reversed as many portfolio investments.

At a time when countries are contemplating limiting certain capital flows, I think the need for FDI flows is all the greater.

Mr. Chairman, thank you for the opportunity to speak to the committee this morning.

[The prepared statement of Professor Slaughter appears in the appendix.]

The CHAIRMAN. Well, thank you for being here.

One of the concerns that is raised is that American companies locate offshore in low-wage developing countries. Is this true? And if so, to what extent does tax policy have any role in these relocations.

Professor Mutti.

Professor MUTTI. I think if you look at U.S. investment abroad, over 75 percent of it occurs in other developed countries. So a very small share is devoted to developing countries. And if we were looking at the competitive balance, we are talking about something that affects our set of regulations and other European and Japanese and Australian competitive regulations as well.

For investments that do take place in low-wage countries because certainly there has been an effort to break the production process and locate some of the most labor intensive steps of that process in low-wage countries, we probably find that those tend to be less capital-intensive forms of operation as well so that the disadvantage in terms of how we treat capital income is not quite as important in those particular industries.

So if I were looking at where I thought tax policy would make the most difference, I do not think it would be locating a very labor-intensive industry.

The CHAIRMAN. Thank you.

Professor Slaughter.

Professor SLAUGHTER. Two comments on your question, the first is even when you look within just the manufacturing sector where I think a lot of people think this kind of exploiting jobs happen, it is not happening. It is clearly happening on an anecdotal basis, but

the aggregate numbers say that that is not the majority of what these affiliates are doing.

So from 1977 to 1994, in 1977, there were about 5 million manufacturing jobs in affiliates around the world. By 1994, that number was down to just over 4 million.

And the second comment that I have is to the extent that certain kinds of activities are relocating from the United States to other countries, that is part of the process by which trade and FDI actually generate the gains that the countries realize overall because it allows countries like the U.S. to focus on the kinds of activities we are relatively good at doing.

The CHAIRMAN. Let me ask you this, how do wages of American companies with foreign affiliates compare with companies with no global presence? And how about the wages of foreign-owned companies doing business in the United States?

Do you want to start with that, Professor Slaughter?

Professor SLAUGHTER. Sure. There have been some good studies done on data for plants located in the United States in the manufacturing sector. We can identify whether they are owned by a purely domestic company or owned by a U.S. headquartered multinational or owned by a foreign headquartered multinational.

And the studies can control for things like plant location, the size of the plant, what industry they are in, how old it is. And when you control for all of these factors and the wage levels in these studies, the studies find that there is something about being a multinational firm that tend to result in higher wages for the employees in these plants.

The wage is gap is anywhere from 5 to 15 percent, depending on what kind of workers you look at and what kind of controls you to try to include in your analysis.

So to the extent these multinational firms do generate these kinas of productivity gains for the country, there is some evidence that shows up actually in higher wages where you would expect it to show up.

The CHAIRMAN. Thank you.

Professor Mutti.

Professor MUTTI. I think that is good characterization of saying what are the companies that are most likely to arrive in the United States? They are most likely to be successful companies that have generated special technologies that can therefore lead to higher productivity and pay higher wages.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Yes. First of all, superb testimony and refreshing. Mr. Chairman, things are not going well for the point of view that you have so wonderfully espoused. Our president is the first president ever to be denied trade negotiating authority.

Jagish Bhagwati—a colleague of yours—writes in the Wall Street Journal today about the folly of fair trade. Economists know it is not fair trade. Free trade is the advantage of anyone who carries it off. And it is just so hard to explain. And the anecdotal evidence is so overwhelming.

You, Professor Mutti, are an associate of Harry Grubert who is a Treasury official. You had a paper a little while ago, Taxing Multinationals in a World with Portfolio Flows, in which you said, in

conclusion, we calculate that on average the U.S. tax rate on active foreign operations is actually negative and in any case could not have much effect on the competitiveness of U.S. affiliates abroad. Well, why does not everybody know that?

Professor MUTTI. Well, I think we would want to be careful how we interpreted that number, but what that number looked at was, what happens when American companies repatriate income to the United States. And what they choose to repatriate may be different than what their total earnings. They defer some of those earnings and leave them abroad.

But for the portion that is repatriated to the United States, we ask, what is the residual amount of tax that is collected by the U.S. Government? And the residual tax that was collected on active income by the U.S. Government was a very small number.

In the year that we cited in that article for 1990, it was U.S. collections were about $2 billion off of foreign source income of $73 billion.

And then, we further looked at that figure of $73 billion and we said, what would happen if we looked at the extent of deferred income, what if we re-characterized income and took into account some of these interest allocation rules that I think do misallocate and call income domestic when it is actually foreign income instead?

So if we took those into account, what sort of adjustments would we come up with. And we come up with the statement that there is not much residual taxation taking place. Now, maybe that——

Senator MOYNIHAN. You said it was actually negative.

Professor MUTTI. Well, that would depend upon how we say we ought to look at the treatment of royalty income in particular.

Senator MOYNIHAN. But you could you write it.

Professor MUTTI. Right. So it could be a small negative number or a small positive number.

Senator MOYNIHAN. Mr. Chairman, it could be a small negative or a small positive number. It is not that the companies involved know this. And I have to assume they do. It is not driving their decisions.

Professor MUTTI. I think what we have heard earlier this morning is it sure takes a lot of time and think about how you would try and structure these transactions so that you would try to minimize this eventual tax that is collected by the U.S. Government.

But if we were just saying on average how much does the U.S. Government collect, they are not collecting a large amount.

Senator MOYNIHAN. Yes.

Professor MUTTI. And so that does not seem to be what would drive a major location decision.

Senator MOYNIHAN. I thank you.

And Dr. Slaughter, again, we are so struck, this Senator is, by your finding for the Emergency Committee on American Trade that the globalization in recent decades has largely just returned the world to the level of integration before World War I.

When this was first pointed out to us by a representative of ECAT, they were sitting where Dr. Mutti is, the president, actually I think if I recall, of New York Life, an old firm. He said, oh, yes,

in 1914, we were in 72 countries, something like that. He said we are now in seven, but we are getting back, climbing up.

The middle of the 20th century was ruinous for trade. And it had consequences beyond the standards of living. I think in this regard, Germany and Britain thought they were competing for colonies in which they would have advantageous trading relations. And did it turn out that in 1914, Germany and England were respectively their largest trading partners?

Professor SLAUGHTER. I think that is right.

Senator MOYNIHAN. Yes.

Professor SLAUGHTER. Big countries tend to trade a lot with each other.

Senator MOYNIHAN. They traded with each other. And what they thought they needed was to own Zimbabwe. And well, pretty soon, there was not anything to trade. They killed each other.

Professor SLAUGHTER. That's right.

Senator MOYNIHAN. And we could be trending in that same direction?

Professor SLAUGHTER. Yes. I think there were some messages that while technology is a big part of what drives the integration of these markets, earlier it was things like the creation of the canals and the telegraphs and railroads. Today, we have computerization and things like that. Policy plays a big role, too. And your earlier comment about the lack of fast-track negotiating authority and trends like that in the United States suggests——

Senator MOYNIHAN. We say "presidential negotiating authority." [Laughter.]

Professor SLAUGHTER. Sorry. Yes. That it is not clear that there is kind of an ongoing consensus today that there is an interest in continuing to reduce political trade barriers. And that is worrisome I think.

Senator MOYNIHAN. Yes. Thank you, gentlemen, both.

Thank you, Mr. Chairman.

The CHAIRMAN. One question that occurs to me as a result of your question, Senator Moynihan, is if not much revenue is being raised, do we have a tremendous amount of complexity that is undesirable? And if there is a need for the revenues, is there a simpler, better way of doing it?

Professor MUTTI. I think that is a good question. In my prepared statement, I mentioned a few aspects of that that I think would merit consideration. I think particularly, we would have to say we could get rid of some complexity if we move to an exemption system and simply did not have to calculate the limit on the foreign tax credit.

But on the other hand, we still would have to have rules for how do you allocate expenses toward exempt income, but that part of the story would not disappear. And so not all the many pages of code would be struck out immediately.

The CHAIRMAN. Professor Slaughter, any comments?

Professor SLAUGHTER. I would just echo that comment of Professor Mutti. I am not a tax expert, but I think the actual cost of the complexities of tax laws and things might be much larger than the actual revenue that is collected just based on if nothing else the anecdotes that were presented in the earlier panel about the extent

to which, you know, the number of employees that need to be allocated to worrying about tax allocation issues and things like that.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Professor Mutti, I am glad to welcome a distinguished Iowa professor here as well.

Professor MUTTI. You are from Iowa, of course.

Senator GRASSLEY. So I do that and then would follow up on a couple of questions. One would be the reference you made to using R&D credits as maybe the better approach than reforming certain aspects of the international tax rules and use that as a way of targeting aid to multinationals.

The question basically is maybe one as much of philosophy as one of just exactly how the tax code works. But if we are really intent upon encouraging capital formation, would it not be better to actually go through the process of reforming the tax code even reducing maybe marginal tax rates so that the corporation itself would have the discretion of how best to invest its money or spend its money as opposed to having kind of industrial policy approach on the distribution of these resources?

Professor MUTTI. I think there are clearly advantages of reformulating corporate tax policy. If we were to look though at what are the ways in which people engaged in R&D currently benefit from the code in the international provisions, we find that it is not uniform, that everybody benefits to the same extent.

People who compete in export markets benefit from and people who have subsidiaries who operate overseas benefit from the extent that they receive royalty payments. And if the parent corporation is in excess credit position, those royalty payments arrive here and there will be residual U.S. tax collected on those royalty payments.

So that is one way of promoting R&D effort, that favorable treatment, but yet not all companies are in that position. There will be other people engaged in R&D who are not producing overseas who do not have exceed foreign tax credits. And therefore, they do not see the same incentive to engage in R&D.

So my simple observation is saying if our goal is to promote R&D and greater technological proficiency of U.S. industries, do we need a broader measure that affects people who are operating strictly within the U.S. market and simply those who are operating overseas and have accumulated the excess credits that will allow them to receive this favorable treatment or royalties at present.

Senator GRASSLEY. All right. Thank you for that clarification. You gave us a pretty good, big picture analysis of possible directions of this international tax reform. It was very helpful to me.

And along the lines of applying it to what one of the witnesses said, I would like to refer to Mr. Beran from Caterpillar. Obviously, his company is already dependent considerably upon exports, but he said by the year 2010, 75 percent of Caterpillar's total sales will be to countries outside the United States.

They operate primarily within the United States as far as manufacturing is concerned. They have the potential of creating many thousand export-related jobs and particularly, if China would lower its tariff's barriers and if and when it would join the world trading organization.

My question is what one or two things could we realistically do with our tax rules to make companies like Caterpillar more competitive in the global marketplace so that they can continue to sell more abroad and create more export-related jobs in the United States.

Professor MUTTI. Well, I think the question in Caterpillar's statement highlights the importance of things that are on the books already, the FISC and the sales source rules for export income.

How those are going to be challenged in the WTO right now, I think I will not have a comment I guess on what we ought to do until we see what that ruling turns out to be if current U.S. practice is found to be incompatible with WTO obligations.

But certainly, you can understand if somebody is going to based domestically and sell into foreign markets and those are the most rapidly growing foreign markets for infrastructure sales, I think that having an open trading system and what gets negotiated in terms of access to those markets is going to be critical.

And I am dodging the question in one sense of saying that I am not sure that the tax elements are as critical right now as what some of the trade negotiations are.

Senator GRASSLEY. Maybe, my question, I was just kind of using as an example with the tremendous market out there that awaits Caterpillar. So forget China and just see if you could give us a couple of examples or things that we ought to do to the tax code to make companies like Caterpillar more competitive in the global marketplace, including China, but generally.

Professor MUTTI. Well, I think in general, efforts to keep tax rates lower are an improvement in terms of cost to capital for U.S. producers. And that is going to hold true whether we are competing in China or whether we are competing in the United States.

Senator GRASSLEY. All right.

Professor MUTTI. So from that perspective, I guess that was what lay behind my first observation that there are certainly companies right in the United States that face much more stringent competition from abroad that I think we need to be worried about what is their position as well.

Senator GRASSLEY. Thank you, Mr. Chairman.

Thank you, Professor Mutti.

The CHAIRMAN. Thank you, Senator Grassley.

And to both of you, I appreciate your very excellent testimony. We look forward to continuing this. Thank you very much.

The committee is in recess.

[Whereupon, at 12:10 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Robin D. Beran

Good morning Mr. Chairman and members of the Committee. I am Robin Beran, Director of Corporate Tax and Assistant Treasurer for Caterpillar Inc. I have global responsibility for Caterpillar's tax planning and compliance. It's a pleasure to be here and to have the opportunity to talk with you about international taxation.

For those of you not entirely familiar with Caterpillar Inc., let me begin with some facts about the company. We are the world's largest manufacturer of construction and mining equipment, natural gas and diesel engines and industrial turbines. We also hope to become a leading manufacturer of agricultural equipment—and have taken a number of steps to establish that distinction.

We design and manufacture machines in countries worldwide for use by customers in highway and building construction, mining, quarrying, agriculture, forestry and waste management. Our engines power our own machines, are sold to other manufacturers to power their products and are the heart of electric power generation systems which provide both primary and emergency power. Our products are distributed and supported around the globe by a world-class network of almost 200 independently owned dealers.

More than 35 years ago, Caterpillar and Mitsubishi Heavy Industries Ltd. formed a 50/50 joint venture in Japan. The joint venture today is the No. 2 maker of construction and mining equipment in Japan—behind only our largest worldwide competitor.

We also own and operate subsidiaries that handle financing, insurance, leasing programs, countertrade and logistics for Caterpillar divisions and other companies. We employ 65,000 people worldwide and posted sales last year of nearly $21 billion. Of that $21 billion, $6 billion were exports from the U.S. We expect sales to grow to over $30 billion in the next decade.

How well we achieve that goal at Caterpillar depends to a great extent on our ability to compete freely and fairly in the global marketplace. Caterpillar is particularly committed to free trade—in a large part because of our unique competitive position. We are globally successful and globally competitive primarily from a U.S. manufacturing base—and although we expect sales outside the United States to grow more rapidly than our U.S. sales, the majority of our manufacturing assets, some 70 percent, are—and are going to remain—in the U.S as long as we have access to world markets from here.

Our facilities are capital intensive and high tech. It doesn't make economic sense to duplicate manufacturing operations for many of our products—and from a political-risk standpoint, in our opinion, the U.S. remains the best place to invest.

We are one of this nation's largest net exporters—we believe Number 2 only after Boeing. By the year 2010, we expect that 75 percent of our total sales will be into countries outside the United States—and that our U.S. exports will reach $10 billion. We've estimated that our total exports last year supported about 45,000 jobs in the United States—15,000 at Caterpillar U.S. plants and nearly 30,000 jobs at U.S. Cat suppliers. And because we plan to continue to operate primarily from a U.S. base, we have the potential to provide thousands more export-related jobs for American workers in the future—but, again, only if we can compete freely and effectively in the world marketplace. That's a big "if"—and, unfortunately, it's one that seems to get bigger every day—growing in direct proportion to increasing protectionist sentiments.

As far back as 30 years ago, we warned in our annual report that trade barriers could stifle companies like Caterpillar which would otherwise compete effectively in

world markets—and we emphasized that free trade is the driving force behind economic growth. The world has come a long way since then—eliminating major barriers through GATT and NAFTA. But there are still those who believe that protectionism is a good policy.

In reality, though, protectionism denies access to new markets, thus eliminating opportunity for increased exports—and creation of jobs in the U.S. In the words of U.S. Secretary of State Madeleine Albright, "Protectionism is an economic poison pill. We cannot expect to gain access to new markets elsewhere if we put a padlock on our own." I couldn't agree more.

While the U.S. has taken many steps to reduce trade barriers, unfortunately, many of our tax policies are still dated. Tax policies implemented in the 1960's—and continually expanded in the years since—don't reflect the current competitive environment facing companies like Caterpillar. Now, there have been a few recent changes that are helpful . . . including the wise decision to include active finance company income in the deferral rules . . . that help keep companies like ours in the competitive arena. I might add, for planning purposes . . . we would certainly appreciate a permanent extension of that provision.

Mr. Chairman, I salute you for your recent comments about preserving two very important features of our current tax code that are under attack, both domestically and abroad. The Export Source Rule and the Foreign Sales Corporation provisions are critically important to U.S. exporters. I also thank you for your support in eliminating unnecessary complexity in the international provisions of the tax code. We struggle with this complexity every single day.

I have a rather unique perspective on this complexity. In the last five years, my staff and I have managed Caterpillar's acquisition of 20 other companies, the formation of 17 joint ventures and establishment of numerous alliances with other global firms. In all these transactions, there is a common thread—especially from the foreign participants—and that is disbelief as to the complexity of the U.S. tax reporting requirements. Keep in mind, these are astute business men and women, from substantial non-U.S. entities who are amazed at the level of detail required for U.S. tax purposes. This surprise is reinforced by accountants in our foreign subsidiaries when first introduced to the U.S. tax requirements

Perhaps some clarification is needed. While I previously mentioned most of Caterpillar's assets are in the U.S., we also invest in foreign operations. There's no real secret why that happens.

When a company grows as fast as we have and acquires new technologies, it's a safe bet not all that technology was developed in the U.S. Global companies operate globally. We service customers where they need us. Since the fastest growing markets for infrastructure-related equipment are outside the U.S., you'll find us there. But there are real benefits to U.S. foreign investment. I'll offer two recent examples.

In 1985 Caterpillar acquired the design for Articulated Trucks from The Brown Group in England. At the same time, an agreement was made with The Brown Group to manufacture ATs for Caterpillar. You've got scale models of the ATs in front of you. This innovative design helped Caterpillar provide solutions that customers wanted. In 1996, we purchased The Brown Group of companies outright, and now own both the design and the manufacturing capacity. An interesting note here—once Caterpillar obtained design rights, we were able to supply components to the Brown Group from our family of U.S.-based suppliers. And this story gets better . . .

Now, Cat is investing in a brand new facility in Texas to manufacture these ATs for the Western Hemisphere market. We will use U.S. labor, U.S. suppliers and U.S. logistics for this enhancement to our product line. Again, had we not made the original investment in England, we wouldn't be introducing U.S. production for these vehicles.

Another recent foreign investment that spurred U.S. investment is Cat's association with Claas of Germany, a leading manufacturer of combines. Caterpillar and Claas agreed on joint ventures to manufacture and market Claas combines in the U.S. and Cat Agricultural Tractors in Europe. Caterpillar Claas America is now a 50/50 joint venture that will begin production of state-of-the-art high-capacity combine harvesters in Nebraska. The same principle is involved here. Had we not made the foreign investment, we wouldn't be adding to our U.S. production.

But the point is, U.S.-based multinational companies face many additional burdens—due primarily to the complexity of our tax laws—that most of our foreign competition does not. If we are to maintain our philosophy of "build it here and sell it there," we need a modern tax policy that is consistent with our global focus. U.S. tax rules must allow us to be competitive bidders when opportunities arise rather than placing us at an immediate disadvantage.

I'm not sure if you want to get into the details here this morning, but true simplification in the international area of our Code would require major revisions to the foreign tax credit provisions . . . including the various "baskets" that have been woven into the system . . . also, adopting GAAP accounting for determining Earnings and Profits; treating the European Union as one entity and somehow pulling together the various sanctions-related (boycott provisions) mandates and trying to make some sense of them all.

I doubt if any one individual with responsibility for Corporate Tax Policy can keep track of all this. So we, in turn invest a lot of time and effort in tax staff, software and consultants to aid us in tracking and complying with the hellishly complex rules we must follow. Rules that have been referred to as "simplifying the process." I submit, they haven't.

Several members of this Committee have been instrumental in proposing and helping to enact some simplification to our international tax system. I understand those efforts will continue this year. Let's keep our eyes on the long-term benefits to the U.S. economy from globally competitive companies, recognizing and responding to the tax-related challenges of new technologies . . . and new markets. By working together, we can assure future generations of Americans an opportunity to participate in world markets—instead of apologizing for lost opportunities.

PREPARED STATEMENT OF JULIETTA GUARINO

Good morning. My name is Julietta Guarino. I am the Vice President of Taxes and Customs for ABB, Inc., the American subsidiary of a global engineering and technology company based in Switzerland. In the United States, ABB, headquartered in Connecticut, employs about 20,000 workers at engineering, construction, sales, manufacturing, research and development facilities in 41 states.

I am testifying today on behalf of the Organization for International Investment ("OFII"), an international business association representing the American subsidiaries of parent companies based abroad. Throughout this testimony, I will refer to these companies as American subsidiaries.

Mr. Chairman, we are very pleased to have an opportunity to discuss with you the important role that American subsidiaries play in the U.S. economy and how the Internal Revenue code impacts these companies.

Although our member companies have headquarters outside the U.S. they are significant American stakeholders. Using most recent government data, let me highlight just a few of their contributions:[1]

- American subsidiaries employ almost 5 million workers in the U.S.
- These firms paid a record-high $13.2 billion in federal income taxes, a 30 percent increase over the previous year.
- More and more, the money these companies earn here, stays here. They reinvested close to $20 billion of their earnings back into their U.S. operations.
- And, in every year since 1980, except for one, they have accounted for more than 20 percent of U.S. exports. At ABB alone, exports from the U.S. accounted for 28 to 31 percent of our almost $6 billion in revenue in each of the past two years.

Mr. Chairman, in my experience, these facts sometimes surprise people—particularly the major contribution American subsidiaries make to U.S. exports.

Let me mention one other surprising fact—more and more Americans are shareholders in companies like ABB. For example, Philips Electronics, headquartered in the Netherlands and a significant employer in the United States, is now more than 40%-owned by shareholders in this country. A recent study by NASDAQ showed that, of the 100 largest inbound investors in the U.S., over 30% of their shares are owned in the U.S.

All of this demonstrates that American subsidiaries are interwoven into the fabric of the U.S. economy. As globalization progresses, the distinctions between American subsidiaries and U.S.-based international companies will become even less relevant. As a multinational enterprise—and a major U.S. exporter—my company's tax interests are very similar to those of my fellow panelists from Intel and Caterpillar. However, American subsidiaries also face unique applications of the U.S. tax system.

As such, OFII has a number of recommendations for improvement of the international provisions of the Internal Revenue code. I would like to submit for the

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[1] Latest available government data: tax data—1995; reinvestment data—1997; and export data—1996.

record a list of detailed suggestions, but will confine my oral remarks to four broad observations and recommendations.

1. PROMOTE NON-DISCRIMINATION

In general, U.S. law provides "national treatment" for inbound companies—which means treatment no less favorable than that given to other U.S. companies. However, there are tax provisions that discriminate against American subsidiaries.

For example, in certain circumstances, when an American subsidiary borrows from a related party or even a U.S. bank with a parent guarantee, present tax law may disallow current interest deductions. My colleagues at Intel or Caterpillar do not, as a practical matter, face the same restrictions on their ability to deduct interest payments on business borrowing.

In addition, we believe that the IRS tends to administer the same tax rules differently for inbound and outbound companies. IRS field agents sometimes take unreasonable—and wildly different positions—based on whether a taxpayer is an inbound or outbound investor. While IRS zeal might be understandable as a negotiating position, it should not create two unequal standards.

We urge the Committee to maintain the national treatment principle as it considers international tax reform, and urge you to consider rolling-back discriminatory provisions.

2. THE U.S. PENALTY REGIME IS TOO HARSH

The U.S. has a system of punitive measures which is much harsher than those of virtually any of its trading partners and is not in harmony with multilateral guidelines. American subsidiaries often feel compelled to overpay their U.S. taxes in order to avoid harsh penalties. Presumably, the penalties are meant to encourage compliance, not overpayment of tax in the U.S. If other countries follow the United States' lead and adopt equally harsh penalties, multinational companies will run into an escalating wall of penalties around the world.

A recent example illustrates the overly harsh U.S. system of punitive measures. The case involves a foreign corporation that failed to file a timely tax return because it believed that its activities in the United States did not constitute a U.S. trade or business. The IRS has denied all their deductions and said the company must pay tax on gross income. Although technically this action may not be a penalty, the effect is clearly punitive. I don't know of any foreign jurisdiction in the world that imposes such a drastic sanction. Further, this U.S. action violates the non-discrimination clause of the relevant bilateral tax treaty: the U.S. tax authority does not impose this same sanction on U.S. companies.

I have included in my written submission some specific proposals for reevaluating the penalty provisions that apply to inbound investors. I would also like to include for the record a letter that I recently sent to the Treasury Department seeking their intervention in the particularly egregious situation that I just outlined.

We urge you to examine how the U.S. penalty regime could be brought more into line with those of our major trading partners and multilateral norms.

3. REDUCE COMPLEXITY

One of the frustrations of doing international business in the United States is the enormous complexity of the tax rules. ABB does business in nearly every corner of the world and nowhere else do we face the mountain of record keeping, documentation and evidentiary requirements that we do here. To comply with U.S. tax rules, my staff is 3 times larger than the parent company's tax department in Switzerland. My staff and I have to rely on more outside advisors and economists than any other ABB tax function around the world. Most OFII member companies have a similar story to tell.

We urge the Committee to examine ways to reduce complexity while still ensuring that multinational firms comply with the underlying tax laws.

4. PROTECT PROGRAMS THAT REDUCE UNCERTAINTY AND CONTROVERSY (APAS)

We share Chairman Roth's view about the importance of allowing taxpayers to negotiate "advance pricing agreements" (APAs) with the IRS to resolve transfer pricing disputes without costly and uncertain litigation.

Given our mutual support of the program, I want to focus your attention on a widely reported development that may undermine its effectiveness. Under pressure from a three-year lawsuit filed by the Bureau of National Affairs, the IRS recently announced that APAs are subject to redacted public disclosure. Taxpayers have participated in the APA program in reliance upon representations by the IRS that sen-

sitive pricing data submitted during the process would never become public or find its way into the hands of competitors. Obviously, public disclosure is an unacceptable risk for many companies.

Many taxpayers are very concerned about this development and I know of several that are seriously considering withdrawing from, or not entering the program as a result of the current uncertainty.

We urge the Committee to actively monitor developments in the current litigation. Congress may need to intervene to save this valuable program.

CONCLUSION

In conclusion, Mr. Chairman let me say that we are very grateful to you and members of the Committee for showing the foresight to hold this hearing. As you move forward, we urge you to keep in mind that American subsidiaries are major contributors to the U.S. economy through employment, increased U.S. exports, reinvestment in U.S. plant and equipment, and adding value to American shareholders.

We hope you keep in mind the four recommendations for international tax reform that we have outlined: promote non-discrimination, lessen the U.S. penalty regime, reduce complexity, and protect programs that reduce uncertainty and controversy. We look forward to working with you as you move forward.

Organization for International Investment

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March 11, 1999

Mr. Philip West
International Tax Counsel
Department of Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220-0001

Dear Phil:

I am writing to you on behalf of the Organization for International Investment (OFII). It has come to our attention that the Internal Revenue Service has tentatively decided to issue technical advice that disallowance of all deductions claimed by the U.S. permanent establishment of a Canadian corporation, under the authority of Treasury Regulation § 1.882-4, does not violate the U.S.-Canada Income Tax Treaty. We view this as a dangerous precedent and urge you to intervene in this matter in the interest of U.S. treaty policy.

As you know, OFII is a Washington, D.C. based trade association representing the U.S. subsidiaries of companies based abroad. American subsidiaries provide millions of good-paying jobs to American workers; invest millions on research and development completed by American doctors, scientists, and engineers; reinvest their profits back into their U.S. businesses by expanding existing operations and building new facilities; and donate millions to American charities.

The non-discrimination article of the Treaty provides that U.S. taxation is not to be "less favorably levied" on the U.S. permanent establishment of a Canadian resident than the taxation applied to a similarly situated U.S. resident. In addition, the business profits article of the Treaty provides that normal expenses of a permanent establishment "shall be allowed" as deductions. No fair reading of the language of the Treaty would permit the U.S. to disallow deductions to a foreign corporation for failure to file a timely return under circumstances in which analogous deductions would unquestionably be allowed to a domestic corporation.

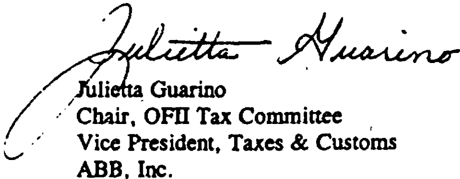
We are aware that the draft Commentary to the 1996 U.S. Model Income Tax Convention asserts that disallowance of deductions under section 882(c)(2) (which is implemented by Regulation § 1.884-4) is not necessarily discriminatory. It is not clear in the Commentary whether this assertion is based on the assumption that "penalties" are outside the purview of the non-discrimination clause or on the notion that foreign enterprises are not "similarly situated" to U.S. residents. In our view, neither rationale is sufficiently compelling to warrant disregard of the clear language of the Treaty. Nor does it make any sense as a policy matter to

impose such a draconian sanction on a corporation whose earnings are fully subject to tax by a treaty partner at rates that are comparable to those of the United States.

An even more troubling aspect of the IRS' position is that it implicitly rejects the Commentary to the OECD Model Treaty as authority for interpretation of U.S. treaty language. The non-discrimination language of the U.S.-Canada Treaty is essentially the same as Article 24, paragraph 3, of the OECD Model. The Commentary to Article 24 of the OECD Model states that a permanent establishment "must be accorded the same right as a resident enterprise to deduct trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits." Moreover, the Commentary makes it clear that such deductions are to be allowed "without any restrictions other than those also imposed on resident enterprises." Insofar as the proposed technical advice cannot possibly be squared with those explicit requirements, we can only assume that the IRS has concluded that the Commentary to the OECD Model has no relevance to U.S. treaties.

It cannot be in the best interests of the United States for the IRS to adopt idiosyncratic and counterintuitive interpretations of non-discrimination and other fundamental treaty concepts that are at odds with those consistently applied by major treaty partners. The inevitable consequence of such a course would be to create disincentives to foreign enterprises contemplating operations in the United States and to precipitate retaliatory action by treaty partners against U.S. corporations doing business abroad. I would very much like to discuss this and other issues with you at your earliest possible convenience.

Sincerely,



Julietta Guarino
Chair, OFII Tax Committee
Vice President, Taxes & Customs
ABB, Inc.

DESCRIPTION OF POSSIBLE TAX INITIATIVES

1. Instruct IRS to enforce tax law standards, especially the "arm's length standard" under IRS § 482, in a consistent manner for both out-bound and in-bound transactions.

Problem: Taxpayers are concerned that the IRS changes its standards based upon whether transactions are "in-bound" or "out-bound" in determining an "arm's length" price for a transaction. For example, in identical factual situations, IRS examiners take very different positions as to what constitutes a reasonable royalty payment based solely on whether the payment is made to a US or to a foreign entity.

Solution: Either in statutory or Committee report language, the IRS should be specifically instructed to apply the same arm's length pricing standard to both in-bound and out-bound transactions. Adherence to the principle of "national treatment" requires the even-handed, non-discriminatory application of the tax law, and a statement to this effect could be inserted in either the IRS Restructuring bill or the International Tax Reform bill. Consideration should also be given to appointing an International Liaison or Ombudsman at the IRS who would be responsible for overseeing the application of the principle and handling complaints about its violation. The Liaison would handle complaints regarding both outbound and inbound transactions.

2. Amend the restrictions on interest deductions contained in IRC § 163(j) to exempt interest paid on loans from unrelated third parties which are guaranteed by a foreign related party, if the guaranty serves to reduce the interest charged on the loan.

Problem: If US subsidiaries of foreign parent corporations borrow from US banks or other US taxpayers and obtain guarantees from their foreign parents in order to lower interest costs, they become subject to the restrictions on interest deductions in IRC § 163(j). These interest restrictions were originally intended to apply to US subsidiaries who borrowed money directly from their foreign parent and as a consequences might be paying very large (deductible) interest payments to the foreign parent rather than (non deductible) dividends to the parent. If the US subsidiary is paying interest to an unrelated US bank, and using the loan guaranty from the parent to reduce its interest costs, the interest should be deductible without restriction, as it would be for any other US corporation.

Solution: Amend IRC § 163(j) to exempt interest payments to unrelated third parties if the borrower can demonstrate that the US subsidiary could have obtained the loan without the guaranty and the guaranty served to lower the interest costs.

3. Ease the burdens placed on companies under IRC § 6038A

Problem: Companies with more than only 25% foreign ownership are required to fill out lengthy forms and comply with voluminous recordkeeping requirements. The IRS needs and uses only a fraction of this information to ascertain the proper tax liability of the companies. These form filing and recordkeeping requirements can be streamlined to eliminate unnecessary burdens on taxpayers, without jeopardizing the ability of the IRS to ascertain tax liability.

Solution: Enact the following changes to IRC § 6038A.

A. **Ease the burden of proof for the taxpayer and the very severe penalties.** For example, clarify in the statute that the IRS will fully take into account applicable treaty provisions and procedures prior to imposing any penalties. Require that before imposing the non-compliance penalty, the IRS must carefully consider all of the information that has been submitted to it by the reporting corporation or the related party, and the IRS should not disregard or fail to take into account information that has been submitted merely because there has been non-compliance with respect to other information. Allow the field agents or others at the local level to reduce or limit the application of penalties.

B. **Liberalize safe harbor for record maintenance and encourage the IRS to enter into more record maintenance agreements.** The statute should state that before requiring creation, submission, or translation of foreign books and records, the IRS must be satisfied that an intercompany pricing dispute can not be fairly resolved based on books, records, and other information available in the US. The statute should also clarify the extent to which the IRS will enter into mutual agreements with treaty partners concerning reciprocal record maintenance or creation procedures.

C. **Simplify reporting on Form 5472** (Information Return of a 25% Foreign-Owned Corporation) by allowing group reporting on foreign subsidiaries. For example, some US subsidiaries are currently filing over 300 of these 5472 forms because they are "related" (using the 25% threshold requirement) to 300 foreign entities, even though most of their transactions (measured by dollar volume) are with only six (6) companies. In such a situation, companies should be allowed to file separate forms for the related foreign companies with which they do most (80%) of their business, (measured by gross payments), but they should be allowed to file one form for a large group (e.g. 300) of companies with which they do a small (e.g.20%) amount of business. Give field agents discretion in assessing penalties, at least if the the payments reported are below a de minimis threshold.

D. **Enact a de minimis rule for small transactions** Exempt from the reporting requirements any foreign related party whose aggregate value of gross payments to or from the reporting corporation is $ 5 million or less. The rule in the Regulations is $5 million aggregated for all related reporting corporations §1.6038A-1(i). Replace this with separate "entity" and/or

category limitations (with an anti-abuse rule) so that payments of a specified amount (e.g. $250,000 or 2% of the reporting corporation's gross income) are exempt. Index these amounts for inflation.

E. **Provide more time for the translation of documents.** The Regulations require taxpayers to translate documents within 30 days of a request subject to extension upon written request [§§ 1.6038A-3(b)(3) and (f)(4)]. The period within which translations must be provided should be automatically extended to at least 60 days. If the IRS requests written translations of more than some fixed number of pages (e.g. 100 pages) of documents in any audit cycle, all expenses incurred by the taxpayer in translating the excess should be borne by the IRS. A reporting corporation should be permitted to satisfy its document translation obligations by making a qualified interpreter available to assist the IRS. Failure to translate should not, in any case, be the basis for non-compliance or monetary penalties except when a reporting corporation is acting in bad faith. Further, the IRS should assist in this process by, for example, requesting translated summaries of documents.

F. **Raise the 25% foreign ownership threshold to 50% for purposes of defining a "reporting corporation" and "related party."** The threshold for reporting status should be increased to conform more closely with other related party rules, for example more than 50% for purposes of the subpart F rules [Code § 954(d)(3)]. The statute should liberally excuse non-compliance with IRS requests for information in cases of related parties that directly or indirectly own less than 50 % and in divestiture situations if the reporting corporation, in good faith, has asked the related party to comply with the IRS request. In cases when there is a lack of control, within the meaning of Code Section 482, the record maintenance requirements should not apply at all.

4. Clarify That Competent Authority Process Can Resolve Application of Penalties

Problem: Officials at the IRS have questioned whether the application of penalties (such as those imposed by IRC § 6662(e)) can be abated in a Competent Authority proceeding. At least one of the six tax treaties ratified in 1997 (the treaty with Ireland) contains a statement in the treaty itself that the application of penalties may be resolved in the Competent Authority process. The other five treaties contain statements to this effect in the technical explanations accompanying the treaties. However, many older treaties are silent on the issue. As a result of the statements of the IRS officials, many are concerned that in the older treaties, or in any instance where the penalty language is not contained in the treaty itself, the U.S. Competent Authority will refuse to consider penalties issues.

Solution: Amend Internal Revenue Code § 894, to clarify that the Competent Authority has the ability to resolve the application of penalties, such as those imposed by IRC § 6662(e), unless the applicable treaty expressly provides otherwise.

5. Clarify that the matching principles of IRC § 267(a)(3) do not apply to payments to a foreign related person which is exempt from US tax pursuant to a tax treaty.

Problem: Under IRC § 267(a)3) "accrual" basis taxpayers may not take deductions for payments made to "cash" basis related taxpayers unless and until the cash basis taxpayer takes the payment into income The Regulations under this provision do not apply this matching principle to any payments made to foreign persons if the payment is exempt from US tax as a result of a tax treaty – except interest. For interest payments only, the Regulations require an accrual basis US taxpayer, to delay taking an interest deduction until the cash basis foreign related party takes the interest into income, even though the foreign related person is totally exempt from tax under a treaty. (These regulations were upheld by the Third Circuit in Tate & Lyle Inc. v. Commissioner.)

Solution: Amend IRC § 267(a)(3) to exempt all payments made to a foreign related person which are exempt from US tax pursuant to a tax treaty.

Prepared Statement of Hon. Orrin G. Hatch

I commend the Chairman for holding this hearing today and thank the witnesses for appearing before us today. I have long been an advocate on reviewing and updating the morass of rules governing the taxation of American multinationals.

The American economy has experienced significant growth and prosperity. That success, however, is becoming more and more intertwined with the success of our businesses in the global marketplace.

It is a well-known fact that the United States plays a critical role in the world economy. This has become even more obvious during the recent financial distress in Asia and Latin America. But most people still don't realize the important contributions to our economy from U.S. companies with global operations. We have seen the share of U.S. corporate profits attributed to foreign operations rise from 7.5% in the 1960s to 17.7% in the 1990s.

As the economic boundaries from country to country merge closer together, as technology blurs traditional geographical boundaries, and as competition continues to increase from previously lesser-developed nations, it is imperative that America-owned businesses be able to compete effectively.

U.S. businesses frequently find themselves at a competitive disadvantage to their foreign competitors due to the high taxes and stiff regulations they often face. On average, U.S. multinational companies face an effective tax rate that is 4% higher than U.S. domestic companies.

Given this, any rule, regulation, requirement, or tax that we can alleviate to enhance competitiveness will be to the benefit of American companies, their employees, and shareholders. We have recognized this in relation to our trade laws. All around the world, we have international trade negotiators working hard to remove the barriers to foreign markets that discourage and hamper U.S. trade. This is very important to the future economic growth of the U.S. economy.

This effort has largely ignored the largest source of artificial and unnecessary trade barriers experienced by U.S. companies operating abroad—the complexities, inconsistencies, and policies contained in our very own tax code. These barriers are why I am continuing to work with my colleague Senator Baucus to introduce the "International Tax Simplification For American Competitiveness Act" again this year. While not a comprehensive solution, this bill contains provisions to simplify and update the tax treatment of controlled foreign corporations, fix some of the rules relating to the foreign ax credit, and make other changes to international tax law. It will take us a long way toward making some sense of the international tax regime.

In the debate about the globalization of our economy, we absolutely cannot forget the taxation of foreign companies with U.S. operations and subsidiaries. These companies are an important part of our growing economy. They employ 4.9 million American workers. In my home state of Utah, employees at U.S. subsidiaries constitute 3.6% of the workforce. We must ensure that U.S. tax law is written and fairly enforced for all companies in the United States. I am glad to see that the Chairman has included this view of the foreign tax debate in the hearing today.

I applaud the Chairman for his commitment to removing barriers to the growth of our U.S. multinational companies. His willingness to tackle the difficult issues underlying a comprehensive review of our international tax policies is heartening. I look forward to working with him throughout the year as we hear the testimony today and hold future hearings on this issue.

Prepared Statement of John Loffredo

My name is John Loffredo, and I am Vice President and Chief Tax Counsel for DaimlerChrysler Corporation, the U.S. arm of DaimlerChrysler. The merger of Chrysler Corporation and Daimler Benz A.G. was a "merger of equals." This was a marriage of two global manufacturing companies, one with its core operations in North America and the other headquartered in Europe, with operations around the world. However, when it came to the choice of whether the new company should be a U.S. company or a German company, the U.S. tax system put Chrysler at a decisive disadvantage.

Generally, the German tax system is based on a "Territorial" theory. By contrast, the U.S. tax system follows the philosophy of taxing the worldwide income of a U.S. company while allowing tax credits for taxes paid to foreign governments. In theory, it is possible for both systems to result in the same tax being imposed on a company whether they are U.S. or German. However, in practice this does NOT happen.

Before I go further, I want to make it clear that the former Daimler Benz has been a good corporate citizen in the U.S. and has paid all taxes believed legally due on its U.S. operations. The same is true for the former Chrysler Corporation. In addition, Daimler and Chrysler will continue to be subject to the U.S. tax laws on their U.S. operations and will continue to pay their fair share of U.S. taxes. However, what we did not want to happen as part of this merger was to increase the company's tax burden by subjecting to U.S. tax Daimler Benz's non-U.S. operations that were NEVER subject to U.S. tax laws in the past.

As mentioned, the main reason that Germany's tax system on global corporations is preferable to the U.S. is the "Territorial" nature of their tax system. What does this mean from a practical standpoint?

1. WORLDWIDE VS. TERRITORIAL TAX SYSTEM

Under the German Territorial Tax System qualified dividends received from foreign subsidiaries are not taxed in Germany. (Recent potential law change may effectively tax 5% of dividend.) When DaimlerChrysler Corporation earns income in the U.S. it may elect to dividend some of its after-tax earnings from the U.S. to Germany, (less a 5% withholding tax). These dividends are not subject to German income tax. The U.S. operations of DaimlerChrysler will only be taxed once (by the U.S.).

However, under the U.S.'s worldwide tax system a U.S. parent company receiving dividends from its foreign affiliates must include the dividends and corresponding foreign taxes paid in its U.S. taxable income. Then it must determine the U.S. tax on those dividends. The U.S. company may be able to offset the U.S. tax on that income if it can meet certain limitations and utilize the foreign tax credits generated by these foreign subsidiaries. If the foreign tax rate is the same or higher than the U.S. tax rate, the foreign tax credits should, in theory, offset the U.S. tax on those dividends. If this occurred, the result would be the same in the U.S. as it is under the German Territorial System. That is, no further U.S. corporate tax would be imposed and the earnings will have been taxed by only one country. However, under restrictions put in the U.S. tax laws over the past several decades, this theoretical result is typically NOT achieved and, in many cases, the U.S. taxpayer can NEVER fully utilize all of the foreign taxes paid by its subsidiaries to offset the U.S. tax on foreign earnings. The result is taxation of at least a portion of the earnings twice, by two countries.

Under these circumstances, the German Territorial Tax System provides a greater degree of certainty for the new DaimlerChrysler company that corporate income earned outside of the country of incorporation for the parent will only be taxed once.

Why does a U.S. company have a problem utilizing all its foreign tax credits so that foreign source income is only taxed once? The main reason for this problem is that a U.S. company has to apportion many of its domestic business expenses (especially interest expense) against its foreign source income, thus reducing the amount of foreign income that may be taken into account in meeting the limitation. This would create unused foreign tax credits.

2. APPORTIONMENT OF BUSINESS EXPENSES

The U.S. tax system requires certain domestic company's business expenses to be apportioned to foreign source income for purposes of determining the amount of foreign tax credits that may be claimed. This apportionment of expenses has the effect of reducing the amount of a taxpayer's foreign source income. The result is a taxpayer does not have sufficient foreign source income to utilize all of its foreign tax credits. In effect, this apportionment of expenses to foreign source income results in an amount of foreign income equal to the apportioned expenses being taxed in the U.S. with NO credit offset. This amount of income is thus subjected to tax twice, once by the foreign country and again by the U.S.

The expense apportioned to foreign source income that creates the most difficulty to a company like DaimlerChrysler, and to many other U.S. companies, is interest expense, which must be apportioned on the basis of the location of an affiliated group's assets. Since interest is apportioned on an asset basis, it is apportioned to foreign source income categories whether or not the foreign affiliates have current income subject to U.S. taxation (e.g. dividends are paid from foreign subsidiary).

DaimlerChrysler has a large affiliated finance company in the U.S. whose primary business purpose is to provide financing to Chrysler dealers and customers who buy Chrysler products in the U.S. However, under the U.S. tax laws, DaimlerChrysler must apportion its U.S. affiliated group's interest expense between its U.S. income and its worldwide income. Had the former Chrysler Corporation become the parent company of the merged group, substantially over 50% of the value of the assets of

the combined companies would have been located outside of the United States. This would have meant that more than 50% of the U.S. affiliated group's interest would have been apportioned to foreign source income. This would have decreased the amount of foreign source income that was eligible for offset by the foreign tax credit. In effect, U.S. tax would have to be paid on the amount of foreign source income equal to the expenses allocated to that income, and that would have been quite a large number.

In our example, the German company is a subsidiary of the U.S. Company. Assume DaimlerChrysler Corporation sold one vehicle in the U.S. and made $1,000 of net taxable income on the sale. DaimlerChrysler's finance subsidiary financed the sale of the vehicle and that company incurred $100 of interest expense. Also, in that year, DaimlerChrysler received a $50 dividend from the former Daimler Benz AG (which paid $50 in tax to the German tax authorities).

Let's assume that 50% of DaimlerChrysler Corporation's assets were foreign, 50% of the interest expense or $50 is allocated to foreign source income. Of DaimlerChrysler Corporation's total income subject to U.S. tax of $1,100 only $100 is foreign source income ($50 dividend plus $50 gross-up for German taxes). Under the method used to calculate foreign tax credits in the U.S., the $100 in foreign source income is reduced by the $50 U.S. interest expense apportioned to foreign source income. This results in net foreign source income of $50. The U.S. tax on that amount is $17.50 which is the maximum amount of credit that may be claimed on the $100 of German income. Therefore on the $100 earnings in Germany, 67.5% would be paid in taxes (50 in Germany; 17.5 in the U.S.) That is, a portion of the German income will have been taxed twice.

With DaimlerChrysler A.G. the parent, if its U.S. subsidiary earned $100 of income from U.S. sources, that income would have been subject to a tax at the 35% U.S. rate. A subsequent dividend to Germany would be subject to an additional 5% U.S. withholding tax and no further German corporate taxation for a total effective tax of around 38%, rather than 67.5%.

In addition to the apportionment of expenses problem, there were three other areas of concern to DaimlerChrysler under the laws in the U.S. for taxation of foreign subsidiaries of U.S. companies.

(a) Foreign finance subsidiaries
(b) Investment income earned by foreign subsidiaries
(c) Foreign Base company sales

A. Foreign finance subsidiaries

Prior to 1997, foreign subsidiaries of U.S. companies who were carrying on an active finance business (borrowing and lending) in a foreign location had to be concerned that these operations were subject to U.S. tax on their earnings even though not distributed to the U.S. parent. The problem has been alleviated by recent legislation that has given taxpayers temporary relief to exclude such active business income from U.S. taxation. The German tax system would NOT tax such an active business. DaimlerChrysler Corporation, which continues to own active finance companies in Canada and Mexico, strongly supports this rule which allows active foreign finance company income to be exempt from U.S. taxation and urges that it be made permanent.

B. Incidental Investment income earned by foreign operating subsidiaries

The U.S. will tax in the year earned passive foreign income (interest) if the tax rate in the foreign country is less than 90% of the U.S. tax rate or less than 31.5%. The Germans, on the other hand, will not tax incidental income (interest on working capital) earned at an active operating company. However, both the German's and the U.S. have similar rules when it comes to taxing foreign sourced passive income where such income is in a tax haven country. In Germany, the income is taxed immediately if it is not subject to a 30% tax rate in the country where it is earned and, as mentioned before, the U.S. rule is that such income must be taxed at a 31.5% tax rate to avoid immediate U.S. taxation.

C. Foreign Base Company Foreign Sales Income

DaimlerChrysler is in the business of selling vehicles worldwide. Let us assume DaimlerChrysler A.G., a German company, establishes a regional distribution center in the United Kingdom as a staging area for the sale of right-hand drive vehicles worldwide. Vehicles manufactured in Germany are sold to the distribution center in the U.K., and then on to a third country. The income earned by the U.K. distribution center would be taxed in the U.K. (not Germany) and eventually the dividend from the U.K. to Germany would not be subject to further tax.

Now assume that DaimlerChrysler, a U.S. company, sent vehicles manufactured by its German subsidiary to the U.K. center. The vehicles in the U.K. will be sold

throughout the world. Under U.S. tax laws the income earned by the U.K. distribution center on vehicles shipped to other countries would be taxed immediately in the U.S. The reason for this is because the new U.K. tax rate of 30% is less than 90% of the U.S. tax rate.

In the above two scenarios there is no difference in operation for the DaimlerChrysler group, only a difference in tax results. The only change in facts is the country of incorporation of the parent company. The U.S. company is placed at a decisive disadvantage.

In the above three circumstances, the foreign source income included in U.S. taxable income is reportable in the year the income is earned by the foreign company. This is the case whether or not the income is repatriated to the U.S. or whether or not the U.S. taxpayer is in a net U.S. taxable income or loss position for the year. Because of the "basket" rules adopted in 1986, many taxpayers with losses may be in a position of including this income in their tax base but they cannot offset the tax on this income with current foreign tax credits. In these cases, the chance for double taxation on the foreign source income increases.

As can be seen from above, DaimlerChrysler Corporation, now a subsidiary of a German company, has minimized the possibility of paying ADDITIONAL tax (NOT TAXES) on its foreign operations. This should help the operations of the company to continue to compete on a global scale. However, there are many U.S. companies which have foreign operations and they are put at a competitive disadvantage in the global economy, just because they are competing against companies who do not have to follow the way the U.S. tax system taxes foreign operations.

PREPARED STATEMENT OF JOHN MUTTI

Chairman Roth and distinguished committee members.

I am pleased to have the opportunity to testify today. I admire the ambitious agenda that you have set for these hearings. I particularly appreciate the fact that you do not plan to look at each item of concern to a particular firm or industry in isolation, but instead you intend to examine the overall rationale behind the U.S. taxation of international income.

Globalization indeed does mean that more U.S. firms face competition from more firms internationally than was previously the case. That observation aptly characterizes sales in foreign markets, but it also applies to sales domestically, too. Electronic commerce makes it easier for foreigners to market directly to U.S. buyers, just as U.S. producers can access foreign markets more easily. Fewer sectors of our economy represent nontraded goods and services protected from foreign competition. Designing policy to take into account the new realities of international competition requires that we look both outward and inward.

My comments today fall in the category of "big picture" issues that are relevant in assessing possible directions for international tax reform. I comment on three issues, each of which involves a question of policy and also a question of the appropriate analytical framework to apply. The three issues are: (1) the taxation of worldwide income; (2) the integration of U.S. individual and corporate income taxes; and (3) the exemption of foreign-source income from U.S. taxation.

With respect to the taxation of worldwide income, globalization has meant that producers are more aware than ever of the way U.S. taxation affects their competitive position. As important as U.S. exports or U.S.-controlled production abroad are, however, we should not ignore the way the competitive positions of other U.S. producers are affected by changes in the way business is done internationally or by proposed tax policy changes. Special provisions to promote one type of activity may well appear to encourage U.S. growth and efficiency, but we should keep in mind an additional question: would the same loss in tax revenue that arises from addressing one concern, such as the enhanced competitiveness of U.S.-controlled production abroad, be just as effective in promoting U.S. growth and efficiency if it were devoted to a measure that reduced the cost of capital for all domestic producers? Alternatively stated, if there is a government budget constraint that must be met, when a loss in revenue occurs as a result of tax measures adopted in one area, what is the effect of increased taxes paid elsewhere in the economy? (Joint Tax Committee, 1991).

For example, some claim that to promote cutting-edge, R&D- intensive U.S. industries that produce worldwide it would be desirable to move away from the standard of taxing the worldwide income of a country's firms or individual residents. From a world perspective that traditional standard, together with the granting of credit for foreign taxes paid, has been favored because it results in capital export neutrality; investment is allocated to the location where its before-tax productivity is great-

est. [Admittedly, this standard does not automatically confer a benefit upon the United States as a whole if real returns are higher in other countries, who attract investment from the United States and gain the opportunity to tax first the income earned in their country. That asymmetric result of capital primarily flowing out of the United States appears less relevant now than was true previously. For example, in 1980 the stock of outward foreign direct investment as a share of U.S. GDP was 8.1 percent and the stock of inward foreign direct investment as a share of U.S. GDP was 2.7 percent; in 1995 these two figures had become 9.8 percent and 7.7 percent, respectively. Inflows of foreign direct investment have grown faster than outflows (United Nations, *World Investment Report 1997).*]

An alternative standard is capital import neutrality, which would result when the final tax on income would be levied in the country where it is earned. Proponents of this standard note that it would allow U.S. corporations that invest abroad to avoid a residual tax in the United States. U.S. multinational corporations could thereby compete more effectively with firms in that country or with firms whose home from countries exempt foreign-source income from taxation. Furthermore, if that improved profitability allowed U.S. firms to expand and carry out more research and development, then their domestic production also would become more competitive; domestic and foreign production would be complementary because of this common dependence on R&D (Hufbauer 1992, Frisch 1990).

Such a line of reasoning is quite plausible. At the same time, however, we should examine whether providing more favorable tax treatment to production abroad is more effective than providing more favorable treatment to production at home (Grubert and Mutti 1995). If U.S. attempts to sell in foreign markets are characterized by more intense competition and greater availability of substitutes than when U.S. producers serve the home market, then a given tax advantage may result in a larger percentage expansion of foreign sales. Given the nature of international commerce today, though, the assumption of a protected home market and less competition the closer to home one is geographically seems less justified than might have been true in the past. Beyond this ambiguity, we further need to examine how the incentive to carry out additional R&D affects domestic versus foreign sales. Some economists report that greater profitability in foreign markets appears to be less of an inducement to additional U.S. R&D, because R&D has its greatest pay off in the domestic market (Bailey and Lawrence 1992). Only with a lag is it transferred to foreign markets. Thus, the type of tax treatment most likely to promote R&D activity at home is not at all obvious. Treating foreign income or royalties from abroad more favorably than domestic income does not necessarily have a greater effect. From the accepted position that there is underinvestment in R&D, because those who generate new ideas cannot appropriate enough of the benefits, the desired domestic policy would be an R&D tax credit. Its effect would be to improve the competitive position of those who compete with foreigners at home as well as abroad. This approach could be pursued quite independently from any change in the principle of worldwide taxation.

The second issue I would like to address is the integration of the corporate and individual income tax systems. I was pleased to see that Chairman Roth raised this issue in his recent speech to the International Finance Association. Given that the United States is one of the few countries to retain a classical system that taxes capital income at both the corporate and the individual level, economists have long recognized that this creates a bias toward using debt rather than equity as a source of funds and a bias against operating as a corporation. Integration will result in a gain in efficiency for the economy as a whole. Nevertheless, how should we predict such a change will affect the competitiveness of U.S. producers or judge whether the policy is successful? In a global setting our intuition can be misleading if we do not apply the appropriate framework to project such consequences.

In a closed economy setting, economists predict that integration will make equity more attractive to investors, reduce the cost of capital to U.S. producers in the corporate sector, and result in lower prices of their output. In an open economy, that would seem to result in greater exports and fewer imports. Yet, that projection is incomplete if we ignore the effect on investment income and the value of the dollar internationally, or if we fail to consider the different effects on flows of debt and equity. Also, we need to specify carefully how inward and outward investment are to be treated in any integration plan (see Grubert and Mutti 1994).

Suppose the United States were to follow the pattern of European integration schemes and to deny the benefits of integration to foreign owners of U.S. stock. In that case, integration would likely result in foreigners buying less U.S. equity. U.S. stockholders would be willing to pay a higher price for U.S. stock because they could claim a credit against their individual income tax liability for the corporate income tax paid; foreign owners would not be able to use this credit and would not benefit

from paying less tax at the individual level. Yet, if we just focus on equity holdings, we may too pessimistically predict a large outflow of capital from the United States. As U.S. investors shift from debt to equity, interest rates will rise and foreigners will have an incentive to buy U.S. debt. Thus, there is not likely to a big inflow or outflow of capital internationally. Nevertheless, U.S. investment income is likely to rise, because U.S. investors now have portfolios more heavily weighted to equity than debt. That greater investment income results in a stronger dollar, fewer exports and greater imports. The U.S. economy benefits from greater output, income and saving, but the effects are distributed differently across industries than we might have first expected; output in sectors that compete most directly with imports in the U.S. market or with exports in foreign markets are adversely affected by the dollar appreciation and instead nontraded industries expand. We should not conclude the policy has failed, however, because the competitiveness of export industries has not risen. Even with a worsening of the trade balance, which is offset by greater net foreign investment earnings, the economy is operating more efficiently.

The choice to deny integration benefits to foreigners often has been motivated by the belief that foreign investors will receive little of this benefit if they owe a residual tax to their home government. Under those circumstances, granting benefits to foreign investors simply benefits foreign treasuries without making investment in the host country more attractive. More recently, there has been less concern over that situation and more attention paid to the role of portfolio investment as an increasingly important source of finance internationally. If portfolio investment has risen substantially from countries where no residual tax is levied, then granting benefits of integration to foreigners may be an important step in ensuring that the cost of capital to domestic producers falls. In the extreme case of a small country that is dependent on portfolio capital as a marginal source of investment funds, denying benefits to foreigners simply means that no change in the cost of capital occurs, as foreigners drastically reduce their holdings of equity and domestic stockholders receive a windfall gain from integration (Boadway and Bruce 1992). Because the United States is not a small country, and foreign investors are not the sole marginal source of funds for new investment, the effect of denying benefits to foreigners would not be so drastic. European countries have reached a variety of different answers in determining how much of a benefit to pass on to foreigners in bilateral tax treaty negotiations; from a unilateral perspective a country implicitly balances the gains from shifting part of its tax burden to foreigners against the benefits from a larger capital inflow when it reduces that tax.

The preceding two issues arise within a residence-based income tax system that taxes the worldwide income of the country's firms and residents. In contrast, the third issue I would like to address, potential exemption of active foreign-source income from U.S. tax, points in a different direction. As suggested above, a tax system could be source based, where only income earned in the source country or territory is taxed. In fact, most countries have elements of both principles included in their tax systems. The competitive disadvantage faced by U.S. MNCs when they are subject to residual U.S. taxation is partially offset by their ability to claim a foreign tax credit, limited by the amount of U.S. tax that would be due on that income, and by their ability to defer U.S. taxation until the income is repatriated. How large, then, is this residual U.S. tax effect? In terms of a residual tax collected by the U.S. government on active non-financial income earned abroad (the general basket), the numbers are not large. In 1990, for example, the U.S. Treasury collected $2.0 billion from repatriated active foreign income of $73.4 billion. The ratio of these two figures suggests that the United States is close to an exemption system already with respect to active income.

In fact, most European countries that have exemption systems do not exempt all foreign source income. Rather, they exempt active operating income. They tax interest income, in part because a bank deposit abroad is a very close substitute for a bank deposit at home, and a country could lose its tax base very quickly if one were exempt and the other not. Also, if an income tax system is designed to tax all income once, then interest, headquarters' charges, and royalties that are deductible expenses abroad are to be taxed by the home country.

If the United States were to exempt active foreign source income, what implications would that have for other measures of the tax code? Currently, U.S. parent corporations that have excess foreign tax credits can receive royalties from abroad or a portion of export earnings free of any residual U.S. tax. Is there a strong rationale to extend that same treatment to all firms, regardless of their foreign tax credit status, or should the usual treatment of royalties and interest under an exemption system be applied? What expenses should be allocated against exempt income? Would tax simplification result? Grubert and I are currently examining those questions.

To summarize my comments today, which admittedly touch on just some of the relevant reform issues before the committee, I reiterate that the analytical questions they raise apply beyond the specific policies discussed. First, heightened international competition occurs both in foreign markets and the domestic market, and therefore tax policy changes need to address both situations. Often, maintaining a broad tax base with a low tax rate is the most effective policy to ensure that the competitiveness of producers in both situations is encouraged. Second, effects of tax changes on capital flows and investment income, and not just on the cost of capital, are important parts of predicting how tax policy changes affect competitiveness. Policies that have the desirable effect of increasing U.S. efficiency and growth do not necessarily improve the U.S. trade balance. Third, even if the U.S. system of taxing foreign-source income approximates an exemption system, would there be major consequences from establishing that as a matter of policy? Fundamental questions of what income is to be taxed, or whether different regimes are appropriate for different types of income, must be answered. I regard these perspectives as important in considering reforms of the international tax system.

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PREPARED STATEMENT OF BOB PERLMAN

The following introductory comments were generally presented by Bob Perlman, Vice President of Taxes of Intel Corporation, before the Senate Finance Committee on March 11, 1999.

Let me begin by stating that if I had known at Intel's founding (over thirty years ago) what I know today about the international tax rules, I would have advised that the parent company be established outside the U.S. This reflects the reality that our Tax Code competitively disadvantages multinationals simply because the parent is a U.S. corporation.

The U.S., economically speaking, is not an 'island'. Certainly, U.S. companies recognized many years ago that business is truly global, and becoming increasingly so. With the capabilities of the Internet, cross-border business decision-making and transactions that formerly took substantial time are now being completed in nanoseconds. Significantly, our government has recognized that tax policy should not impede the growth of this new technology and its ability to increase the productivity of U.S. companies.

Competing in global markets means that the number of competitors broadens, and their costs, including taxes, become highly relevant. U.S. international tax policy which does not acknowledge that this global reality puts a price on the consequences of the actions of U.S. companies creates a competitive disadvantage.

This competitive disadvantage is, tangible, measurable, and is recognized by senior management of U.S. companies and is taken into account in business decisions. Several years ago, Dr. Gordon Moore, one of Intel's founders, noted the irony of one consequence of the so-called "Excess Passive Assets Rule." It motivated U.S. companies to invest in physical assets overseas, despite the rule's avowed purpose of causing the opposite result. Nonetheless, Gordon also appreciated and understood the need for U.S. companies to avail themselves of this course of action to avoid suffering a competitive disadvantage relative to our international competitors. Their home countries had no comparable rule (and they suffered no adverse tax consequences

if cash or other passive assets were retained abroad). Wisely, the excess passive assets rule was subsequently repealed.

Competitive disadvantage can occur from procedural as well as substantive governmental action. Frequent changes in the tax code, and the administrative rules to enforce it, create uncertainty which is highly disruptive to sound business planning. An example of this is the recent schizophrenic experience with so-called hybrid entities. The Treasury Department and IRS initially issued regulatory rules which greatly simplified entity classification for tax purposes. Shortly thereafter, they attempted to revoke the regulations. The rationale of the hybrid regulations was to allow certainty, reduce the costs of international business, and reduce compliance burdens as well as potential disputes, including litigation. After Congressional concern was expressed, Treasury withdrew the revocation, but also announced its intention to issue similar regulations in the future. Businesses that had acted upon the hybrid regulations cannot simply undo structuring, and thus, would have suffered adverse U.S. tax consequences.

Another area subject to great uncertainty is the Possessions Tax Credit, which has undergone numerous changes and curtailments throughout its history. Notably, this part of the Tax Code was intended by our government to stimulate U.S. investments in possessions, and yet that result has prompted frequent reconsideration and change.

In contrast to foreign competitors, U.S. companies cannot proceed with sound business planning, without checking numerous non-intuitive, potential tax consequences first. The degree to which our tax code intrudes upon business decision-making is unparalleled in the world. Complex rules relate to numerous foreign tax credit "baskets," extensive expense allocations, and detailed earnings and profits computations. Other countries do not have such complex rules. Simplicity in our Tax Code seems at times the eternal dream. The international tax rules engender much of the Code's complexity, and policy changes in these rules offer great potential for significant simplification. For example, the anti-deferral rules, under Subpart F, are very complicated—with reform of them based on sound policy, greater simplicity will also be a welcome outcome.

When politics enters the equation, in lieu of policy, perception becomes of paramount importance; good economic policy becomes the victim of terms such as "loophole closers" and "corporate welfare." When unintended or inappropriate results are recognized later, it is very difficult to correct them. A notable example of this occurred with the overlapping rules within the Passive Foreign Investment Company provisions, which duplicated the anti-deferral rules, under Subpart F, already applicable to foreign subsidiaries of U.S. multinationals. Once this over-kill was acknowledged, the fiscal cost to correct the unintended portion of the result exceeded the original revenue estimate of the entire statutory provision by a factor of ten, and the correction was not completed for over ten years.

I said earlier that competitive disadvantages suffered by U. S. companies via our international tax rules are measurable. An example is the contrast between our deferral-based international tax system and those systems that employ tax sparing or are territorial-based. Given the global business reality of needing to secure market access and service international customers, U.S. multinationals, such as Intel, need to locate production and other facilities in foreign countries. Interestingly, our international competitors line the streets in these same locations.

If an international competitor's home country tax system is based upon territoriality, income generated by the foreign facility is not taxed at all, currently or upon repatriation. Consequently, a U.S. company will have a sixty-five cent residual in the U.S., with which to do research or otherwise invest, while the foreign competitor will have a full dollar in its home country. Tax sparing provisions, found in many tax treaties between developing countries and developed countries, produce similar results.

An area of our international tax rules particularly ripe for reform is Subpart F. These anti-deferral rules have been in place for thirty-seven years and, although subject to periodic changes, the rules have not been purposefully re-examined in light of the global business realities that U.S. multinationals face today. Although certain other countries followed our lead and adopted similar rules, none today are as expansive as ours.

The anti-deferral rules were, in substantial part, intended to be a "back-stop" to U.S. transfer pricing rules, which were yet to be fully developed in 1962. In contrast, today's strict enforcement of transfer pricing rules occurs on a worldwide basis. Accordingly, manufacturing, sales, and services income should not be taxed until remitted. The foreign base company sales income and foreign base company services income provisions should be repealed.

The U.S. tax consequence of an activity should depend upon whether the activity occurred within the U.S. taxing jurisdiction, and not upon whether sales or service activities occurred within the country in which a foreign subsidiary was incorporated. Minimization of foreign taxes through a foreign base sales or services company should not concern the U.S. Many of our foreign competitors' tax jurisdictions do not tax such earnings, and reserve their anti-deferral rules only for passive income. This reduction of foreign taxes through the use of base companies ultimately benefits the U.S. Treasury through reduced foreign tax credits upon ultimate remittance.

Another troubling outcome of the current Subpart F rules occurs when U.S. companies attempt to cope with difficult exchange control and customs issues, frequently in developing countries. These risks of controlled currencies and adverse customs results can be avoided if the U.S. multinational sells into the country through a subsidiary incorporated elsewhere. Unfortunately, doing so runs afoul of the Subpart F anti-deferral regime. For example, for a U.S. company wanting to sell in China, if it located a corporation there it would be exposed to currency controls and customs issues; if, instead, the U.S. company sells into China through a Hong Kong subsidiary it would avoid the foreign currency and customs exposures. However, by doing so, it would suffer the loss of deferral on the sales income.

It is difficult to understand why avoiding adverse business risks of currency controls harsh customs rules and foreign taxation should also cause an adverse U.S. tax impact. This "Hobson's Choice" is not suffered by foreign competitors. Similarly, if faced with a high dividend withholding tax, but no branch profits tax in a foreign country, doing business through a branch of a foreign subsidiary would minimize tax costs. However, Subpart F would apply, even though the withholding tax ultimately would be borne by the U.S. Treasury through increased foreign tax credits.

Also, under Subpart F, certain profits of foreign subsidiaries of U.S. multinationals lose deferral when the profits are "invested" in the U.S. These rules penalize U.S. companies from investing in, among other things, stock of start-up companies unrelated to the investor or its parent company. For example, if the Japanese subsidiary of a U.S. company were to use its profits to invest in an unrelated Internet start-up company in the U.S., there would be a U.S. tax cost suffered if the acquired stock exceeded twenty-five per cent of the Internet company. If a Japanese competitor made a similar investment in the same start-up company, it could do so without triggering Japanese or U.S. tax.

Another indication of Subpart F not keeping pace with the changing international business environment is its restrictive focus on activities occurring within the country of incorporation of a foreign subsidiary (for the activities to retain deferral of U.S. tax on earnings produced.) In 1992, the European Community created a single market—now fifteen countries. This action enables European business operations to be consolidated, producing reduced operating costs. However, the failure of our Subpart F rules to acknowledge this single market, and treat it as a single country, prevents U.S. companies from availing themselves of similar cost savings to those enjoyed by our European competitors.

Other provisions than the Subpart F anti-deferral rules in our international tax rules should also be examined and reformed. The U.S. system taxes worldwide income of U.S. multinationals on a current or deferred basis, and the foreign tax credit is essential to income earned in foreign jurisdictions not being taxed by the U.S. as well. The credit enables such income to be taxed primarily in the jurisdiction in which it is earned. This is a long-standing, fundamental premise of our Tax Code. For alternative minimum tax purposes, however, such double taxation is only relieved to the extent of ninety per cent. This restriction of the foreign tax credit originated more from revenue considerations than policy reasons, and is yet another competitive disadvantage suffered by some U.S. companies competing internationally. This produces a guaranteed 10% current double taxation result.

Another aspect of the foreign tax credit which can increase tax costs for U.S. companies operating globally is the limited nature of the carry-over period for excess foreign tax credits, compared with periods for other business credits. Unlike such incentive credits, this instead prevents exposure to double taxation; yet, business credits enjoy substantially longer carry-over periods—21 years versus 7. More akin to the foreign tax credit is the net operating loss provision (since both are based upon fairness)—its carryover period spans 22 years. Recently, proposals have been made to further curtail the foreign tax credit carry-over period—instead, it should be unlimited, at least prospectively.

The comments which follow are more detailed points on some of the issues, discussed above, as well as additional areas in the U.S. international tax rules, which entail competitive disadvantages and which would also benefit from reform.

SUBPART F

OVERVIEW

The Subpart F rules have been the subject of much discussion recently—and with good reason. Originally enacted in 1962, these rules were intended to curb the ability of US companies to unjustifiably allocate income and/or assets to controlled foreign subsidiaries, of U.S. multinationals, in low-tax jurisdictions. Ordinarily, if the income of such subsidiaries was not repatriated to the U.S., a "deferral" of the U.S. tax on that income was achieved. A potential for abuse existed through inappropriate income allocations, and by simply moving passive assets to controlled foreign subsidiaries. Consequently, deferral under Subpart F is denied to certain types of income produced by activities of controlled foreign corporations. In the ensuing thirty-seven years since enactment of the Subpart F rules, however, there have been significant changes to the tax laws in the U.S. and other countries, and significant changes in the U.S. industrial and economic profile. In particular, the enactment and enforcement of the)482 transfer pricing rules has made the Subpart F provisions relating to active income superfluous. At this point it is virtually impossible to simply "allocate" income to another taxing jurisdiction—the transfer pricing rules ensure that functions and income are aligned and determined under an arms-length standard. Even the IRS recognizes that the original policy objectives for Subpart F may no longer be appropriate, and solicited taxpayer feedback in Notice 98-35. Unfortunately, the Notice suggested that nonetheless new policy objectives for Subpart F might include:

1. To prevent undue incentives for U.S. businesses to invest in operations abroad;
2. To prevent U.S. businesses operating internationally from achieving lower rates of taxation than their domestic counterparts; and
3. To deter harmful tax competition between countries.

These suggestions signal a clear message that U.S. tax policy makers may not grasp the realities of today's global economics. Nowhere are these realities more sharply illustrated than in the area of high technology. Taking each of the above points in order, the following comments are relevant:

1. The first thing to understand about investing abroad is that not all investments are created equal. Clearly, the act of simply moving cash offshore to avoid the taxation of investment income should be discouraged, and we would not propose a change in this respect. However, investing abroad in business operations (manufacturing, distribution and services) may be essential to the ultimate survival of a business. For example, in the technology sector, rapid software and hardware innovation drive short product lifecycles and our customers must minimize their start-up time and inventory risk. This means that they not only want the latest technology, but they want it exactly when and where they need it, and they want the technical support to get their products to market as quickly as possible. To meet these demands, U.S. businesses must invest in regional distribution and support infrastructures for our offshore customers. If we cannot deliver, our customers will go elsewhere. Unfortunately, the Subpart F provisions make this business necessity more costly for a U.S. multinational than for a foreign-based multinational.
2. This brings us to the apparent Treasury/I.R.S. belief that it is necessary to equalize the tax burden of U.S. multinational and U.S. domestic companies. This rationale only makes sense if you assume that these companies are primary competitors. However, the true competitors to U.S.-based businesses with international operations are not only domestic companies, but also foreign-based businesses. One telling confirmation of this is the loss of the DRAM semiconductor business by U.S. chip companies to foreign competitors a number of years ago. This has been the story time and again for American businesses; in the 60's, eighteen of the twenty largest industrial corporations were U.S.-based, but by the 90's this number had fallen to eight. American industry has had to make the tough, but necessary, decisions to reclaim its global economic position by increasing productivity, quality and service, while also decreasing costs. The Subpart F provisions are one more economic hurdle for American industry that our foreign-based competitors simply do not face. It is time for U.S. tax policy to be part of the solution rather than part of the problem.
3. The IRS perception that the Subpart F provisions can prevent harmful tax competition between countries is problematic and unrealistic. The first problem with this concept is the assumption that tax competition is, de facto, harmful. The reality is that foreign countries, particularly developing countries, view the ability to provide tax incentives for investment as critical to their national eco-

nomic futures. For U.S. tax policy to attempt to control or undermine these sovereign decisions is futile at best, and arrogant at worst. The reality is that the Subpart F provisions can only attempt to curb tax competition with respect to U.S. multinationals. Foreign-based multinationals will continue to seek—and obtain—the most favorable tax treatment possible. Ignoring this, U.S. tax policy places U.S. multinationals at an economic disadvantage in the global economy.

The following sections provide brief explanations of the operation of the Subpart F provisions in specific situations, and illustrate the disadvantages produced in the global context.

FOREIGN BASE COMPANY SALES INCOME

Foreign Base Company Sales Income (FBCSI) is subject to current U.S. taxation under the Subpart F rules—even though there is no repatriation of income to the U.S. FBCSI is income earned by a controlled foreign corporation (CFC) from the purchase and sale of personal property, if the property was either purchased from a related person or sold to a related person, and if the property was manufactured outside and sold for use outside the CFC's country of incorporation. The original intent of this provision was to prevent a CFC of a U.S. company from earning income in a low-tax rate jurisdiction without having added any appreciable value to the product. As mentioned previously, transfer pricing rules now essentially no longer permit the allocation of income without verifiable corresponding value being added, so this provision, as a tax policy, is no longer relevant.

This provision can render active foreign business income subject to current U.S. income tax. For example, the sales and distribution logistics of U.S. companies in Asia make it most efficient to channel sales through a single CFC that handles all regional order management, freight scheduling, VAT reporting, customs clearance, and inventory management. This CFC definitely adds value to the product by ensuring maximum efficiency in getting it to Asian customers. Nevertheless, because this CFC is purchasing from a related party, and selling to customers throughout Asia (not just within its country of incorporation), virtually all of its income will be considered FBCSI subject to current U.S. taxation. If the CFC's tax burden were only, say 17%, the overall tax cost would still be the U.S. effective rate—35%. Compare this result with that of a German parent company with the same sales and distribution model in Asia: German tax law would not subject the income to current taxation, so their tax cost is truly only 17%. This clearly gives the German company a competitive cost advantage in doing business in Asia

Eliminating this portion of the Subpart F provisions will "level the playing field" for U.S. multinationals. At the same time, eliminating this provision should result in no particular advantage for U.S. multinationals over U.S. domestic corporations, as both companies will continue to bear a comparable tax burden on income earned in the U.S.

FOREIGN BASE COMPANY SERVICES INCOME

Like FBCSI, Foreign Base Company Services Income is also subject to current U.S. taxation under the Subpart F rules—even if there is no repatriation of the income to the U.S. Such income is derived from the performance of technical, managerial, engineering, architectural, scientific, skilled industrial and commercial services which are performed for any related party, outside of a CFC's country of incorporation. This makes little sense in today's world. The original tax objective in 1962 was to discourage U.S.-based companies from separating services from manufacturing activities, and organizing the service activities in a low-tax country. Once again, the transfer pricing rules have essentially neutralized the potential for abuse in this area. Furthermore, the provision can result in the current taxation of active business service income simply by virtue of the place of incorporation—even if it is the optimal structure from a business, administrative, and tax perspective.

For example, optimal parent-branch structuring permits a taxpayer to segregate active and passive income taxation. Some countries permit a business to operate through a foreign parent—local branch structure, and do not tax the earnings of the non-resident foreign parent. Furthermore, the country may also permit the free remittance of cash from the operating branch to the foreign parent. In this scenario, the branch can remit all excess capital to the foreign parent, which it would then invest, creating foreign base personal holding company income—subject to U.S. taxation. To illustrate how this provision can cost U.S. tax dollars, assume a service business in country (A) that taxes both active business income and investment income at a 25% tax rate—but also permits the foreign parent-operating branch structure. Further, assume that the foreign parent is in country (B) and the tax rate is zero. The tax consequences under current law would be:

- Subsidiary Incorporated in Country A—All income would be subject to the local 25% income tax. The active business income would not be subject to current U.S. tax under Subpart F, however, any interest on excess funds would fall under the Subpart F FPHCI rules. The Subpart F inclusion would carry a 25% foreign tax credit as well, so the net U.S. tax dollars amount to only the 10% tax rate difference between the U.S. tax rate and the local tax rate levied specifically on interest income.
- Foreign Parent/Local Branch Structure—Active business income of the branch will be taxed locally at 25%, however, the interest income will not be taxed at either the branch or parent company level. Because services are now being provided outside the country of incorporation, the entire parent/branch income would be subject to current U.S. tax of 35%. Under this structure, the service operation would have a higher tax cost overall, and would be at a significant economic disadvantage relative to companies domestic to country (A) and most other non-U.S. multinational companies.

If the Subpart F provisions were amended to eliminate the same-country incorporation requirement, the branch would retain an effective tax rate of 25%, and only the parent's interest income would be taxed currently in the U.S. at the 35% rate. Further, the interest income would carry no offsetting credits, and as such, would fully produce tax revenues for the U.S. Overall, this would yield a more competitive profile, while ensuring that tax dollars on passive income are accrued solely to the U.S.

FOREIGN PERSONAL HOLDING COMPANY INCOME

The U.S. normally imposes tax based on either (a) the residence of the taxpayer, or (b) the source of the income. The worldwide income earned directly by U.S. resident companies and certain U.S. source income of non-resident companies is taxed in the U.S. on a current basis. The foreign-source income of foreign corporations, on the other hand, is not ordinarily subject to tax in the U.S., because the U.S. has neither a residence basis nor a source basis for imposing tax. In the case of foreign corporations controlled by U.S.-based companies, U.S. tax is normally not imposed until the foreign earnings are repatriated to the U.S.-based companies.

Foreign Personal Holding Company Income (FPHCI) generally consists of dividends, interest, rents, royalties, and other ostensibly "passive" income earned by foreign corporations that are controlled by U.S.-based companies. The U.S. generally accelerates the taxation of U.S.-based companies on such foreign affiliate income by deeming such income to be a "dividend" when earned.

The U.S. imposes tax on the FPHCI of foreign affiliates controlled by U.S.-based companies, even though (a) the income is from foreign sources, (b) the income is earned by foreign taxpayers, and (c) the income remains offshore. The basis for the U.S. imposing such tax on FPHCI (and other Subpart F income) appears to be founded on the principle of "capital export neutrality." Capital export neutrality means that income from capital is taxed in the same manner whether the capital is deployed in the jurisdiction of the investor or in a foreign jurisdiction.

In Notice 98-11, the U.S. Treasury Department summarized the purposes of Subpart F as follows:

> U.S. international tax policy seeks to balance the objective of neutrality of taxation as between domestic and foreign business enterprises (seeking to neither encourage nor to discourage one over the other), with the need to keep U.S. business competitive. Subpart F strongly reflects and enforces that balance.

Thus, with a view to creating a "level playing field," the U.S. generally taxes FPHCI (and the U.S.-based company is eligible for a limited foreign tax credit for the taxes paid by the affiliate on such income in the foreign jurisdiction).

The reality is that a "balance" between maintaining U.S. business competitiveness abroad and capital export neutrality does not exist. U.S.-based companies are placed at a distinct disadvantage when competing with foreign-based companies for offshore business. In its efforts to foster capital export neutrality, the U.S. has lost sight of the importance of permitting U.S. companies to engage in business abroad on an equal footing with foreign competitors.

Capital export neutrality, while an admirable goal, only works if other jurisdictions share the same goal and make cross-border investments subject to similar rules. Capital export neutrality cannot be achieved unilaterally. For example, assume X and Y are controlled foreign corporations owned by P, a U.S.-based company, and that X and Y are incorporated in different foreign jurisdictions. X is engaged in an active business with primarily unrelated parties and develops intellectual property. Y is also engaged in an active business and pays X royalties for the use of the intellectual property.

In the U.S., the royalty income earned by X would be FPHCI and would be attributed to P. As a result, U.S. tax would be accelerated on the royalty income, notwithstanding the fact that the income is from foreign sources, earned by a foreign corporation, kept offshore, and is traceable to an active foreign business.

If P were instead a German, Canadian, U.K., French or Japanese company, the royalty income would not be taxable to P. Unless other taxing jurisdictions adopt tax systems consistent with the capital export neutrality principle, and the notion that profit-seeking companies should make cross-border investments as if in a world without taxes, the application of the capital export neutrality principle by the U.S. is not viable. With it, U.S.-based companies are placed at a competitive disadvantage.

To combat this competitive disadvantage, undistributed FPHCI that remains offshore should not be taxed in the U.S., provided the FPHCI is traceable to active income earned by the foreign affiliate or is active foreign income itself. The FPHCI characterized as active foreign income or attributable to active foreign income would become taxable, but only upon repatriation to the U.S. In effect, a "look-through" rule for FPHCI should be enacted. The FPHCI should be looked through to the ultimate source of the income, and if that income is active and foreign-source, then the FPHCI should be characterized as such, and hence be non-taxable until repatriated to the U.S.

Interest and Other Investment Income

If a U.S. company sets up a Cayman Islands corporation for the purpose of investing some of its U.S. passive assets, then clearly any FPHCI earned by the Cayman company should be taxed in the U.S., whether or not the investment income is repatriated to the U.S. While the investment income may be traceable to active income, the active income would be U.S.-source. Taxing the FPHCI in this case is the right result, because there are no competitive disadvantage implications and, more importantly, taxpayers would otherwise be free to shift their U.S. capital to low-tax jurisdictions for the purpose of avoiding U.S. tax (i.e., an "incorporated offshore pocketbook").

On the other hand, for example, if an Israeli subsidiary with active income from its microprocessor factory invests some of the Israeli profits either directly within Israel or through a Cayman Islands subsidiary, then the FPHCI earned by the Israeli company or the Cayman subsidiary should not be taxed in the U.S., unless and until the investment income is repatriated to the U.S. The investment income is traceable to the active foreign income of the Israeli subsidiary. The Israeli company should be free to invest its profits to grow capital for a new factory if it so chooses without effectively having its capital base undercut, by its U.S. parent having to pay U.S. tax on the investment income.

Similarly, if the Israeli company lends some of its profits to another foreign affiliate, then the interest income earned that is traceable to active foreign income should not be subject to U.S. tax, until the income is repatriated to the U.S. Redeployment of active foreign earnings among foreign affiliates should be a natural byproduct of conducting business on a globally-competitive basis. Under the current Subpart F regime, the interest income would be FPHCI taxed in the U.S., unless the borrower were an Israeli affiliate. The situs of incorporation of the borrower should not be relevant for purposes of determining whether the income is taxable in the U.S.

Dividends

In the context of foreign dividends, if a Dutch distribution company pays dividends to its Cayman Islands parent holding company, the dividends that are traceable to active foreign income (both FBCSI and income from sales within Holland should be active foreign income) should not be subject to U.S. tax, until the income is repatriated to the U.S. The same competitiveness concerns as above apply in connection with the redeployment of active foreign earnings. The Cayman company should be free to use the dividends to fund the operations of other foreign subsidiaries without U.S. tax first being imposed on such dividends. In addition, it is worth noting that dividends paid by active foreign companies to holding companies in different foreign jurisdictions are tax-deferred or exempt to the ultimate parent in many countries, including the U.K., Canada, France, and the Netherlands.

Under the current Subpart F regime, the dividend income, as FPHCI, would be taxed in the U.S., unless the holding company were incorporated in Holland. Again, the situs of incorporation of the holding company should not be relevant for purposes of determining whether the income is taxable in the U.S.

Rents and Royalties

The rental and royalty income of foreign affiliates controlled by U.S.-based parent companies is considered FPHCI and is, thus, taxed currently in the U.S. There is a "same country" exception that applies if the underlying property is used within the country where the lessor or licensor is incorporated, and also an exception for rental and royalty income derived in an active business if the income is received from unrelated parties.

Whether the foreign rental or royalty income is taxable currently in the U.S. should hinge on whether the lessor or licensor is engaged in an active business. If the lessor or licensor is engaged in an active business, then such rental and royalty income should be characterized as active foreign income, and hence not be taxable in the U.S., until the income is repatriated to the U.S. This should be the case whether or not the underlying property is used within the country of the lessor or licensor, and also whether or not the property is licensed or leased to an unrelated or related party.

If an Israeli manufacturing subsidiary leases manufacturing equipment to another manufacturing affiliate, the rental income received by the Israeli subsidiary should be characterized as active foreign income, because the subsidiary is engaged in an active business. The same analysis should apply in the context of royalty income. Otherwise, competitors with foreign-based parent companies enjoy a competitive advantage, because rents and royalties earned in active businesses are not taxed to the parent companies in most foreign jurisdictions until repatriation occurs.

With a view to achieving tax parity with foreign competitors, U.S.-based companies should not be currently taxed on the FPHCI of its controlled affiliates where the income is either (a) traceable to active foreign income, or (b) royalty or rental income earned in an active business. Such income should not be taxable in the U.S., until such income is repatriated. However, investment income earned by controlled foreign affiliates on capital that originated from the U.S. should continue to be taxed by the U.S. on a current basis, and rents and royalties of controlled foreign affiliates where no active business exists should also be taxed by the U.S. on a current basis.

FOREIGN SUBSIDIARY INVESTMENTS IN U.S. PROPERTY

The U.S. generally taxes the profits of foreign affiliates controlled by U.S.-based companies where the profits are (a) loaned to the U.S.-based company, or (b) used to purchase at least a 25% interest in an unrelated U.S. company. The profits of the foreign affiliate are treated as deemed dividend distributions to its U.S.-based parent company.

The legislative intent behind this rule was essentially to restrict U.S.-based companies from doing an "end run" around the taxable dividend rules by effecting foreign subsidiary repatriations to the U.S. in a form other than as a dividend. This is a valid concern where the profits of the foreign subsidiary actually end in the hands of the U.S.-based company or one of its U.S. affiliates. The rule, however, does not make sense where the foreign subsidiary profits are invested in, or are used to purchase, U.S. property wholly disconnected from the U.S.-based parent company.

A foreign affiliate controlled by a U.S.-based company should be free to invest its profits in U.S. property without triggering U.S. tax, so long as such profits are not disguised dividends that are destined for the U.S.-based company or one of its affiliates. In the case where the foreign subsidiary profits are used to purchase stock in an unrelated U.S. company, however large the ownership interest, no U.S. tax should apply.

If a multinational's Japanese subsidiary uses its available profits to invest in an unrelated start-up company in the U.S., and the subsidiary's profits have not yet been taxed in the U.S., the profits of the Japanese subsidiary should not be taxable in the U.S. until the profits are repatriated to the U.S. If a Japanese competitor wanted to make a similar investment in the start-up company, it could do so without triggering Japanese or U.S. tax.

There is no reason why the U.S. parent company should be penalized, nor is there any reason why the start-up company should be penalized, as a result of there not being competition on an equal basis between the U.S. parent company and its Japanese competitor. Under current law, the U.S. multinational would be penalized because there would be a tax cost to having its Japanese subsidiary acquire 25% or more of the stock of the company. The company could be penalized, because it may not get the highest price for the sale of its stock, given that there is not free and open competition (the U.S. multinational has to take into the extra tax cost into account in making its bid).

EARNINGS AND PROFITS OF CONTROLLED FOREIGN CORPORATIONS

The "earnings and profits" ("E&P") of foreign affiliates of U.S.-based companies must be tracked by such U.S. companies for a variety of reasons. In the international tax area, E&P is used to determine the amount of Subpart F income that will be taxable in the U.S. on a current basis, the amount of a foreign affiliate distribution that will be taxable as a dividend, the amount of foreign taxes that are deemed paid by the U.S.-based company for foreign tax credit purposes, and the amount of gain taxable as a dividend upon the sale by the U.S.-based company of a foreign affiliate's stock.

The Internal Revenue Code essentially requires that the E&P of a foreign corporation be computed substantially in accordance with the accounting rules that apply for domestic corporations. The E&P for a domestic corporation is generally calculated by making adjustments to U.S. taxable income.

The inherent problem is that the E&P of foreign corporations must necessarily start with foreign book income. As a result, the adjustments that must be made to convert (a) from foreign book income to U.S. taxable income, and (b) from U.S. taxable income to E&P are an administrative nightmare. The adjustments are particularly difficult in the case of minority-owned foreign corporation, since the U.S.-based company may be unable to obtain all the information that is necessary to compute E&P.

Although foreign corporations owned by U.S.-based companies do not adjust foreign book income to conform to U.S. taxable income, they do often adjust foreign book income to conform to U.S. generally accepted accounting principles ("GAAP") for financial reporting purposes. There are many differences between GAAP and E&P, but most are short-term timing differences. The differences as a result have a small and transitory impact on the determination of U.S. tax liability.

Corporate taxpayers should be allowed to use the earnings of foreign affiliates adjusted to conform to U.S. GAAP as E&P for their respective foreign affiliates. This approach is necessary to ease the substantial administrative burden currently borne by corporate taxpayers in calculating the E&P of foreign affiliates.

UNIFORM CAPITALIZATION RULES

Adoption of a GAAP E&P rule, as suggested above, would have an added benefit of confining the application of the uniform capitalization rules to domestic companies. Under Section 263A, manufacturers and certain retailers and wholesalers must uniformly capitalize direct and certain indirect costs, including interest, incurred with respect to property produced or acquired for resale. The capitalized costs become part of the tax basis of the property.

When the property is sold or otherwise disposed of, the capitalized costs reduce the taxable profit or increase the taxable loss. In effect, the uniform capitalization rules postpone the ability to take the tax benefits associated with the incurred costs.

The Treasury Department and the I.R.S. currently take the position that the uniform capitalization rules apply to foreign affiliates of U.S.-based companies. The revenue raised through the application of the uniform capitalization rules to foreign companies is relatively small, particularly when balanced against the sizable administrative burden imposed on U.S.-based taxpayers. The uniform capitalization rules should not be applied at the foreign level.

EXPENSE ALLOCATION AND APPORTIONMENT RULES OVERVIEW

While the Subpart F rules on anti-deferral rules originated in 1962, the rules for allocating and apportioning deductions to worldwide income, prescribed under)861 of the Code, has its roots dating back to 1918 (Revenue Act of 1918, sections 214(b) and 234(b)). Initially, the goal was to properly apportion and allocate deductions to the net income of "in-bound" taxpayers (i.e., non-resident aliens and foreign corporations). The shift of focus from primarily an in-bound concern to an out-bound—U.S. multinational view—occurred as post-war U.S. multinational corporations expanded overseas and the Code was used to reduce the availability of foreign tax credits to offset U.S. tax.

The expense allocation and apportionment rules impact the foreign tax credit (FTC), because the FTC limitation is calculated based on a formula, the numerator of which is foreign source taxable income (after deductions); consequently, as foreign source income is reduced, so too are foreign tax credits that can be claimed to offset U.S. tax liability. The unfairness in this calculation occurs when a foreign taxing authority doesn't permit the same deductions. As a result, the income is exposed to international double taxation.

The calculation, in its purest theoretical state, is not offensive to sound tax policy. However, practically speaking, the calculation is very burdensome. As described above, the taxpayer must first calculate its various foreign income sources by category. Once the foreign source income is calculated, the regulations provide extensive and detailed rules relating to the following types of expenses:

1. Interest expense
2. Research and Experimental expense
3. Stewardship expense
4. Professional Fees expense
5. Income Tax expense
6. Losses

(It should be noted that before allocation and apportionment rules are applied, the taxpayer must already have made all necessary)482 adjustments.

The administrative burden to analyze, and gather information, and calculate the allocated and apportioned deduction is enormous. To make a reasonable allocation and apportionment, the taxpayer must create information-gathering systems not otherwise required by their financial books and records. Much of the data, both financial and operational, are not found in accounting books and records or even on tax returns. The regulations and rules envision documentation that includes personnel interviews, time reports, work assignments, comparison of sales, cost of sales, profits, assets, and valuation records. The degree to which such precise record-keeping will be required can only actually be known during audit.

For Intel, it takes over two weeks to calculate the interest expense allocation. The principal time commitment is in the development of a tax basis balance sheet. All of this time and effort reduces our active foreign source gross income by only 00.33%.

The allocation of state income taxes involves similar time commitments and the benefit to the Treasury is only a 00.73% allocation to foreign source gross income. In the first year after the final state income tax regulations were issued, the time spent analyzing the regulations, working with outside consultant experts, and developing a methodology to implement them involved over four weeks (and produced 145 pages of work-papers). Even IRS auditors are dumbfounded when it comes to the execution of these regulations. Aside from the complexity and administrative burden that is placed on taxpayers, the allocation and apportionment rules place U. S. taxpayers in a non-competitive position in comparison to foreign owned corporations, because their home jurisdictions do not impose similar rules and compliance burdens.

INTEREST EXPENSE

The theory underlying the allocation and apportionment of interest expense is based upon the premise that money is fungible. In determining the allocation and apportionment, affiliated groups are treated as one taxpayer. This approach considers that, in the use of funds, and those corporate activities that acquire funds, corporate management has flexibility as to where those funds will be employed. As an example, if management decides to borrow funds for Project A, it frees-up other corporate funds for Project B. This approach differs from most of the allocation rules, under)861, that require a factual relationship exist between the items of expense and income for the expense to be allocated and apportioned to such income. Instead, the rules deem interest expense attributable to all income-producing activities and assets of the taxpayer. In order to accomplish this objective, the rules require the use of an asset-based apportionment formula. The use of an asset based formula causes great complexity, administrative burden, and time commitment to achieve the required allocation and apportionment.

The rules do not allow netting of interest expense to interest income. Thus, a U.S. multinational corporation that has interest income in excess of interest expense will nonetheless required to apply the rules to interest expense. In the case of Intel, with a balance sheet reflecting over $12 billion of cash and $700 million of interest and other investment income, the rules still have to be applied to less than $50 million of interest expense. It is questionable how this reconciles with the fungibility theory. Without a netting of such income and expense, the application if these rules results in an unbalanced allocation of expenses.

With the current state of the global economy, why should the worldwide capital structure of a U.S. multinational corporation be impacted by the application of these rules, and the result in double taxation. For example:

> Assume two similarly-sized multinational corporations, one in the U.S. and the other in a foreign country. Each corporation has similar home country internal expense. Both have similarly-sized subsidiaries in the same third foreign

country. These subsidiaries are highly leveraged, with local debt (in a high tax jurisdiction, this would be considered good local tax planning). In applying the U.S. rules, the assets of the U.S. parent's foreign subsidiary would be included in the interest expense allocation and apportionment formula, which would attract U.S. sourced interest expense, thereby reducing foreign source income, and a resulting reduction in foreign tax credits. The foreign corporation would not be generally confronted with such rules, and its cost of business would be less. The U.S. corporation is placed at a competitive disadvantage.

The current structure of the interest expense rules have exceeded the goal of reining in perceived tax abuses and instead, impose a competitive disadvantage on U.S. multinational corporations.

RESEARCH EXPENSES

The underlying rationale, for the allocation and apportionment of research and experimental (R&E) expense conflicts with the national economic need to create and retain research in the U.S. Congress and Treasury is concerned that U.S.-created R&E would, without allocation and apportionment, result in foreign source income disproportionately large compared to U.S. source income. Through the allocation and apportionment of R&E expenses, foreign source income and associated foreign tax credits are reduced. In this manner, it is argued that the R&E expenses are assigned to the foreign source income they, in part, produce.

Contrary to the goal of encouraging U.S. research (as seen through the R & E Credit), the allocation and apportionment of such expenses results in an increased cost of undertaking U. S. research activities. This can be shown in the following example:

> If a U.S. multinational corporation performs significant domestic R&D activity, its R&E costs must be allocated and apportioned to foreign source income. If the foreign jurisdiction doesn't recognize such U.S. domestic R&E expenses as allowable expenses in computing taxable income, the corporation will pay foreign income tax on foreign income without the benefit of the deductions. Particularly in high-tax foreign countries, this results in a portion of the corporation's worldwide income being subject to double taxation.

A corporation with continuing excess foreign credits would be adversely impacted by the R&E allocation and apportionment rules. Such companies would be put in a competitive disadvantage relative to their foreign competition which would enjoy a lower cost for their research activities. Obviously, the U.S. corporation could avoid this extra cost and exposure to double taxation by simply moving their R&D activities offshore (equally obviously, this would be counter to the national goal of keeping research in the U.S.).

The inherent conflict between the pure tax policy of the allocation and apportionment rules versus the retention of research in the U.S. has, since 1977, produced a myriad of rules and confusion for taxpayers and the government alike. There have been at least eight major statutory or regulatory events. These have included an outright moratorium on the application of the regulations. At other times, mandated allocations of varied percentages of U.S. research to U.S. source income have been in effect (the most recent rule includes a 50% mandated allocation). If a U.S. corporation tried to look for jurisdictional stability in the treatment of R&E expenses, the U.S. would not be a country that would come to mind. Coupled with limited extensions of the research tax credit, our national research policy is left wanting. In the interest of assuring that research remains in the U.S., as well as to stay competitive with foreign multinationals, the rule should be that U.S. research is allocated solely to U.S. source income.

HYBRID ENTITY REGULATIONS

The Treasury Department and IRS, in issuing the so-called hybrid regulations (sections 301.7701-1 through 301.7701-3) greatly simplified entity classification for tax purposes. Prior to the issuance of these regulations, U.S. multinational corporations could generally achieve the same entity classification results, but through far more complicated mechanisms. These regulations reduce the costs of tax planning and compliance, as well as significantly reduce, if not eliminate, disputes, including litigation, in this area.

Subsequently, Treasury attempted a partial "take back" of the favorable hybrid rules, under Notice 98-11 and proposed regulations. This was unfortunate, and is counter-productive to U.S. interests in the global arena. Although Notice 98-11 and the related proposed and temporary regulations were ultimately withdrawn, after Congressional concern and interest was expressed, it is still Treasury's intention (as announced in Notice 98-35) to issue similar regulations in the future.

If the Treasury Department does issue such regulations, it will penalize U.S. multinational corporations by requiring recognition of Subpart F income where, among other things, foreign taxes are reduced. This not only places U.S. multinationals at a competitive disadvantage, but is also counter to the fiscal interests of the U.S., since the additional foreign taxes that the Treasury policy will cause to be paid will come out of the Treasury in the form of additional foreign tax credits.

The perversity of this policy, coupled with making the United States the tax "policeman" for other countries, has motivated some members of the House and Senate to introduce legislation to prevent the I.R.S. and the Treasury Department from issuing future regulations dealing with foreign hybrid transactions and Subpart F. We applaud these legislative efforts, and encourage their continuation.

OVERALL "DOMESTIC" LOSSES

The U.S. taxes worldwide income of U.S. corporations. Dividends received from foreign subsidiaries and Subpart F income deemed received from foreign subsidiaries are included in worldwide income. In order to prevent double taxation of a U.S. corporation's foreign earnings (dividends and "deemed" dividends from foreign subsidiaries plus any foreign branch and partnership income), the U.S. corporation is entitled to a foreign tax credit for foreign income taxes paid or deemed paid on the foreign earnings.

The ability to actually take the foreign tax credit is generally limited to the amount of U.S. tax that would otherwise be imposed on the taxpayer's taxable foreign source income that year. Stated in terms of a fraction, the foreign tax credit is limited to foreign source taxable income over worldwide taxable income multiplied by the pre-credit U.S. tax on the U.S. corporation's worldwide income.

Thus, if a taxpayer has foreign source income of $500, worldwide income of $1000, a pre-credit U.S. tax liability of $350, and foreign taxes paid of $250, the foreign tax credit limitation is $175 ([500/1000]*350). Thus, although foreign taxes of $250 have been paid, only $175 may be credited in that year.

Section 904(f) provides that a taxpayer who has sustained an "overall foreign loss" (OFL) in a prior year and that has foreign source taxable income in the current year must "recapture" the OFL by re-characterizing foreign source taxable income as U.S. source taxable income to the extent of the OFL.

Consequently, in the above example, if the taxpayer had a prior year OFL of $100, then its foreign source income would be reduced from $500 to $400. The ultimate impact of the OFL is that the ability to take a foreign tax credit would be further limited, and the foreign tax credit limitation would decrease from $175 to $140.

The Tax Code contains no corollary provision for overall "domestic" losses. If a taxpayer sustains an overall domestic loss in a prior year and has foreign and domestic source income in the current year, then the overall domestic loss should be applied to re-characterize domestic source income as foreign source.

The net effect of being able to use the overall domestic loss is that the ability to take a foreign tax credit is increased. Symmetrical treatment for foreign and domestic losses is a more equitable approach, and through the enhanced ability to claim foreign tax credits it would foster U.S. competitiveness.

TRANSFER PRICING / ADVANCED PRICING AGEEMENTS / COST-PLUS RULINGS

As previously mentioned, the transfer pricing rules of)482 are the cornerstone to ensuring that CFC profits are determined in an arms-length manner. However, the globalization of these rules present new challenges to taxpayers, as well as the competent authority mechanism. As other countries have enacted transfer pricing laws and enforcement practices, it has become apparent that there are inconsistencies that will give rise to instances of double taxation. This will, in turn, burden the competent authority system.

As other countries issue their transfer pricing rules, the common stated objective of these rules is to derive an arms-length determination of profit. However, some countries may sanction audit practices that leave the taxpayer in an indefensible position, and result in the wrong profitability conclusion. Specifically, the practice of utilizing "secret" comparables as well as "cherry-picking": comparables in audit situations are simply untenable for the taxpayer. This leads to situations where the taxpayer literally cannot see the documentation on which the assessment is based, and there is simply no way to evaluate appropriateness or applicability. It is also frustrating when tax authorities attempt to set a business profit level on the basis of an extremely small population of transactions, while ignoring the preponderance of industry and transactional evidence. U.S. tax policy must not only make clear that such practices are unacceptable, but also that competent authority will aggressively challenge inappropriate assessments based on these practices. To safeguard

their foreign tax credit, it would seem that taxpayers would need to seek competent authority on any incremental transfer price assessment. This could, indeed, create an enormous logjam in the competent authority mechanism.

Following the 1986 Tax Act, the U.S. risked veering from the arm-length standard for transfer pricing as the rest of the world knew it and producing international double taxation that would result for U.S. multinationals. Fortunately, through administrative interpretation, this was largely avoided. In positive contrast, the U.S. has implemented another program which many other countries have acknowledged and accepted as offering a way to avoid transfer pricing disputes, and international double taxation, through advance clearance of transfer pricing methodology by the I.R.S. (in some instances, bilaterally by the U.S. and other jurisdictions). This program, the Advanced Pricing Agreement (APA) program, has proven useful to many U.S. multinationals, and has likely avoided many disputes and the potential for litigation. The program, however, could be made better by extending the period of time for which agreements can be obtained, and by reducing the annual reporting required to be filed to maintain the agreements. Recently, the IRS agreed to the disclosure of APAs, following court action to mandate such disclosure. This could have a chilling effect on taxpayers who would otherwise have sought such agreements, but are now fearful that disclosure could make public their proprietary information. It also may dissuade other countries from entering bilateral APAs, since their involvement would also be disclosed.

Another transfer pricing area of contrast between foreign jurisdictions and the U.S. relates to the availability of, and certainty produced by, so-called cost-plus rulings. Such rulings are typically applicable to the rendering of service, and are readily available to assure that the tax consequences and the amount of income from such services can be known in advance. Such rulings are routine in many foreign countries, but not in the U.S.

TRANSACTION APPROVAL AUTHORITY

On occasion, complex U.S. tax rules, completely unrelated to the substance of a transaction, can lead to a surprising and unfortunate outcome for U.S. tax revenue collection. Consideration should be given to establishing a mechanism to cut through the maze of the law and regulations, which strangle the ability to get to the right answer. An example follows where the U.S. lost tax revenues due to the inability to execute a simple reorganization:

> In 1994, Japan implemented a tax incentive designed to reduce the Japanese income tax paid by high technology companies that increased qualified imports into Japan. This program was designed to help reduce the Japanese trade surplus with the United States and was, therefore, very much in line with U.S. trade policy. The incentive could be taken in one of two ways: 1) as a permanent credit reduction in Japanese income tax or 2) as a temporary reduction to taxable income in Japan through a current deduction that would be reversed over the subsequent five years. Either method would be a "tax neutral" decision for Intel, since we consistently dividend all income from our Japanese distribution subsidiary and would be subject to full taxation either way. However, method 1 clearly would shift permanent tax dollars from Japan to the U.S. Unfortunately, one clear requirement to qualify for the permanent credit was that our Japanese sales company needed to be directly owned by the manufacturer of the product—in this case, the U.S. company. Unfortunately, although this is a 100% owned and controlled subsidiary, it was a second-tier subsidiary. What we needed to do was a simple change of shareholder. However, executing this is no simple matter under U.S. tax law. To effect a reorganization free of any other tax consequences, we would have needed to establish the fair market value for some twenty brother-sister subsidiaries and also implement a complex compliance system to track resulting deferred inter-company profits for the indefinite future. The overall time and cost to execute were simply prohibitive.
>
> Even more frustrating, the IRS had no authority to waive the complex reorganization requirements to facilitate this transaction, the sole purpose of which was to legitimately reduce Japanese income tax and, therefore, the foreign tax credits the U.S. would allow. Intel should have been the "poster-child" for the Japanese import tax incentive, and the U.S. government should have been the beneficiary. The incentive was in effect only through 1997, so the opportunity has been lost. For the future, however, it is strongly urged that there be a forum to which a taxpayer can go for approval to "fast track" such transaction and shed unnecessary compliance requirements where U.S. tax avoidance is not a motive of the transaction.

PREPARED STATEMENT OF MATTHEW J. SLAUGHTER

INTRODUCTION

Good morning, Mr. Chairman. My name is Matthew J. Slaughter, and I am an Assistant Professor of Economics at Dartmouth, a Faculty Research Fellow at the National Bureau of Economic Research, and a Visiting Scholar at the Institute for International Economics. I am pleased to have the opportunity to speak to your committee this morning regarding the ongoing "globalization" of the world economy. My testimony will make three points. First, that it is very important to have clear facts about this process. Second, that greater international trade and foreign direct investment (FDI) help raise U.S. living standards. Finally, that policy aimed at liberalization should account for how trade and FDI are interconnected—particularly today in light of recent international financial turmoil. A good deal of my testimony draws on a recent study, Global Investments, American Returns , which I helped produce for the Emergency Committee on American Trade (ECAT).

CLEAR FACTS ABOUT THE PROCESS

The first point I'd like to make is that a lot of the ongoing discussion about globalization is full of hyperbole. In particular, it is repeatedly claimed that today there are no meaningful barriers to the international flow of products, people, and capital. It is also claimed that this state of the world is an entirely new thing, never before seen and for which we need an entirely new way of thinking. Neither claim is true, and it is very important that policy makers have a clear idea of the facts. Yes, international markets are integrating thanks to declining natural and political barriers. But the process is by no means complete, and by no means has the world never been here before.

An important goal of my ECAT study was to present a set of facts about American companies with global operations (i.e., multinationals) and FDI. For example, these companies are not completely footloose enterprises which have been massively "exporting" jobs out of the United States. In fact, their employment patterns have been quite stable in recent decades. From 1977 to 1994 (the most recent year of complete data) total U.S. parent employment for these firms increased slightly, from just under 19 million to just over 19 million (see Figure 1). At the same time total foreign employment actually declined slightly, from just over 7 million to just under 7 million. Thus U.S. parents account for a large and growing share of total employment in these companies, from 72.8% to 74.3%. This example makes a general point: yes, markets are integrating—but the reality is not what is often claimed. It is essential that facts like these, rather than incorrect perceptions based on unrepresentative anecdotes, inform policy discussions.

As for the claim that we've never been here before, we have. The decades leading up to World War I, roughly 1870 to 1914, were a period of extensive globalization. Like today, much of it was driven by advances in technology. Railroads spread greatly both within and across countries, and ocean-going vessels became much larger and faster. In July 1866 the first U.S.-U.K. trans-Atlantic telegraph cable opened, an innovation which reduced the delay for international investors in gathering information and executing orders from three weeks (by ship) to under one day. During the period from 1914 until just after the end of World War II, however, international markets fragmented. Much of this was due to inward-looking policies which raised barriers, such as large increases in tariffs. Thus, the globalization in recent decades has largely just returned the world back to the level of integration before World War I. On some measures world markets are still less integrated than they were. Figure 2 shows that net international capital flows, averaged across 12 of the world's largest countries, are still a fair amount smaller today than they were pre-1914. The relevance of all this for policy is that globalization is not inevitable. Policy can foster the process, but it can also reverse it quite dramatically.

HOW TRADE AND FDI RAISE AVERAGE U.S. LIVING STANDARDS

As globalization goes on, there is much concern about its effects. My second main point is that increased trade and FDI raise average U.S. living standards. On the role of American companies with global operations, there are two important points. First, these companies raise U.S. living standards through their investments in physical capital and research and development in the United States, as well as their contribution to international trade. These firms perform the majority of total U.S. investment in physical capital in manufacturing; they undertake the majority of U.S. R&D; and they ship the majority of U.S. exports and receive a sizable share of U.S. imports (see Figure 3). All these activities contribute to U.S. productivity, the single best measure of a country's standard of living. The productivity gains

seem to translate into higher wages: American companies with global operations pay their workers higher wages than those paid by comparable American companies without global operations (see Figure 4). Even after controlling for many factors which affect wages, research finds that plants of American companies without global operations pay from 5% to 15% less than do comparable plants of American companies with global operations.

The second important point about living standards is that the U.S. and foreign activities of American companies with global operations tend to complement each other, not substitute for each other. This point has come out of many broad academic studies and also anecdotal case studies. Figure 5 shows an example of this evidence. When classified by the industry of their U.S. parents, the majority of all foreign affiliates is in the manufacturing sector. But when classified by their own industry, the majority of these affiliates is in the services sector. In fact, of the roughly 20,000 affiliates worldwide in 1994, in fully 25% the main line of business was wholesale trade. A big part of what affiliates do is perform services—wholesale and retail trade, consulting pre-and post-sale, and the like—which cannot be efficiently done from the United States. Accordingly, within American companies with global operations, affiliate expansion generally triggers in U.S. parents additional investment, R&D, and trade. Again, all these activities are key determinants of the U.S. standard of living. This means the ability of these companies to raise U.S. living standards depends a lot on their ability to undertake FDI abroad. In general, then, policy restrictions on FDI (and trade) tend to reduce U.S. living standards.

POLICY ISSUES

In closing, I'd like to offer three thoughts on policy issues I think are most relevant today. These thoughts reflect my personal opinions only, not those of any of my affiliated institutions. First, U.S. trade and investment policies should recognize that restrictions on the one are likely to entail restrictions on the other. Limit U.S. trade flows, and you limit the activity of American companies with global operations—with commensurate damage to average U.S. living standards. This policy harmonization should apply not just to U.S. laws but also to U.S. efforts to open foreign markets. It is important to work towards greater access to foreign markets for U.S. exporters, but access for host-country sales by affiliates of American companies with global operations is at least is important. In 1996 total U.S. exports were $851 billion, but total sales by affiliates were more than double that at $2.2 trillion.

Second, the success of reduced tariffs in recent decades forces trade policy today to deal increasingly with more subtle trade barriers such as voluntary export restraints and product standards. The General Agreement on Tariffs and Trade succeeded in slashing world average tariff rates. But border taxes are easy to see and focus on. What remains are myriad non-tariff barriers which generally seem more stubborn. Trade policy needs to consider what policy institutions can best address these kinds of barriers.

Finally, in the wake of recent international financial turmoil the need for commitment to trade and investment liberalization is increased, not reduced. This is particularly relevant for FDI. The discussions on how better to regulate international capital flows are very important. But these discussions should not sidetrack a crucial aspect of these flows, FDI. FDI generally benefits source and host countries alike. And by its very nature FDI is immune to lots of the problems that portfolio investment can generate. In particular, it's not prone to contagion and panics, in part because its long-term nature means FDI cannot be quickly reversed as many portfolio investments can. At a time when countries are contemplating limiting certain capital flows, the need for FDI flows is all the greater.

Thank you, Mr. Chairman, for the opportunity to speak to the committee this morning.

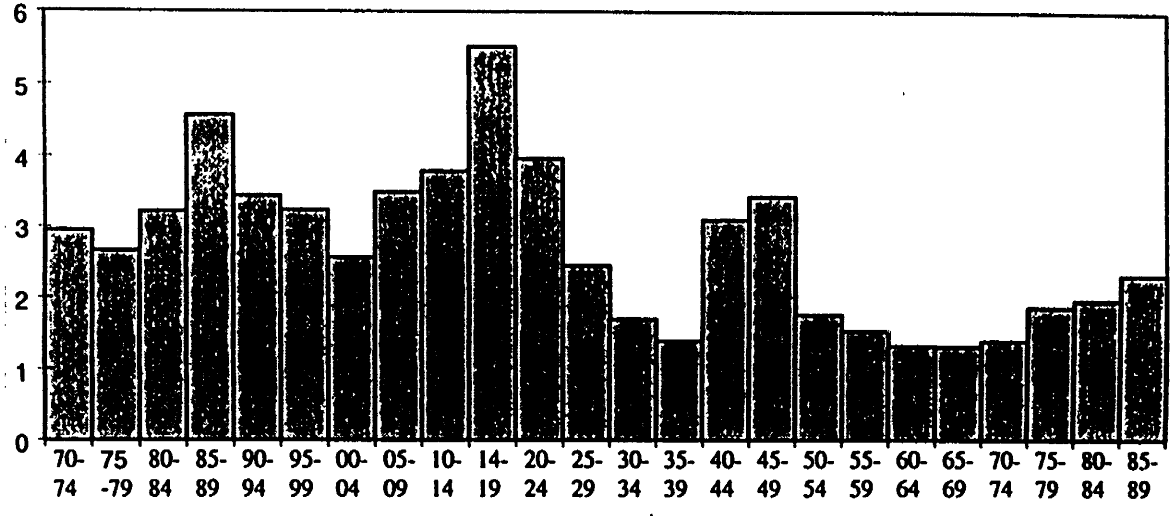
Figure 1
U.S. and Foreign Employment in American Companies with Global Operations

Year	Parent Employment	Affiliate Employment	Parent Share of Total
1977	18,945	7,075	72.8
1982	18,476	6,554	73.8
1989	19,291	6,731	74.1
1994	19,347	6,681	74.3

Notes: All employment numbers are in thousands of jobs. Parent employment is employment in the United States of the parent operations of U.S. multinationals. Affiliate employment is employment abroad of the affiliates of U.S. multinationals.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

Figure 2
Net International Capital Flows



Notes: Vertical axis is in percent. Each bar reports the average net international capital flow across 12 major countries (Argentina, Australia, Canada, Denmark, France, Germany, Italy, Japan, Norway, Sweden, United States, and United Kingdom), where for each country the net international capital flow is the absolute value of its current account as a percent of GDP. Each bar corresponds to the average across the 12 countries for each five-year period listed on the horizontal axis.

Source: Alan Taylor, "International Capital Mobility in History," National Bureau of Economic Research Working Paper #5743, 1996, as reproduced in Richard E. Baldwin and Philippe Martin, "Two Waves of Globalization," National Bureau of Economic Research Working Paper #6904, 1999.

Figure 3

Total U.S. Share of Various Activities Performed by American Companies with Global Operations

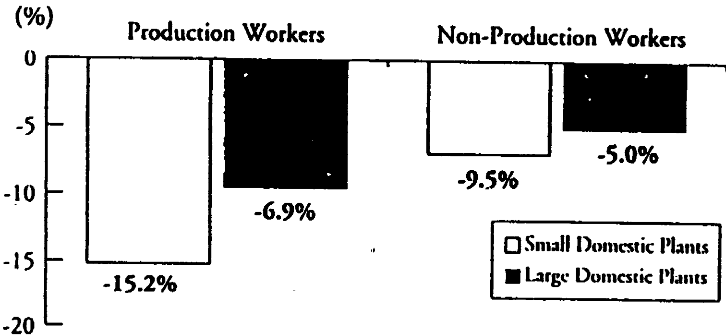
Year	Investment Share	R&D Share	Export Share	Import Share
1977	57	N.A.	75	28
1982	52	62	65	24
1989	57	57	61	33
1994	57	51	63	31

Notes: Each cell reports the share of total U.S. activity for that column performed by the parent operations of U.S. multinationals. The data for investment are for the manufacturing sector only; R&D refers to research and development spending.

Source: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Census Bureau; National Science Foundation

Figure 4

American Companies *without* Global Operations Pay Lower Wages than American Companies with Global Operations



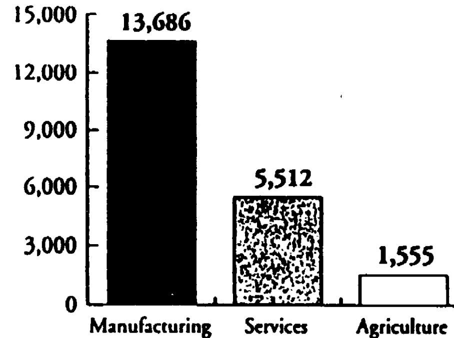
When differences across plants in terms of workers' skills, industry of operation, output level, age, and state of location are accounted for, the U.S. plants of American companies *without* global operations pay significantly lower wages than do U.S. plants of American companies with global operations.

Source: Mark Doms and Brad Jensen (1996)

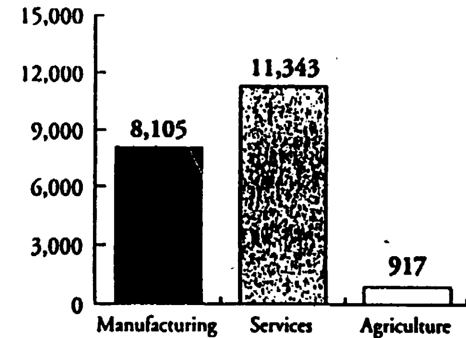
Figure 5

Foreign Affiliates Classified by Sector

The Majority of Foreign Affiliates are Classified as Manufacturing Companies when Classified by the Sector of their U.S. Parents.

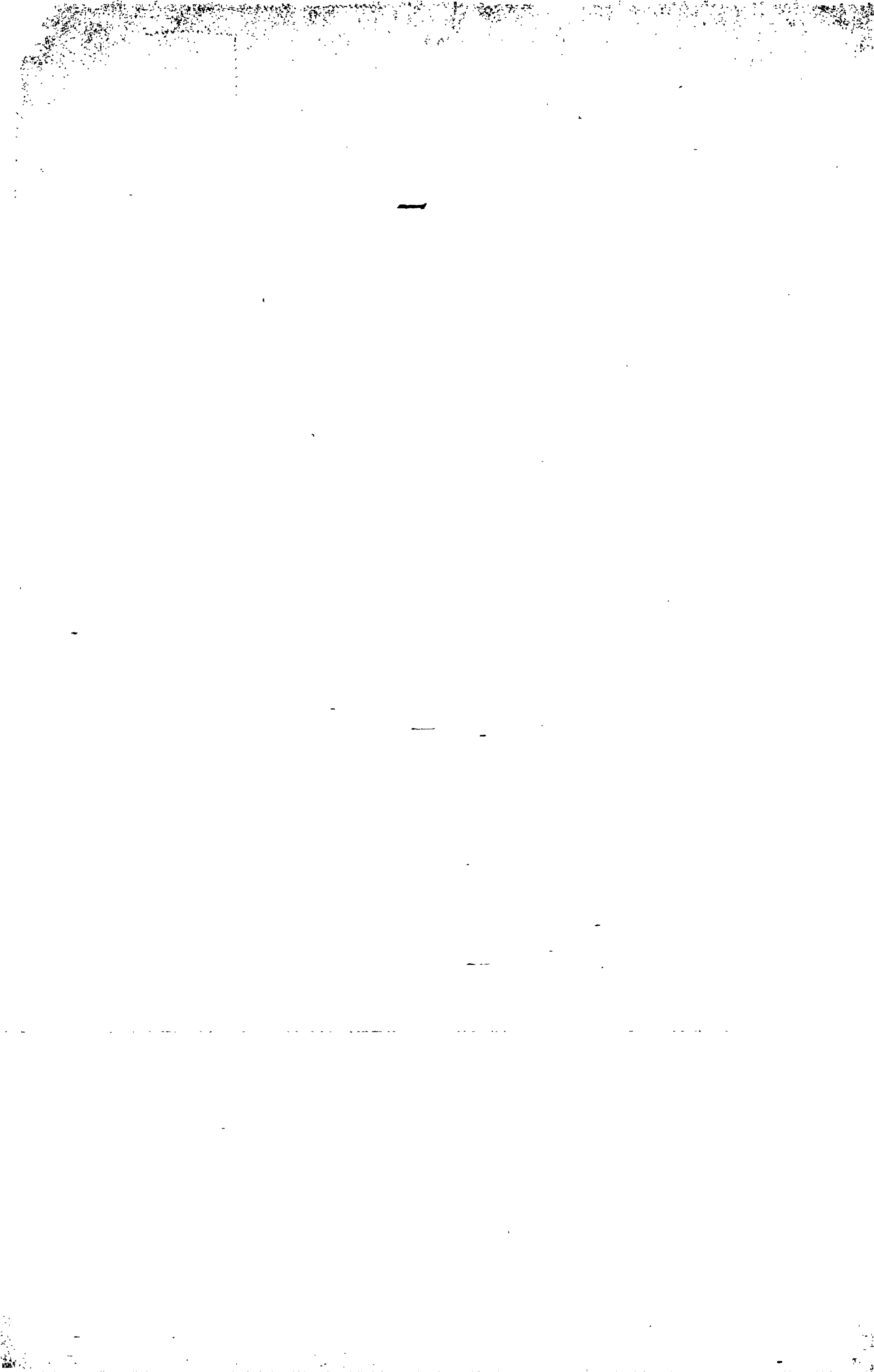


The Majority of Foreign Affiliates are Classified as Services Companies when Classified by their Own Activity.



Although the majority of U.S. parents -- and thus, their foreign affiliates when classified by the sector of their parents -- is in the manufacturing sector, the majority of affiliates is in the services sector. This comparison, using 1994 data, is strong evidence that the activity of foreign affiliates and their U.S. parents is complementary.

Source: U.S. Department of Commerce, Bureau of Economic Analysis



COMMUNICATIONS

STATEMENT OF THE COALITION OF SERVICE INDUSTRIES (CSI)[1]

INTRODUCTION

International tax reform is a critical element of a strong U.S. trade policy. As part of that trade policy, CSI, on behalf of the undersigned industry groups, believes that the active financing exception to subpart F, providing that the active business foreign earnings of U.S.-based financial services companies are not subject to current U.S. taxation, should be made permanent, or at least extended in conjunction with the other expiring provisions. The current-law provision expires at the end of the calendar year 1999.

BACKGROUND

When subpart F was first enacted in 1962, the original intent was to require current U.S. taxation of foreign income of U.S. multinational corporations that was passive in nature. The 1962 law was careful not to subject active financial services business income to current taxation through a series of detailed carve-outs. In particular, dividends, interest and certain gains derived in the active conduct of a banking, financing, or similar business, or derived by an insurance company on investments of unearned premiums or certain reserves were specifically excluded from current taxation if such income was earned from activities with unrelated parties. In 1986, the provisions that were put in place to ensure that a controlled foreign corporation's (CFC) active financial services business income would not be subject to current tax were repealed in response to concerns about the potential for taxpayers to route passive or mobile income through tax havens. In 1997,[2] the 1986 rules were revisited, and an exception to the subpart F rules was added for the active income of U.S. based financial services companies, along with rules to address concerns that the provision would be available to passive operations. The active financing income provision was revisited in 1998, in the context of extending the provision for the 1999 tax year, and considerable changes were made to focus the provision on active financial services businesses that perform significant operations in their home country.

Active financial services income is universally recognized as active trade or business income. Thus, if the current law provision were permitted to expire at the end of this year, U.S. financial services companies would find themselves at a significant competitive disadvantage vis-a-vis all their major foreign competitors when operating outside the United States. In addition, because the U.S. active financing exception is currently temporary, it denies U.S. companies the certainty their foreign competitors have. The need for certainty in this area cannot be overstated. U.S. companies need to know the tax consequences of their business operations. Over the last two years US companies have implemented numerous system changes in order to comply with two very different versions of the active financing law, and are unable to take appropriate strategic action if the tax law is not stable.

A comparison of current U.S. law with the laws of foreign countries shows that the United States imposes significantly stricter standards on U.S.-based financial

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[1] The Coalition of Service Industries (CSI) was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for US service companies; and encourage US leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of US service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.

[2] Taxpayer Relief Act of 1997, Conference Report to H.R. 2014, H. Rept. 105-220, pages 639-645.

services companies in order for them to not pay current tax on active income from their foreign operations. For example, German law merely requires that income be earned by a bank with a commercially viable office established in the CFC's jurisdiction. Germany does not require that the CFC conduct the activities generating the income or that the income come from transactions with customers solely in the CFC's country of incorporation. The United Kingdom has an even less restrictive regime than Germany. These countries do not impose current taxation on CFC income as long as the CFC is engaged primarily in legitimate business activities primarily with unrelated parties. In sum, current U.S. treatment of CFC active financing income is more restrictive than the treatment afforded such income by many of the United States' competitors.

I. THE ACTIVE FINANCING EXCEPTION TO SUBPART F IS ESSENTIAL TO THE COMPETITIVE POSITION OF AMERICAN FINANCIAL SERVICES INDUSTRIES IN THE GLOBAL MARKETPLACE

The financial services sector is the fastest growing component of the U.S. trade in services surplus (which is expected to exceed $80 billion this year). It is therefore very important that the Congress act to maintain a tax structure that does not hinder the competitive efforts of the U.S. financial services industry, rather than allowing the active financing exception to subpart F to expire (and thereby revert to a regime that penalizes U.S.-owned financial services companies).

The growing interdependence of world financial markets has highlighted the urgent need to rationalize U.S. tax rules that undermine the ability of American financial services industries to compete in the international arena. From a tax policy perspective, financial services businesses should be eligible for the same U.S. tax treatment of worldwide income as that of manufacturing and other non-financial businesses. The inequitable treatment of financial services industries under prior law jeopardized the international expansion and competitiveness of U.S.-based financial services companies, including finance and credit entities, commercial banks, securities firms, and insurance companies.

This active financing provision is particularly important today as the U.S. financial services industry is the global leader and plays a pivotal role in maintaining confidence in the international marketplace. Also, recently concluded trade negotiations have opened new foreign markets for this industry, and it is essential that our tax laws complement this trade effort. The Congress must not allow the tax code to revert to penalizing U.S.-based companies upon expiration of the temporary provision this year.

II. THE ACTIVE FINANCING EXCEPTION SHOULD BE MADE PERMANENT.

According to House Ways and Means Committee member Amo Houghton's floor statement during the debate on the Conference Report on the 1997 legislation that first re-enacted an active financing exception to subpart F, the fact that the provision would sunset after one year was "a function of revenue concerns, not doubts as to its substantive merit."[3] Indeed, even in the course of subjecting the original active financing exception to a (now defunct) line-item veto, the Administration acknowledged, and continues to acknowledge that the "primary purpose of the provision was proper."[4]

The international growth of American finance and credit companies, banks, securities firms, and insurance companies will be impaired by an "on-again, off-again" system of annual extensions that does not allow for certainty. Making this provision a permanent part of the law would enhance the position of the U.S. financial services industry.

CONCLUSION

On behalf of the entire American financial services industry, the Coalition of Service Industries urges the Senate Finance Committee to support legislation that would make the active financing exception to subpart F permanent. Such legislation would provide a consistent, equitable, and stable international tax regime for the U.S. financial services industry.

Signatories:

American Bankers Association
American Council of Life Insurance
American Financial Services Association

[3] Congressional Record, July 31, 1997.
[4] White House Statement, August 11, 1997.

American Insurance Association
The Bankers Roundtable
Coalition of Finance and Credit Companies
Coalition of Service Industries
Council of Insurance Agents and Brokers
National Association of Manufacturers
Securities Industry Association
The New York Clearing House Association L.L.C.
The Tax Council
US Council for International Business

STATEMENT OF THE CROWLEY MARITIME CORPORATION

[SUBMITTED BY MICHAEL G. ROBERTS, VICE PRESIDENT, GOVERNMENTAL RELATIONS]

SHIPPING INCOME TAX REFORM

Good morning and thank you for including me in this discussion of legislation affecting the maritime industry. Two years ago last week, at the end of the 104th Congress, we celebrated passage of the Maritime Security Act. The MSP saved what was surely one of the most endangered species existing in the world's oceans—American mariners sailing on commercial ships in international trades. With the clock running out on the existing government support programs, enactment of MSP was essential—in the words of Congressman Herb Bateman, a matter of the very survival of the American mariner in international trade. The entire maritime industry—liner carriers, non-liner carriers, unions, shipbuilders, ports—the entire industry pulled together and pushed MSP through Congress despite long odds. While MSP needs to be expanded and made permanent, its passage has helped assure the survival of a critical part of the American maritime industry.

We are now confronted, as we move toward the 106th Congress, with the threatened extinction of another critical part of our industry—the American shipping company operating in international trade. According to the U.S. Maritime Administration, American liner carriers' share of the market for moving U.S. import and export cargoes fell by almost half between 1990 and 1996, from over 17% of the market in 1990, to less than 9% in 1996. As the first slide shows, that's a huge and precipitous drop, an exodus that starts from an already unacceptably low level of U.S. carrier participation. Let me add that, while this slide focuses on liner cargoes, I understand that U.S. carriers' share of non-liner cargoes is even more dismal—in the one to three percent range.

We can assess the strength of American shipping companies not only on the basis of our share of the cargo market, but also based on the vessel capacity we own or operate. With this group I don't need to go into the number of U.S. flag vessels remaining. We know the U.S. flag fleet operated in international trades has been in long term decline. It is approaching the 47 ships in the MSP, and it will likely expand only if and when the government decides to expand MSP.

Slide 2 shows the decline in U.S. controlled tonnage flying foreign flags of convenience. And let me at this point touch on the issue of U.S. carriers operating foreign flags of convenience vessels. We all want to see as many ships as possible flying the U.S. flag and manned by U.S. crews. That's one of the central purposes of this organization. But unless and until we are able to eliminate the huge cost advantages available to flag of convenience vessels, we have to fully reconcile ourselves, as most of us have, to the fact that U.S. carriers must have the same ability to operate flag of convenience vessels as do our foreign competitors. To the extent we limit or condition U.S. carriers' rights in this regard (and not also limit or condition foreign carriers' rights), we don't stop or reduce flag of convenience shipping one bit. We simply shift it to foreign carriers instead of U.S. shipping companies. And U.S. shipping companies become more and more irrelevant.

This is not in any way meant as an endorsement of flag of convenience shipping. On the contrary, I thoroughly and completely agree that flag of convenience shipping fosters a "culture of evasion" that hurts the entire industry. David Cockroft, one of the leaders of the International Transport Workers Federation, was a little more blunt when he said the system "stinks," and I agree with that, too.

But as we all know, we have tried for decades to come up with a way to stop foreign flags of convenience, and as this chart shows, all we've succeeded in doing is to take Americans out of the business while flag of convenience shipping continues to grow. In 1975, U.S. carriers owned about 22 million of the 85 million gross registered tons in the world flag of convenience fleet. This accounted for about 26% of

the world fleet. By 1996, the world flag of convenience fleet had almost tripled, to 241 million tons, while U.S. carrier ownership fell almost in half. The next slide shows what this means on a percentage basis, as American carriers' share of that fleet fell in 1996 to one-fifth the level it was in 1975.

So it's not a pretty picture, whether you look at cargo flows or vessel ownership. America, the world's largest trading nation, is almost a non-factor in the business of transporting its imports and exports.

Let me take a few minutes to talk now about why it is we have seen such a stark decline in the American shipping industry, and then get into what we might consider doing about it. First, let's be clear as to what is not the cause of our decline. It is not because we are incompetent. Looking at the liner sector, Sea-Land is the largest container shipping company serving the United States. Not the most profitable, but the biggest. Crowley is not the most profitable nor the biggest, but it is big and has consistently been rated the "Best of the Best" of the world's shipping companies. Lest this seem too much like a plug, APL has for many years been one of the world's strongest container lines, and other American shipping companies have been similarly well-managed. Even our biggest detractor, Rob Quartel, has conceded that Americans are the best in the world at this business.

So I'm pleased to report that we're not stupid and incompetent. And I don't believe the decline of our industry results from a comparative cost advantage that foreign carriers enjoy over U.S. carriers. Certainly in the liner sector, most costs are simply not affected by the nationality of the shipping company. With respect to vessel costs, which account for about one-fifth of total costs, American carriers operating U.S. flag MSP ships or foreign flag charters can be fully cost competitive. The remaining portion of liner operating costs, consisting of administration and overhead, does vary by nationality of the carrier, according to living costs in the area where these services are provided. But with headquarters located in places like Jacksonville or Charlotte, American carriers actually have a cost advantage over foreign carriers operating out of Tokyo or Hong Kong or London.

So what is the problem, why is the American shipping industry internationally in such a state of decline if not because of incompetence or cost disadvantages? The answer, as a matter of simple logic, must be profitability. The prices we charge keep going down, revenues are inadequate and returns, or profitability, is unacceptably low. This next slide, from Mercer Management, shows operating margins for the liner shipping industry compared to the operating margins for companies included in the Standard & Poors 500. As you can see, profits for the 24 liner shipping companies surveyed consistently averaged between one-third and one-half of the average profits earned by S&P 500 companies.

The unprofitability of the international liner industry can be traced, at least in substantial part, to two factors. First is overcapacity, which is attributable in part to the cyclical nature of the business, but also to the fact that governments love to subsidize the building of ships. Too many ships are built not because of market demand for transportation services, but because of the desire primarily of foreign governments to put their people to work building ships. Those of us in the ship operating business are left to deal with this mess and try to make a living with too much capacity in our markets. Hopefully, the OECD Shipbuilding Agreement or something like it will be implemented so that capacity in the shipping business can settle back toward a more rational, market-based level.

Another reason for unprofitability, at least in the liner sector, is a hyper-competitive market structure. Having 15 or 20 shipping companies doing the same thing in the same markets is not efficient nor conducive to rational business decision making, especially when some of the state-owned competitors are not fully motivated to making decent profits. Industry consolidation may be painful, but it is needed and is likely, particularly given the imminent enactment of the Ocean Shipping Reform Act. Consolidation, we hope, will eventually produce a more stable market structure and better profit margins.

These factors help explain why the industry as a whole is not profitable, but not why it is apparently less profitable for American carriers than for foreign carriers. Why is it, then, that foreign carriers are growing while American carriers decline if foreign carriers (1) have no cost advantage, (2) have no quality advantage, and (3) foreign investors apparently have the same incentive as Americans to seek higher investment returns elsewhere? Who can say for sure, but the one factor that we can readily identify and that goes a long way in explaining this mystery, is income taxes. To be clear, I'm talking about income taxes, below-the-line taxes assessed after all the costs and above-the-line tax benefits—accelerated depreciation, generous deductions, etc.,—are taken out of the revenues. American carriers pay income tax at a base rate of 36%. Most foreign carriers pay little or no income tax. The next slide is an analysis we've done in-house using the actual financial statements

of nine liner carriers—three American, six foreign. While a larger sample of financial statements needs to be analyzed, even this small sample absolutely illustrates the point. On average, the foreign carriers sampled got a net tax credit in 1996, while American carriers paid over 45% of their profits to Uncle Sam. In 1997, it was about 7% foreign income tax liability versus 43% for the Americans.

What this all means is that, if the industry has an average profit margin of say 6%, the effective rate of return for foreign investors may range from 8% to 11% depending on foreign income tax rates. Considering that some companies in some years do much better than 6%, it's not a bad return if you're a foreign carrier paying no income tax. Certainly, the incentive for foreign investors to leave the industry is much less than for American investors. In short, it is the income tax disadvantage, more than any other factor that I can identify, that explains the current condition of the American shipping industry. In fact, I understand that income tax liability played a crucial—perhaps decisive—role in the decision to merge APL into NOL instead of the other way around.

We've got to fix this problem, and there are any number of ways to do it. Most of the attention has centered around restoring Subpart F tax deferral, which until 1986 provided a means for American carriers to defer their income tax liability on shipping income earned using foreign flag vessels. Congressmen Shaw and Jefferson have introduced legislation that would restore the Subpart F exemption, but improve on it by allowing tax deferred money to be invested in U.S. flag shipping. Their bill has broad but not unanimous support within the industry. A variation on this approach would not just allow tax deferred money to be reinvested in U.S. flag shipping, but require such reinvestment as a condition for receiving tax deferral on some or all of the foreign flag earnings. Still another approach would not involve Subpart F at all, but would simply adjust the income tax rates of American shipping companies engaged exclusively in international trade to match the average tax rates of our foreign competitors.

I'm not here today to suggest a specific solution to the problem. But I would like to do two things. First, is to express the hope that the top leadership of the maritime industry—primarily seagoing unions and shipping companies—will commit to make a concentrated effort over the next several months until we find a solution to this problem. It took a long time, but the entire industry eventually came together over MSP and we got a program that has helped insure the survival of American mariners. We need to make the same commitment to assure the survival of American shipping companies, and I am hopeful and optimistic that we will.

Secondly, I'd like to suggest at least a couple of principles that would help guide our work. There are undoubtedly others, but the two that come to my mind are as follows:

First, "Foreign income tax advantages harm all American shipping companies in international trade, and must be addressed on an industry wide basis." We simply cannot afford to lose time while companies or unions jockey for advantage against one another over this issue. If we succeed in fixing the problem, the pie will grow maybe a lot and everyone's sustainable, long-term benefit will far exceed what might be gained or lost by attempting to rig the system. Let's not beat each other up, but let's be fair and work together for tax equity.

Secondly, "The solution to this problem must avoid placing burdens on American carriers that are not faced by their foreign competitors." This is the whole point of the exercise. If we don't stick to that very basic and obvious and important principle, we run a real risk of getting nowhere, or passing legislation that will accomplish nothing, and see the final loss of what's left of our industry.

Thank you very much for your attention, and I'd be happy to hear your comments and answer your questions.

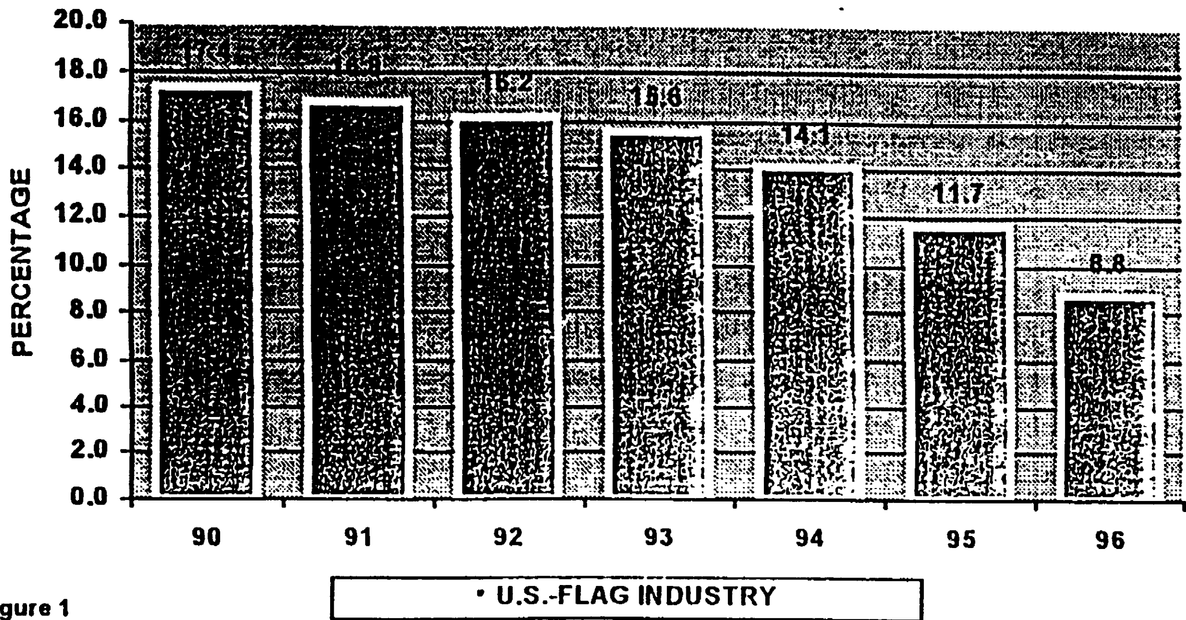
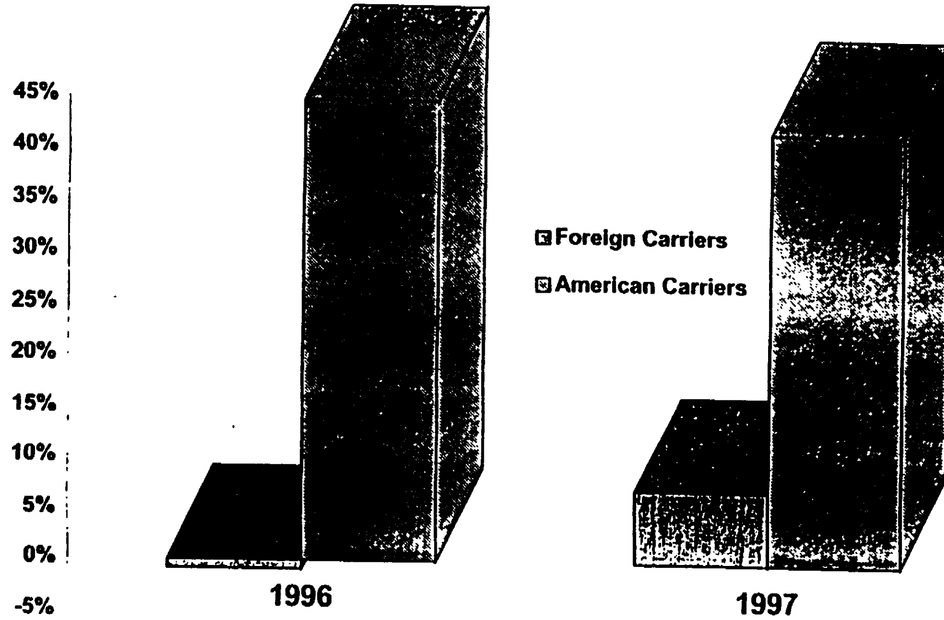


Figure 1

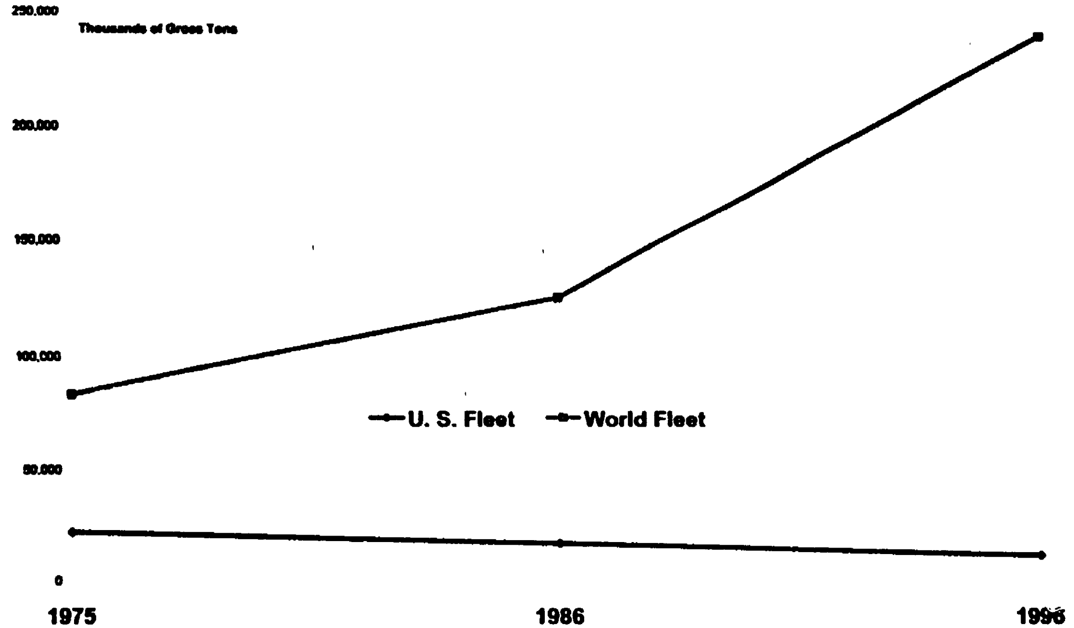
Average Income Tax Paid
American Carriers Versus Foreign Carriers



Propeller Club Convention
Portland, Oregon

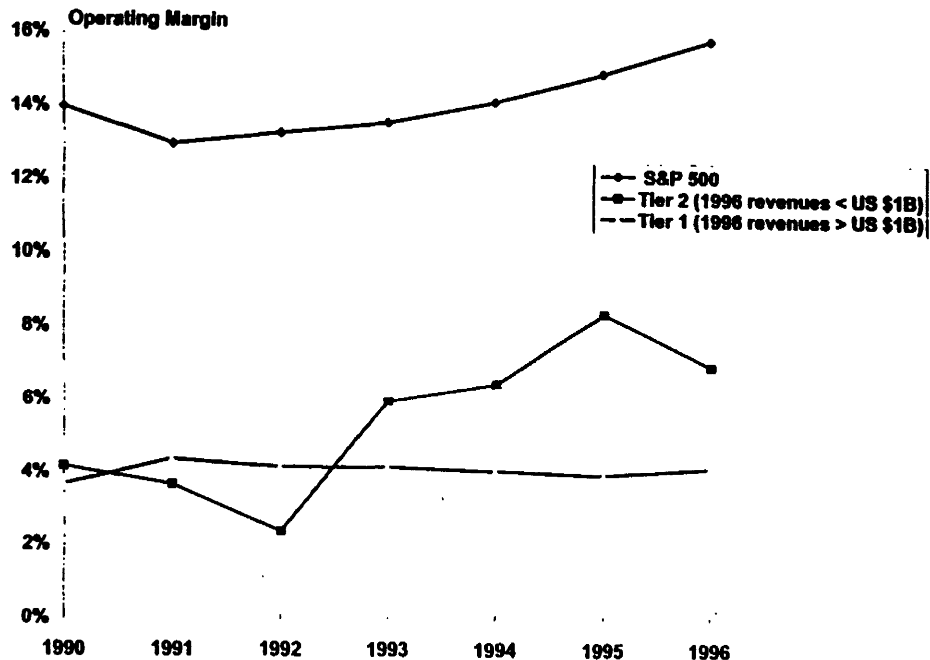
Merchant Shipping Fleet in Open-Registry Countries: 1975, 1986, 1996

(thousands of gross tons)



Propeller Club Convention
Portland, Oregon

Liner Shipping Operating Margins Versus S + P 500



Propeller Club Convention

Statement of Ernst & Young LLP

[MICHAEL F. PATTON AND ROBERT E. ACKERMAN]

The announcement for the Senate Finance Committee's March 11, 1999, hearing on international tax issues indicated that one of the subjects to be covered was promoting taxpayer use of Advance Pricing Agreements (APAs) as a means of avoiding or resolving cross-border transfer pricing controversies. We are writing to express our concern that recent actions by the Internal Revenue Service (IRS) may have the opposite effect of discouraging the use of APAs. As the former representatives, respectively, of the taxpayer and the IRS during the negotiation of the first APA, and as representatives for either the taxpayer or the IRS in many other APAs, we believe that we have unique insights to offer this Committee about the genesis of the APA program, why it has been a success, and how it should be managed to encourage broader use by taxpayers. We request that this letter be accepted as part of the record of these hearings.

BACKGROUND

After the amendment of section 482 in 1986 to add the "commensurate with income" provisions and the publication in late 1988 of the Treasury IRS White Paper on Transfer Pricing, there was a general concern in the international tax community and among U.S. treaty partners that aggressive enforcement of transfer pricing rules and related procedural provisions would lead to substantial double taxation of cross border transactions, or to unacceptably high levels of compliance costs to avoid double taxation. Between 1989 and 1993, Congress strengthened reporting and record keeping rules for foreign controlled corporations and added contemporaneous documentation requirements. In addition, it enacted severe penalties applicable to all taxpayers for substantial transfer pricing adjustments that were not based upon the exercise of reasonable care by the taxpayer. Between the date of the publication of the White Paper and 1996, the IRS and Treasury issued regulations under these new statutory provisions as well as proposed, temporary and final revisions to the 1968 section 482 regulations.

During this same time period, the Oversight Subcommittee of the House Ways and Means Committee, under the leadership of former Representative J.J. Pickle, held hearings to determine whether foreign controlled corporations were paying their fair share of taxes to the U. S. or whether those taxes were arbitrarily being reduced due to abusive transfer pricing practices. In addition, new types of business transactions, notably "global trading" of financial instruments, were emerging that did not fit neatly into the transactional patterns-such as the purchase and sale of goods and the provision of services-addressed in existing transfer pricing rules, leaving both taxpayers and the IRS with little to go on as to how these transactions should be handled.

Also during this time period, several large transfer pricing cases were litigated before the courts with mixed results for the IRS and taxpayers. While both sides could claim victories from these cases (and did), it was becoming clear that litigation of transfer pricing cases was a long and expensive process for the parties that produced substantial additional revenue to the government in some cases, but which provided precious little useful precedent for taxpayers and the IRS as to how other cases with different facts should be handled. It was against this backdrop that the APA program was born.

The APA process began in 1989 with discussions between a single taxpayer and IRS. There were several key objectives the taxpayer was seeking to achieve through what became the APA process, including:

Certainty—The taxpayer wanted assurance that the results of selected transactions (or at least the transfer pricing method used) would be accepted by IRS. In the event of significant changes in facts, taxpayer wanted the agreed terms to be subject to renegotiation.

Reduced Administrative Expense—The taxpayer wanted to reduce the administrative burden of record keeping, responding to IDRs and following controversy procedures for what were really agreed issues.

Avoid Potential Double Tax—If possible, the taxpayer wanted to get agreement between the IRS and a foreign Competent Authority that was consistent with the IRS domestic agreement in order to avoid potential double tax and to reduce the administrative expense and burden of responding to a foreign challenge to the treatment of the same items that were the subject of the agreement with IRS.

For its part, the IRS had on several occasions considered granting rulings on transfer pricing issues, but had rejected this possibility each time it was considered, primarily on the basis that transfer pricing issues are inherently factual. The ruling

process (as well as the Technical Advice procedure) is designed to resolve legal issues, not factual ones. Consideration was also given to using the closing agreement procedures. This alternative was also rejected because the closing agreement procedures were considered to be too inflexible and cumbersome to resolve transfer pricing issues prospectively. Accordingly, IRS decided to try to establish a new procedure.

There were several key objectives that IRS had in mind when they began this experiment.

Enhanced Voluntary Compliance—IRS wanted to increase voluntary compliance—especially by specific taxpayers or groups of taxpayers that were continually subject to transfer pricing audits and proposed adjustments.

Better Deployment of IRS Examination Resources—IRS recognized that while transfer pricing examinations and litigation were bringing in significant additional tax revenues, there was also a significant commitment of resources required, which resulted in relatively small percentages of proposed transfer pricing adjustments being ultimately sustained. There was also a recognition that the controversy process, including Competent Authority procedures, took a long period of time, during which no guidance was being developed that could be used to determine how recurring issues were to be resolved. A policy decision was made that IRS resources would be better deployed in seeking a "good enough" result from taxpayers that wanted to pursue reasonable policies.

Make Determinations of Tax Liability More Current—In addition to deploying resources more efficiently, IRS wanted to have determinations of major transactions significantly affecting tax liability become more contemporaneous. By definition, the examination process deals with issues on filed returns. For issues such as transfer pricing, which are highly factual and complex, issue development takes a significant amount of time—especially when development is conducted in an atmosphere in which litigation or controversy procedures may occur. IRS believed that if it could get the taxpayer to voluntarily submit information applying a transfer pricing method to the most recent tax years and, further, if the taxpayer would project results into the future, determinations could be made of the correct tax liability much more contemporaneously, which would benefit voluntary compliance.

Explore Emerging Areas—IRS recognized that it needed to be able to explore emerging business trends both to provide guidance to the public and to educate itself with respect to new types of transactions. One primary area of concern in the early 90's (as alluded to earlier) was "global trading" of financial products. IRS recognized that a detailed understanding of the products and business transactions was necessary in order provide guidance to taxpayers and IRS agents. Without voluntary assistance from industry and affected taxpayers, IRS was concerned that billions of dollars would be lost to the U.S. Treasury while IRS learned the industry and the transactions. Having something like the APA process available gave IRS the opportunity to explore transactions in depth with the help of the affected taxpayers at a small risk of revenue loss.

The first agreement and what became the procedures for the APA process were negotiated and developed simultaneously. In January 1991, Apple Computer publicly announced that it had obtained the first prospective agreement between two countries (the U.S. and Australia) dealing with transfer pricing issues. The agreement was referred to as an Advance Determination Request, the name by which such procedures are known in Australia. In March 1991, IRS published procedures governing the Advance Pricing Agreement program, Revenue Procedure 91-22, 1991-1 C. B. 526. Rev. Proc. 91-22 incorporates the results of the IRS's and the taxpayer's experience in negotiating the first agreement, as well as the comments of the taxpayer and its representatives. Since that first agreement was reached there have been over 130 AP as concluded.

One of taxpayers' key concerns at the onset of the APA program was protection of the confidentiality of information submitted during the APA negotiation process. In order for the IRS to reach its goals, it was necessary that there be a free exchange of what in essence amounted to detailed transfer pricing examination information. It was also necessary that this exchange be initiated by the taxpayer and that there be cooperative development of issues. Given the prior successful FOIA litigation regarding Private Letter Rulings and Technical Advice Memoranda, as well as the enactment of IRC 6110, it was obvious that if the APA program became successful, a similar suit might be brought to seek access to APAs and, more importantly, to the background information exchanged between IRS and the taxpayer during the negotiation of the APA. The IRS specifically considered these concerns and Rev. Proc. 91-22 contains an express determination by the IRS that the APA agreement itself and the background files are, among other things, protected from public

disclosure by IRC 6103. This legal conclusion was repeated in Rev. Proc. 96-53, 1996-2 C. B. 375.

At the beginning of the APA program, IRS tried to convince treaty partners that they should agree, pursuant to the general procedures under the Mutual Agreement procedures of the tax treaty, to enter into APAs. Both taxpayers and IRS had concerns about the disclosure in the treaty country of the terms of an APA agreement or information exchanged during the APA negotiation process. In discussions with the U.S.'s treaty partners, IRS used its decision to treat APAs and background files as confidential under IRC 6103 and applicable treaty provisions as a basis for obtaining the agreement of treaty partners that they would grant similar confidentiality to the APA agreements and background information exchanged during the negotiation process. Confidential treatment of this information was expressly provided for in the procedures published by Australia and Canada governing their APA procedures.

During the hearings held in the early 1990's by the Oversight Subcommittee of the Ways and Means Committee into potential transfer pricing abuse by foreign controlled corporations, the Subcommittee was presented with information regarding the successes the IRS had enjoyed in convincing taxpayers to voluntarily comply with transfer pricing requirements through the APA process. When Congress amended section 6103 to allow the U.S. Customs Service to have access to otherwise confidential tax return information, the legislative history to that provision explicitly precluded disclosure to the U.S. Customs Service of APAs and APA negotiating documents. Congress recognized that this information was both subject to confidentiality provisions of IRC 6103 and sensitive enough that it should not be disclosed to the Customs Service for purposes of enforcing the customs laws.

CURRENT STATUS

Against this background, it is shocking to us that IRS has now unilaterally decided that APAs are subject to public disclosure under IRC 6110. This decision was made without consulting the affected taxpayers that have obtained these agreements, without consulting the treaty partners who agreed to follow the IRS lead on confidentiality, and without consulting the Congress, which clearly believed this information too sensitive to give to another government revenue agency.

We are writing to you to express our concerns about the continued viability of the APA program, as well as the mistreatment of the taxpayers who received these agreements, who were told that any information they provided during the process of obtaining the agreements would be treated as confidential return information. In our opinion, the decision recently made by IRS reflects a fundamental misunderstanding by IRS of the APA process, the reasons why taxpayers seek APAs and the benefits the IRS receives through the APA process. We would like to briefly comment on these issues.

At the very heart of an APA is a joint determination of the taxpayer's tax liability through a negotiation process. Although the APA procedures state that an APA is a prospective agreement, this is only partly true. From the very beginning of the APA program, APAs were used as part of a process to resolve issues both prospectively and for filed tax years. This process is referred to as the "rollback" of an APA. Most APAs involve rollback situations. Indeed, the IRS recognized in Rev. Proc. 96-53 that there was a preference for rollback of APAs to resolve similar issues in open tax years. Even APAs that have no rollback are not truly prospective since it may take several years for the agreement to be negotiated, during which time returns will have been filed and adjustments to those returns may be made based upon the final agreement. Unless Congress and IRS are prepared to also make taxpayer examination results and administrative files public (a result that we believe would be detrimental to voluntary compliance), it should ensure the grant of confidential treatment to APAs and the relevant background files.

APA agreements are inherently facts and circumstances driven. The reason the IRS rejected giving rulings on transfer pricing issues is that resolution of these issues involves applying a general set of legal and regulatory principles to a taxpayer's specific facts. APAs do not establish legal precedent nor do they resolve unsettled legal issues as Rulings or Technical Advice Memoranda do. APAs are negotiated agreements designed to determine the taxpayer's tax liability.

A majority of APAs are also the result of bilateral negotiations with U.S. treaty partners. The agreements embody the terms of negotiations between the U.S. and its treaty partner that by treaty are considered confidential. Congress also considers treaty exchanges of information to involve confidential communications protected from public disclosure under IRC 6103. Disclosure of APAs could lead to unforeseen consequences with U.S. treaty partners. In this connection, it is not reasonable for

the U.S. to expect its treaty partners to keep information confidential when the IRS reserves to itself the right to change its mind without consulting its treaty partners.

FUTURE STATE

This brings us to the future of the APA program. The news release for the March 11 hearing indicated that the Committee was interested in encouraging the future use of APAs by taxpayers. According to published reports, IRS also would like to build upon the success of the APA program and expand it into other areas, such as the recent procedures for Small Business Taxpayer APAs. In order for the APA process to function as efficiently as it has in the past (which includes extensive use of APA rollbacks and exploring emerging business trends through the APA process), or indeed to function at all, there must be a free exchange of information between the IRS and taxpayers. If both parties need to "look over their shoulders" to consider how documents would be perceived if they were publicly disclosed, even subject to limited redactions, the process simply will not work the way it has in the past. For some taxpayers, notably smaller business taxpayers, the potential costs of section 6110 procedures regarding public disclosure for the APA and related background files may outweigh the benefits to be obtained from an APA.

Most importantly, taxpayers are seeking certainty through the APA process. The IRS apparently feels that it can change the terms of the confidentiality agreement retroactively and without consulting the affected parties. Given this, what other parts of an APA contract will the IRS feel that it can ignore in the future? If they were to decide that certain agreed transfer pricing methods are not as advantageous as an alternative, will they feel they can reconsider and unilaterally change the terms of the APA? In order for the APA process to work, taxpayers must have assurance that IRS will live up to the negotiated terms of the agreement. Without such trust, not only the APA process, but the entire voluntary compliance process, will suffer.

If the APA program is to be encouraged, we think that Congress needs to act quickly to do the following:

- Pass legislation protecting the confidentiality of existing and future APAs and background files under IRC 6103;
- Clarify that any treaty partner exchanges of information made in connection with negotiating the terms of an APA are not subject to public disclosure; and
- Specify that the terms of APAs are binding upon IRS and that taxpayers may sue IRS to enforce the terms of validly executed APAs.

We will be happy to provide the Committee with any information or assistance we can to help continue the viability of this important program.

STATEMENT OF THE FINANCIAL EXECUTIVES INSTITUTE

[SUBMITTED BY GRACE L. HINCHMAN, VICE PRESIDENT, GOVERNMENT RELATIONS]

The FEI Committee on Taxation would like to present our views regarding the need to continue defending against attacks on so-called "deferral" by the Clinton Administration and certain members of Congress. For multinational corporations in general, and U.S. based oil companies in particular, these earlier "repeal of deferral" proposals would significantly change the foreign tax credit rules and have significant implications regarding the ability of multinationals to compete in the international arena.

FEI is a professional association comprising 14,000 senior financial executives from over 8,000 major companies throughout the United States. The Tax Committee represents the views of the senior tax officers from over 30 of the nation's largest corporations.

GENERAL DISCUSSION OF DEFERRAL

Under current law, ten percent or greater U.S. shareholders ("Shareholders") of a controlled foreign corporation ("CFC") generally are not taxed on their proportionate share of the CFC's operating earnings until those earnings are actually paid in the form of a dividend. Thus, U.S. tax on the CFC's earnings is "deferred" until an actual dividend payment, just as an individual holding shares in a company "defers" U.S. tax on the earnings of the company until such time as the company actually pays a dividend to the shareholder.

The acceleration of U.S. tax on Shareholders of CFC operations has no counterpart in the tax laws of our foreign trading partners. For example, according to a 1990 "White Paper" submitted by the International Competition Subcommittee of

the American Bar Association Section of Taxation to congressional tax writing committees, countries such as France, Germany, Japan, and The Netherlands do not tax domestic parents on the earnings of their foreign marketing subsidiaries until such earnings are repatriated. To the extent that the U.S. tax burden on these operations increases overall tax costs, we will become less competitive and the U.S. economy will suffer.

Similarly, in situations where one U.S. corporation owns less than a controlling ownership interest in another U.S. corporation (i.e., no tax consolidation), U.S. law does not require income to be recognized by the investor corporation until the subsidiary corporation pays a dividend. In fact, the phrase "deferral of tax" as used here is as unjustified as it would be to criticize the estate tax because it "defers" the tax until death.

Thus, eliminating deferral would not eliminate a privilege but simply impose a penalty. It would accelerate tax and may, in fact, tax income never realized. This could happen for a number of reasons, such as the existence in a foreign country of exchange or other restrictions on profit distributions, reinvestment requirements of the business, devaluation of foreign currencies, subsequent operating losses, expropriation, and the like.

Other problems posed by the repeal of deferral are:

- It may lessen the likelihood or totally prevent U.S. companies from investing in developing countries by vitiating tax incentives offered by such countries to attract investment. This result would be counter to U.S. foreign policy objectives by opening the door to foreign competitors who would likely order components and other products from their own suppliers rather than from U.S. suppliers. Moreover, any reduced tax costs procured by these foreign competitors would likely be protected under tax sparing-type provisions of tax treaties that are typically agreed to by other nations, although not by the U.S. Treasury.
- It may result in double taxation in those countries which permit more rapid recovery of investment than the U.S., because the U.S. tax would precede the foreign creditable income tax by several years and the carryback period may be inadequate. Moreover, even if a longer carryback period were enacted, the acceleration of the U.S. tax would be a serious competitive disadvantage vis-a-vis foreign-owned competition.
- It would discriminate against Shareholders of U.S. companies with foreign operations, as contrasted with domestic companies doing business only in the U.S., by accelerating the tax on unrealized income. However, U.S. multinational companies have been and continue to be responsible for significant employment in the U.S. economy, much of which is generated by their foreign investments.
- It could harm the U.S. balance of payments. Earnings remitted to the U.S. from foreign direct investments have exceeded those investments and have been the most important single positive contribution to the U.S. balance of payments. The ability to freely reinvest earnings in foreign operations results in strengthening those operations and assuring the future repatriation of earnings generated therefrom. However, the elimination of deferral would greatly erode this advantage.

In statements justifying the elimination of deferral for CFC earnings, CFCs have sometimes been compared to U.S. subsidiaries operating abroad but still included in the U.S. tax consolidation. The point here is that tax on earnings of such U.S. subsidiaries is not deferred. However, it must also be kept in mind that companies included in a U.S. tax consolidation bring all of their results to the consolidated return on a current basis, including losses. In a 1993 article, two respected Washington-based tax attorneys, Paul W. Oosterhuis and Roseann M. Cutrone, noted that treating CFCs like members of the U.S. tax consolidation would actually result in a significant cost to the U.S. Treasury (See "The Cost of Deferral's Repeal: If Done Properly, It Loses Billions," Tax Notes, Feb. 8, 1993, p. 765).

Some recent Congressional proposals (for example, S. 1597 introduced by Senator Dorgan and H.R. 3252 by Congresswoman McKinney, both in 1986), would have changed present law by currently taxing U.S. shareholders on the operating earnings of certain CFCs, even though such earnings are reinvested abroad and not available for distribution, and even though the U.S. shareholders may never receive such earnings. This proposed penalty on foreign investment, which our foreign competitors will not suffer, is justified by the belief that U.S. jobs will somehow be preserved if deferral is eliminated. However, in reality, foreign operations of U.S. multinationals create rather than displace U.S. jobs, while also supporting our balance of payments and increasing U.S. exports.

U.S. firms establish operations abroad because of market requirements or marketing opportunities. For example, it is self-evident that those who seek natural resources must develop them in the geographical locations where they are found. In

addition, as a practical matter, local conditions normally dictate that U.S. corporations manufacture in the foreign country in order to enjoy foreign business opportunities. This is not surprising as we have seen a number of instances of foreign multinationals setting up manufacturing operations to serve the U.S. market. For example, car-makers such as BMW, Honda, Mercedes, and Toyota found they could not adequately serve the U.S. market without manufacturing here.

Foreign manufacturing creates U.S. jobs, often for the manufacture of components. A good example is the purchase of components by the U.S. manufacturing plants of the car-makers cited above. Frequently, foreign markets are explicitly closed to U.S. companies without local manufacturing facilities through restrictive import duties, requirements that a percentage of the product be manufactured locally, on-site inspection requirements, governmental procurement practices, and other regulatory provisions. Where the manufacturer cannot serve that market in a cost efficient manner through exports from the U.S., its only alternative to manufacturing abroad is to leave the market to non-U.S. competitors.

Moreover, CFCs are generally not in competition with U.S. manufacturing operations but with foreign-owned and foreign-based manufacturers. A very small percentage (less than 10% in 1994) of the total sales of American-owned foreign manufacturing subsidiaries are made to the U.S. Most imports come from sources other than foreign affiliates of U.S. firms. In addition, a decrease in foreign investment would not result in an increase in U.S. investment, primarily because foreign investments are undertaken not as an alternative to domestic investment, but to supplement such investment.

There is a positive relationship between investment abroad and domestic expansion. Leading U.S. corporations operating both in the U.S. and abroad have expanded their U.S. employment, their domestic sales, their investments in the U.S., and their exports from the U.S. at substantially faster rates than industry generally. In a 1998 study entitled "Mainstay III: A Report on the Domestic Contributions of American Companies with Global Operations," and an earlier study from 1993 entitled "Mainstay II: A New Account of the Critical Role of U.S. Multinational Companies in the U.S. Economy," the Emergency Committee for American Trade ("ECAT") documented the importance to the U.S. economy of U.S. based multinational companies. The studies found that investments abroad by U.S. multinational companies provide a platform for the growth of exports and create jobs in the United States. (The full studies are available from The Emergency Committee for American Trade, 1211 Connecticut Avenue, Washington, DC 20036, phone (202) 659-5147).

CLINTON ADMINISTRATION'S DEFERRAL PROPOSAL

Under the Administration's budget proposal of a few years ago, so-called "deferral" would be eliminated for oil and gas multinationals. That would result in the current taxation of foreign subsidiary oil & gas income before it is ever distributed through dividends. All foreign oil & gas income ("FOGI") would be treated as "Subpart F" income as defined under Code Section 952, meaning it would not be eligible for deferral, and the proposal would also trap that income in a new separate FOGI basket under Code Section 904(d).

This proposed change to the Foreign Tax Credit rules for FOGI, combined with the repeal of so-called "deferral," are in marked contrast and conflict with the Clinton Administration's announced trade policy. The Administration has demonstrated an intention to subscribe to the integration of worldwide trade, with a continuing removal of trade barriers and promotion of international investment (for example, the GATT and NAFTA agreements). Moreover, because of their political and strategic importance, foreign investments by U.S. oil companies have been supported by the U.S. government. For example, participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan has been praised as fostering the political independence of that newly formed nation, as well as securing new sources of oil to Western nations, which are still heavily dependent on Middle Eastern imports.

Given this background, the Administration's proposals would further tilt the playing field against the U.S. petroleum industry's foreign exploration and production efforts, and increase (or make prohibitive) the U.S. tax burden on foreign petroleum industry operations. These proposals would not only stymie new investment in foreign exploration and production projects, but also change the economics of some past investments. In fact, the proposed changes in the Foreign Tax Credit rules would likely reduce the return on project investments by approximately one-third.

In the case of natural resource extraction and production, the reason for foreign investment is obvious. If U.S. oil and gas concerns wish to stay in business, they must look to replace their diminishing reserves. Currently, such opportunities are

seriously restricted in the U.S. Thus, that replacement must come from outside our borders. If U.S. companies cannot economically compete overseas, those foreign resources will still be produced. However, they will be produced by foreign competitors without any benefit to the U.S. economy, and without U.S. companies or American workers deriving any direct or indirect income from the foreign production activity.

The availability of the Foreign Tax Credit, along with so-called "deferral" of taxation of foreign subsidiary earnings until repatriation, make up the foundation of U.S. taxation of foreign source income. These targeted Administration proposals would destroy such basic rules of foreign income taxation on a selective basis for foreign oil and gas income only. Again, this would be in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

Regarding the tax concept of "deferral," one must emphasize that taxing a U.S. shareholder on all or part of its foreign subsidiary's earnings before dividends are distributed already exists in the Internal Revenue Code to cover potentially abusive situations. It is the exception rather than the norm. In the corporate context, the norm is that although U.S. corporations are taxed on their worldwide income, there is no taxation before realization. Accordingly, there is generally no taxation of the earnings of foreign subsidiaries before they are received in the form of a dividend, or before disposing of the subsidiary's stock. This is symmetrical with individual shareholders not being taxed on earnings from companies in which they own shares until dividends are declared and paid, or they sell their shares.

Concentrating on the Administration's Foreign Tax Credit limitation proposal for oil and gas income, it must be repeated that such action is targeted at one industry only and would further tilt the playing field against overseas oil and gas operations by U.S. based oil companies. It would also increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies when competing with foreign-owned oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, since the home countries of our foreign competitors generally do not tax their multinational corporations on foreign source income.

For example, those countries may either exempt foreign source income, or utilize a liberal foreign tax credit regime which truly prevents double taxation. Under the Administration's proposal, a U.S. company's after tax return could be one-third less than its foreign competitor's. Even if the foreign competitor is unable to match the U.S. company's efficiencies and effectiveness, the U.S. company would still be at a serious competitive disadvantage that would surely harm it in any competitive bidding situation. Only the continued existence of the Foreign Tax Credit, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business. Under current U.S. tax law, we are already competitively disadvantaged—don't make it worse.

To install a separate Foreign Tax Credit limitation category for FOGI, as the Administration's proposal would do, would single out the active business income of oil companies and separate it from the general business income Foreign Tax Credit basket. There appears to be no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGI is difficult if not impossible to manipulate: Foreign Oil & Gas Extraction Income is derived from the country where the natural resource is produced while Foreign Oil Related Income is derived from the country where the processing or marketing occurs.

CONCLUSION

Many impediments already exist in the current Internal Revenue Code regarding the taxation of foreign income. These impediments cause severe competitive disadvantages for U.S. based multinationals. For example, the financial services industry has had to struggle over the last few years to convince Congress that their "active" financing-type income should be eligible for deferral. However, their battle is still continuing since Congress has only temporarily extended deferral for active financing income for 12 months at a time.

Moreover, until at least the year 2003, the tax rules regarding so-called "10/50 Companies" will cause Foreign Tax Credits to be trapped in separate baskets for each 10% to 50% owned companies. Excess Foreign Tax Credits from one 10/50 company basket cannot be used to offset shortages in other 10/50 company baskets, resulting in significant additional U.S. tax costs for these entities. Partnerships, however, are not subject to the 10/50 rules. Thus, in order to level the playing field versus our foreign competitors, some U.S. companies have been put in the perverse position of having to cede competitive benefits to foreign partners in order to achieve their agreement to partnership status for our joint operations. No foreign country utilizes such restrictive rules in their taxation systems for their multinational com-

panies, so our foreign competitors have little reason to be overly generous when negotiating with us.

The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil & gas business environment.

We thank you for the opportunity to provide our comments on this extremely important issue for multinationals in general and the oil industry in particular.

Statement Of
Washington Counsel, P.C., Attorneys at Law
and
Ernst & Young LLP[1]
on behalf of the
The Global Competitiveness Coalition[2]

on
The International Tax System

Submitted for the record of the Hearing before the
Senate Committee on Finance
on March 11, 1999

Introduction

The Global Competitiveness Coalition appreciates the opportunity to submit testimony to the Senate Committee on Finance as part of its hearing on the international tax system. We applaud the Committee for undertaking this first hearing in a series of hearings to examine the tax rules that affect the global competitiveness of U.S. multinational corporations. U.S. companies operating in the global marketplace should not be disadvantaged by U.S. tax rules that do not apply to their foreign competitors, or by tax policies that conflict with the objectives of U.S. trade policy. We believe that the Congress is the appropriate forum for any re-examination of U.S. tax policy in the international area. In order for that examination to proceed without prejudice, Treasury should be prevented from implementing major new international tax initiatives that could prove to be inconsistent with the Committee's views of this area. A case in point is Treasury's announced intention to issue regulations that restrict hybrid branches (*i.e.*, entities treated as corporations under one country's tax system and as branches or partnerships in another), pursuant to Notice 98-35.[3] For this and other reasons set forth below, we urge the Congress to adopt legislation that would impose a permanent moratorium on the Treasury Department's authority to issue regulations relating to the tax treatment of hybrid branches.

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[1] This statement is presented by LaBrenda Garrett-Nelson and Mark Weinberger of Washington Counsel, P.C., and David Benson and Henry Ruempler of Ernst & Young LLP.

[2] The Coalition consists of more than 20 U.S. multinational corporations representing a broad cross-section of American industries.

[3] Notice 98-35; 1998-26 I.R.B. 1.

I. Last year, Treasury Sought to Launch a Major New International Tax Initiative That (Many Believe) Would Undermine the Competitive Position of U.S. Multinationals.

A. Background Regarding The Issuance of Notice 98-11 and Notice 98-35 on Hybrid Branches

Notice 98–11, issued on January 16, 1998, restricted the use of hybrid branches under Subpart F.[4] Basically, Treasury and the Internal Revenue Service ("IRS") concluded that the use of hybrid branches is contrary to the policy and rules of Subpart F. On March 23, 1998, temporary and proposed regulations dealing with hybrid branches were issued pursuant to Notice 98–11. Under these regulations, certain payments between a CFC and its hybrid branch or between hybrid branches of the CFC were treated as giving rise to currently taxable Subpart F income. In addition, the Administration's budget for FY1999 included a proposal for an exceedingly broad grant of regulatory authority to curtail the use of hybrid branches.

The effect of the rules proposed in Notices 98-11 and 98-35 is to trigger tax under subpart F where hybrid branches are used to lower *foreign* (not U.S.) tax payments. This restriction under the subpart F regime is not supported by the Code's clear statutory language, and there has been no express delegation of regulatory authority to the Treasury that relates specifically to the issues presented in the Notice. Moreover, a majority of the members of the Congressional tax-writing committees challenged the very premise that Treasury had sufficient authority to issue regulations pursuant to Notice 98-11.

Not only did Congress decline to expand Treasury's regulatory authority as proposed in the President's FY99 budget, in the wake of strong bipartisan congressional opposition to Notice 98-11,[5] Treasury withdrew Notice 98-11 and the hybrid branch regulations. Nevertheless, in Notice 98-35, Treasury announced the intention to reissue the hybrid branch regulations in proposed form, to be finalized no earlier than January 1, 2000.

B. <u>The Issues Raised By Notices 98-11 and 98-35 Involve Fundamental Tax Policy Concerns That Should be Addressed by The Congress.</u>

As recognized by the IRS in describing the background of Notice 98-11, "U.S. international tax policy seeks to balance the objective of neutrality of taxation as between

[4] "Subpart F" refers to the anti-deferral regime prescribed by Sections 951-964 of the Internal Revenue Code of 1986, as amended (the "Code"); all references to "Sections" hereinafter are to the Code.

[5] Bipartisan congressional opposition was expressed by way of a "Sense of the Senate" (included in the IRS Restructuring Bill that passed the Senate 97-0), and strong written protests by 36 Ways and Means Committee members, in addition to letters by House Ways and Means Chairman Archer and Ranking member Rangel to Treasury.

domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other, [referred to as "capital export neutrality"]) with the need to keep U.S. business competitive." The legislative history of Subpart F is clear that "capital export neutrality" is not the only policy goal. Nevertheless, the Administration's position (as evidenced by Notices 98-11 and 98-35) would elevate the policy of capital export neutrality over international competitiveness.

The basic structure of the U.S. international tax regime dates from the early 1960s when the U.S. economy was so dominant that it accounted for over half of all multinational investment in the world. The decades that followed saw a migration from domestically-based to globally-competitive markets. With this transformation comes new challenges for Congressional policy makers interested in helping U.S. companies remain competitive. Indeed, the Congress has adopted trade laws that recognize both the need for expanded markets and the reduction of trade barriers. In like manner, it is for the Congress to determine whether to alter the extent to which international tax rules bolster or hinder the competitiveness of U.S. companies in global markets.

The Congress is the only proper forum for determining whether to revisit the balance that has been struck between the competing U.S. tax goals of international competitiveness versus capital export neutrality. Further, Treasury is seeking to usurp the legislative process by raising this issue by Notices that grant Treasury open-ended authority to prescribe rules. Any change in law should be made through substantive statutes enacted prospectively by the Congress, not Notices issued retroactively by Treasury.

II. Why A Permanent Moratorium Is Needed

Notice 98-35 left the door open for Treasury to issue new regulations that are substantially similar to those issued pursuant to Notice 98-11. Thus, the withdrawal of Notice 98-11 and the related regulations was only a temporary solution to the anti-competitive threat posed by Treasury's insistence on preventing taxpayers from taking appropriate steps to reduce foreign tax payments.

Notices 98-11 and 98-35 presuppose a substantive policy conclusion that is not supported by the current statute. The determination of fundamental policy matters (*e.g.*, the policy goals underlying Subpart F or the treatment of branches thereunder) is the prerogative of Congress—not the Treasury. The Subpart F provisions have a direct impact on the competitiveness of U.S. companies in the global marketplace and, historically, the Congress has moved carefully when making changes to those sections of the Code. Unwarranted or injudicious action in these areas can have a substantial adverse impact on U.S. businesses operating abroad.

A. Any Regulations Issued Pursuant to Notice 98-35 Would Have a Widespread and Adverse Impact on Legitimate U.S. Economic Activity

The hybrid branch rules announced in Notice 98-35 will prevent U.S. multinational businesses from employing strategies that permit them to fund their active business operations in an efficient manner. Foreign multinationals generally are not subject to the constraints that the U.S. tax code imposes upon U.S. companies and thus are able to fund their overseas operations in a more cost efficient manner. Many foreign jurisdictions do not have anti-deferral regimes and, if they do, they are not as restrictive as Subpart F. The hybrid branch rules in Notice 98-35 will only exacerbate this disparity.

Notice 98-35 is premised on the notion that allowing U.S. multinational corporations to reduce their foreign taxes through the use of hybrid arrangements provides an improper incentive to invest overseas rather than in the United States. This view is fundamentally incorrect. Economic studies of the effect of taxes on the location of investment have found that investments outside the United States are driven by business concerns—*e.g.*, the need to open new markets, the availability of natural resources, or the desire to compete internationally in regulated businesses—not tax rates.

B. Treasury Should be Prevented from Implementing New Policy Initiatives When the Committee is Just Beginning A Comprehensive Review of Reforms in the International Tax Area

On Wednesday, March 10, 1999, members of the Senate Finance Committee (Connie Mack (R-FL) and John Breaux (D-LA)) introduced bipartisan legislation to express their continuing concerns that Treasury's policy in this area threatens to upset the long-standing balance between the two competing policy goals that form the foundation of Subpart F. A companion bill was introduced by House Ways and Means Committee members Phil Crane (R-IL) and Robert Matsui (D-CA) (H.R. 672). These bills would impose a permanent moratorium on Treasury's authority to issue regulations dealing with the treatment of hybrid branches pursuant to Notice 98-35. Additionally, the bills would require that a study be conducted of the tax treatment of hybrid branches, with a written report provided to the Senate Committee on Finance and the House Committee on Ways and Means.

The Global Competitiveness Coalition wholeheartedly endorses this legislation as a sensible step in the process of updating the international tax system to complement, not conflict with, the efficient operations of U.S. multinationals.

C. The Issuance of Hybrid Branch Regulations Would Necessarily Taint Treasury's Pending Subpart F Study.

Treasury is undertaking a comprehensive review of subpart F, scheduled for completion by the summer of 1999. A Treasury official recently was quoted as stating that the Treasury study has no preordained conclusion and that the purpose of the regulations—which also are expected to be released sometime this summer—would be to

enforce existing law, whereas the study is designed to examine subpart F in light of today's circumstances and policy objectives.[6]

We believe that the regulations promised by Notice 98-35 presuppose a substantive policy conclusion that is not supported by statute and that taints the review of Subpart F currently underway at Treasury. Congress should have the opportunity to review the conclusions and recommendations made by the Treasury in the expected report, as well as reach its own conclusions, without the "gun" of Notice 98-35 and the soon-to-be-issued regulations pointed at the heads of U.S. multinational businesses.

Conclusion

This Committee has taken up the task of reviewing our international tax rules and ultimately deciding whether changes to current rules should be made. That review should proceed unprejudiced by administrative pronouncements by the Treasury Department that reach an unsubstantiated conclusion. Therefore, we urge that tax legislation include the Mack-Breaux and Crane-Matsui proposal to impose a permanent moratorium on Treasury's ability to issue regulations restricting the use of hybrid arrangements by U.S. multinational corporations.

[6] Sheppard, Lee A., *IFA Meeting Considers Present, Future International Rules.* Tax Notes (Vol. 82, No. 9, March 1, 1999), pp. 1243-1244.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

[SUBMITTED BY MICHAEL STERN, LEGISLATIVE REPRESENTATIVE]

The Investment Company Institute (the "Institute")[1] urges the Committee to enhance the international competitiveness of U.S. mutual funds, treated for federal tax purposes as "regulated investment companies" or "RICs," by enacting legislation that would treat certain interest income and short-term capital gains as exempt from U.S. withholding tax when distributed by U.S. funds to foreign investors.[2] The proposed change merely would provide foreign investors in U.S. funds with the same treatment available today when comparable investments are made either directly or through foreign funds.

I. THE U.S. FUND INDUSTRY IS THE GLOBAL LEADER

Individuals around the world increasingly are turning to mutual funds to meet their diverse investment needs. Worldwide mutual fund assets have increased from $2.4 trillion at the end of 1990 to $7.6 trillion as of September 30, 1998. This growth in mutual fund assets is expected to continue as the middle class continues to expand around the world and baby boomers enter their peak savings years.

U.S. mutual funds offer numerous advantages. Foreign investors may buy U.S. funds for professional portfolio management, diversification and liquidity. Investor confidence in our funds is strong because of the significant shareholder safeguards provided by the U.S. securities laws. Investors also value the convenient shareholder services provided by U.S. funds.

Nevertheless, while the U.S. fund industry is the global leader, foreign investment in U.S. funds is low. Today, less than one percent of all U.S. fund assets are held by non-U.S. investors.

II. U.S. TAX POLICY ENCOURAGES FOREIGN INVESTMENT IN THE U.S. CAPITAL MARKETS

Pursuant to U.S. tax policy designed to encourage foreign portfolio investment[3] in the U.S. capital markets, U.S. tax law provides foreign investors with several U.S. withholding tax exemptions. U.S. withholding tax generally does not apply, for example, to capital gains realized by foreign investors on their portfolio investments in U.S. debt and equity securities. Likewise, U.S. withholding tax generally does not apply to U.S. source interest paid to foreign investors with respect to "portfolio interest obligations" and certain other debt instruments. Consequently, foreign portfolio investment in U.S. debt instruments generally is exempt from U.S. withholding tax; with respect to portfolio investment in U.S. equity securities, U.S. withholding tax generally is imposed only on dividends.

III. U.S. TAX LAW, HOWEVER, INADVERTENTLY ENCOURAGES FOREIGNERS TO PREFER FOREIGN FUNDS OVER U.S. FUNDS

Regrettably, the incentives to encourage foreign portfolio investment are of only limited applicability when investments in U.S. securities are made through a U.S. fund. Under U.S. tax law, a U.S. fund's distributions are treated as "dividends" subject to U.S. withholding tax unless a special "designation" provision allows the fund to "flow through" the character of its income to investors. Of importance to foreign investors, a U.S. fund may designate a distribution of long-term gain to its shareholders as a "capital gain dividend" exempt from U.S. withholding tax.

For certain other types of distributions, however, foreign investors are placed at a U.S. tax disadvantage. In particular, interest income and short-term capital gains, which otherwise would be exempt from U.S. withholding tax when received by foreign investors either directly or through a foreign fund, are subject to U.S. withholding tax when distributed by a U.S. fund to these investors.

IV. CONGRESS SHOULD ENACT LEGISLATION ELIMINATING U.S. TAX BARRIERS TO FOREIGN INVESTMENT IN U.S. FUNDS

"Investment competitiveness" legislation introduced in both the Senate and the House in every Congress since 1991, and most recently in 1997,4 effectively would modify the "designation" rules applicable to U.S. funds. The Institute has supported fully these "investment competitiveness" bills, which would permit all U.S. funds to preserve, for withholding tax purposes, the character of interest income and short-term gains distributed to foreign investors, provided the interest income and gains would be exempt from U.S. withholding tax if received directly or through a foreign fund.[5]

The Institute urges the Committee to support the enactment of this "investment competitiveness" legislation. Following enactment of such legislation, the full pano-

ply of U.S. funds—equity, balanced and bond funds—would be available to foreign investors without this adverse U.S. tax treatment. Absent this change, foreign investors seeking to enter the U.S. capital markets will continue to have a significant U.S. tax incentive not to invest in U.S. funds.

An important first step toward improving the investment competitiveness of U.S. funds is contained in the President's Fiscal Year 2000 budget proposal. Under the President's proposal, distributions to foreign investors by a U.S. fund that invests substantially all of its assets in U.S. debt securities or cash generally would be treated as interest exempt from U.S. withholding tax. A fund's distributions would remain eligible for this withholding tax exemption if the fund invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries.

Should the Committee determine to accept the Administration's narrower bond fund proposal, the Institute recommends that such legislation draw a distinction between (1) a foreign bond that is exempt from foreign tax in the hands of a U.S. investor pursuant to the domestic law of the relevant foreign country (a "tax-exempt" foreign bond) and (2) a foreign bond that would be subject to foreign tax in the hands of a U.S. investor but for an income tax treaty with the United States (a "taxable" foreign bond). This approach, which would ensure that foreign investors could not avoid otherwise-applicable foreign tax by investing in U.S. funds that qualify for treaty benefits under the U.S. tax treaty network, was contained in legislation introduced in both the Senate and the House in 1998.[6]

* * *

U.S. mutual funds cannot compete effectively in the rapidly-expanding global economy so long as U.S. tax law encourages foreign portfolio investors to make their investments either directly or through a foreign fund, rather than through a U.S. fund. The Institute urges the enactment of legislation to remove this inadvertent U.S. tax barrier to foreign investment in U.S. funds.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,446 open-end investment companies ("mutual funds"), 456 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.662 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

[2] The U.S. statutory withholding tax rate imposed on non-exempt income paid to foreign investors is 30 percent. U.S. income tax treaties typically reduce the withholding tax rate to 15 percent.

[3] "Portfolio investment" typically refers to a less than 10 percent interest in the debt or equity securities of an issuer, which interest is not "effectively" connected to a U.S. trade or business of the investor.

[4] The "Investment Competitiveness Act of 1997" was introduced by Senators Baucus, Gorton and Murray (as S. 815) and by Representatives Crane, Dunn and McDermott (as H.R. 707).

[5] The taxation of U.S. investors in U.S. funds would not be affected by these proposals.

[6] The "International Tax Simplification for American Competitiveness Act of 1998" was introduced by Senators Hatch and Baucus (as S. 2331) and by Representatives Houghton, Levin and Crane (as H.R. 4173). Under this legislation, no limit would have been placed on the ability of U.S. funds to invest in "tax-exempt" foreign securities, such as Eurobonds. Investments in "taxable" foreign bonds, however, would have been subject to very strict investment restrictions.

STATEMENT OF THE MULTINATIONAL TAX COALITION

[SUBMITTED BY PRICEWATERHOUSECOOPERS]

I. INTRODUCTION

The Multinational Tax Coalition, a group of U.S. companies in a wide range of industries competing in world markets, appreciates the opportunity to present this written statement to the Senate Finance Committee in conjunction with its March 11, 1999, hearing on international tax reform and simplification. Members of the Multinational Tax Coalition include ARCO, Bank of America, Caterpillar Inc., DuPont, Emerson Electric Co., General Electric, General Mills, Inc., Hewlett-Packard

Company, PepsiCo, Inc., and Tupperware Corporation. PricewaterhouseCoopers serves as consultant to the group.

Our comments center on a series of Clinton Administration initiatives relating to cross-border transactions—involving "hybrid branches"—undertaken by U.S. companies. The net effect of these Administration initiatives would be to increase taxes paid to foreign governments by American companies conducting business globally and thereby to hamper the ability of U.S.-based multinationals to compete in the global marketplace. These initiatives fail to recognize the fact that U.S. companies must be present in global markets in order to grow and that foreign operations do not come at the expense of, but rather contribute to the domestic economy.

The Multinational Tax Coalition believes the Administration's views regarding hybrid branches—reflected in Internal Revenue Service Notices 98-11 and 98-35—run counter to sound international tax policy principles. We respectfully ask that the Finance Committee give consideration to legislation that would reverse these ill-conceived initiatives as part of its review of the U.S. international tax system. As we explain in this statement, such action would promote U.S. competitiveness and would be consistent with other criteria outlined by Chairman Roth for reforming the U.S. tax rules applicable to foreign-source income.

II. BACKGROUND

The Administration's initiatives regarding hybrid branches have been scrutinized by the Congress and criticized sharply by business groups over the past year. The following have been key milestones in this ongoing debate:

A. IRS Notice 98-11

The Internal Revenue Service ("IRS") on January 16, 1998, issued Notice 98-11, announcing that Treasury regulations subsequently would be issued to prevent the use of certain "hybrid branch" arrangements deemed contrary to the policies and rules of subpart F of the Internal Revenue Code.[1] These arrangements generally involve structures that are characterized for U.S. tax purposes as branches of a U.S. controlled foreign corporation ("CFC"), but are characterized under the tax law of the country in which the CFC is incorporated as a separate entity. The Notice stated that the regulations would recharacterize payments made by a hybrid branch to a CFC as subpart F income (i.e., income subject to immediate U.S. tax).

IRS Notice 98-11 drew swift opposition from affected taxpayers and strong comments from Congressional tax-writers, who expressed the general view that the positions taken in Notice 98-11 would represent fundamental changes to U.S. tax policy that should be considered as part of the normal legislative process.

B. Temporary Treasury Regulations

The Treasury Department on March 23, 1998, issued temporary and proposed regulations providing detailed rules implementing the general principles outlined in Notice 98-11, generally effective with respect to hybrid branch arrangements entered into on or after January 16, 1998. Taxpayers questioned the statutory authority for these regulations. Taxpayers also noted that issuance of these regulations in temporary form with an immediate—indeed, retroactive—effective date represented a significant departure from the normal process of issuing regulations in proposed-only form and then allowing for an appropriate period of public comment.

C. Senate-Passed Moratorium on Regulations

As part of its consideration of the IRS Restructuring and Reform Act of 1998, the Senate Finance Committee on April 1, 1998, approved a six-month moratorium on implementation of the Treasury regulations issued with respect to Notice 98-11. The Committee report explained the reasons for this action:

> Notice 98-11 and the regulations thereunder address complex international tax issues relating to the treatment of hybrid transactions under the subpart F provisions of the Code. The impact of such administrative guidance on U.S. businesses operating abroad may be substantial. The Committee believes that it is appropriate to place a moratorium on the implementation of the regulations with respect to Notice 98-11 so that these important issues can be considered by the Congress.[2]

A "Sense of the Senate" resolution also was approved expressing the view that Treasury and the IRS should withdraw Notice 98-11 and the regulations thereunder and that Congress should determine the tax policies regarding the treatment of hybrid transactions under subpart F. The Committee report explained:

> The subpart F provisions of the Code reflect a balancing of various policy objectives. Any modification or refinement to that balance should be the subject of serious and thoughtful debate. It is the Committee's view that any significant

policy developments with respect to the subpart F provisions, such as those addressed by Notice 98-11 and the regulations issued thereunder, should be considered by the Congress as part of the normal legislative process.[3]

D. IRS Notice 98-35

The threat of a Congressionally imposed moratorium and the strongly worded "Sense of the Senate" resolution led Treasury on June 19, 1998, to issue IRS Notice 98-35, withdrawing Notice 98-11 and announcing the intention to withdraw the related temporary and proposed regulations and to reissue the regulations in proposed form only. In Notice 98-35, consistent with the views of the Committee regarding the need for Congressional consideration of these issues, Treasury stated that it would not finalize before January 1, 2000, any regulations in this area in order to give Congress time to consider the issues originally raised by Notice 98-11 and to take legislative action, if appropriate.

Because of the issuance of Notice 98-35, which reflected Treasury's agreement to a moratorium on the hybrid regulations, the final conference agreement on the IRS reform legislation did not include the Senate-passed moratorium. In this regard, the conference report indicates that the conferees expected that the Congress would consider the policy issues and would consider taking legislative action. The conference report further provides that no inference was intended regarding the authority to issue the Notice or the regulations.

III. TAX POLICY CONCERNS

As Treasury itself indicated in Notice 98-35, the Notices and the related regulations raise important tax policy issues. The Multinational Tax Coalition has fundamental policy concerns regarding both the positions reflected in the Notices and the manner in which those positions have been implemented.

First, we disagree with the statements made in Notices 98-11 and 98-35 that hybrid branch arrangements "circumvent the purposes of subpart F." The rules of subpart F do not operate to impose U.S. tax currently on all income that is not subject to a certain level of foreign tax. Had the Congress intended to provide such a rule, presumably it would have done so. Instead, the Congress enacted a general deferral regime, and chose to impose U.S. tax currently only on specified types of income. Accordingly, U.S. tax generally is deferred without regard to the level of foreign tax on the income (other than a tax-favorable exception for certain high-taxed income).

As was noted in Notice 98-11, subpart F reflects a balance between various international tax policy objectives. However, the Congress in 1962 gave far more weight to competitiveness concerns in enacting the subpart F rules than is suggested by Treasury and the IRS. Both the House and Senate reports to the 1962 Act cite preservation of the international competitiveness of U.S. business as the major reason for rejecting a proposal at that time to eliminate deferral altogether. Moreover, this emphasis on competitiveness concerns is evidenced by the statutory regime itself, which retains deferral as the general rule rather than the exception.

Indeed, the competitiveness concerns that the Congress focused on in 1962 have only increased over the intervening years. U.S. businesses face far more intense competition around the world than was the case in 1962. With the increasing globalization of the economy, it has become critical for businesses to compete internationally if they wish to remain competitive in their home markets. As discussed in more detail in the following section, many features of the U.S. tax rules operate to hinder the ability of U.S.-based businesses to compete in the global economy; the positions reflected in the Notices only serve as a further impediment to the global competitiveness of U.S. business.

The attack on hybrid branch arrangements in Notices 98-11 and 98-35 is premised on the view that these arrangements somehow undermine the integrity of the U.S. tax system. The Multinational Tax Coalition strongly believes there is nothing inherently abusive about the reduction of foreign taxes as contemplated by applicable foreign law. Indeed, the IRS and the courts have recognized that a reduction of foreign tax is a legitimate business purpose.[4] Moreover, if U.S. multinationals are able to pay less in foreign tax, they will have fewer foreign tax credits to claim and can be expected over the long term to pay more residual U.S. tax on their foreign-source income. Notices 98-11 and 98-35 seem to be aimed at ensuring that U.S. multinationals pay higher foreign taxes than would be permitted under the foreign countries' own tax laws. We are at a loss to understand why it would be in the United States' interest to insist that its multinationals pay more foreign tax than their foreign competitors.

The saga over the U.S. tax treatment of hybrid branch arrangements began in January of 1998 and continues today. Treasury and the IRS thus far have used the administrative route—through Notice and regulations—to address fundamental tax

policy issues. As the Committee noted in the "Sense of the Senate" resolution it approved last April, developments of this magnitude "should be considered by the Congress as part of the normal legislative process." Indeed, even Treasury recognized this with its decision to issue Notice 98-35 withdrawing Notice 98-11 and with its announced intention to undertake a comprehensive reexamination of subpart F. However, in the meantime, considerable uncertainty over these issues remains. And that uncertainty continues to have a significant and detrimental chilling effect on normal business operations. The only way to remove the cloud of uncertainty that has been created in this area is through legislative action.

IV. ECONOMIC ISSUES

In announcing the Committee's March 11, 1999, hearing on international taxation, Chairman Roth identified five specific criteria for reforming the U.S. rules for taxing foreign source income, which are listed in summary fashion, below:

1. Reduce complexity;
2. Promote U.S. exports;
3. Strengthen integrity of the U.S. tax system;
4. Respond to changes in the way business is conducted as a result of new technology; and
5. Promote long-term U.S. competitiveness.

As discussed in the previous section, use of hybrid branches to reduce foreign tax does not threaten the integrity of the U.S. tax system (Criterion 3). Moreover, we also note that Treasury's pronouncements regarding "hybrid" transactions (IRS Notices 98-11 and 98-5) effectively curtail the scope of the "check the box" regulations that Treasury has issued separately with the express purpose of simplifying tax compliance (Criterion 1).

In this section we consider—from an economic standpoint—whether Treasury's approach to hybrid branches is consistent with the Chairman's vision for promoting long-term competitiveness (Criterion 5) and promoting exports (Criterion 2). We also address the revenue implications of hybrid branches.

A. U.S. International Competitiveness

The hybrid branch structures that Treasury has sought to curtail through Notices 98-11 and 9835 are used by U.S. multinationals to reduce their foreign income tax obligations. Such structures, where permitted by applicable foreign law, increase after-tax cash flow, and thus facilitate increased foreign investment and growth in global market share. Moreover, these structures allow U.S. multinationals to compete on a more equal basis with foreign-headquartered multinationals that can reduce foreign taxes without running afoul of home country tax rules. As a result, the policy embodied in Notices 9811 and 98-35 is antithetical to the long-run competitiveness of U.S. multinationals.

Even without Notices 98-11 and 98-35, U.S. multinationals operate under tax rules that frequently put them at a competitive disadvantage in foreign and domestic markets:

- Worldwide vs. territorial tax system: Many of our trading partners do not tax foreign source business income earned by a foreign subsidiary, either by statute or by treaty, under "territorial" tax systems.[5] By contrast, the United States taxes income earned through foreign corporations when it is remitted (or deemed remitted under various anti-deferral rules in the Internal Revenue Code).
- Taxation prior to distribution: Among countries that tax on a worldwide basis, active foreign source business income of a foreign subsidiary generally is not taxed until distributed to a domestic shareholder ("deferral").[6] By contrast, many types of active business income earned abroad by U.S.-controlled foreign subsidiaries are subject to tax in the hands of U.S. shareholders even when reinvested abroad.
- Foreign tax credit restrictions: The United States has an unusually complex and restrictive foreign tax credit system, which limits relief from international double taxation of cross-border income.[7]
- Integration of corporate and shareholder income taxes: Almost all of the major trading partners of the United States provide some form of integration of their corporation and individual income taxes, which reduces or eliminates domestic double taxation of corporate equity income.[8]

The net effect of these anti-competitive tax rules is that a foreign subsidiary of a U.S. corporation frequently pays a greater share of its income in foreign and U.S. tax than a similar foreign subsidiary owned by a company headquartered outside of the United States.[9] This makes it more expensive for U.S. companies to operate abroad than their foreign-based competitors.

A non-competitive international tax regime ultimately will cause a reduction in the global market share of U.S. headquartered companies. From 1960 to 1996, the number of U.S.-headquartered companies among the 20 largest companies in the world (ranked by sales) declined from 18 to 8.[10] While foreign-headquartered companies can operate in the U.S. market without subjecting their foreign activities to the complex and burdensome U.S. international tax system, a U.S.-headquartered company does not have this advantage.[11]

The U.S. tax rules already in place make it difficult for American companies to compete in global markets. Treasury's anti-hybrid initiatives only serve to exacerbate this problem, contrary to the Chairman's goal of promoting long-term U.S. competitiveness. The Treasury anti-hybrid initiatives focus on the use of hybrid branches to reduce foreign taxes; as discussed above, this ability to reduce foreign taxes is important to the ability of U.S. companies to compete in foreign markets.

B. U.S. Exports and Jobs

Some have argued that U.S. investment abroad comes at the expense of exports and thus U.S. jobs. However, the facts do not support this claim; indeed, U.S. multinational corporations play a crucial role in promoting U.S. exports and high-paying U.S. jobs. The most recent Commerce Department data show that U.S. multinationals were responsible for $407 billion of merchandise exports in 1996—65 percent of all U.S. merchandise exports.

Foreign affiliates of U.S. companies promote exports in a variety of ways. First, many foreign affiliates market and distribute U.S. exports. In 1994, 25 percent of all foreign affiliates were primarily involved in wholesale trade.[12] Without on-the-ground marketing and distribution facilities, U.S. companies would be less successful in exporting into foreign markets. Second, foreign manufacturing affiliates of U.S. companies rely heavily on U.S. sources for inputs. Third, due to local content requirements, it is often necessary to have some level of investment in a country in order to gain access for U.S. exports (e.g., the Canadian auto pact). Fourth, foreign acquisitions and joint ventures frequently result in access to new technology that can be used in domestic manufacturing operations.

Academic studies confirm that U.S. investment abroad promotes U.S. exports. For example, Professor Robert Lipsey finds a strong positive relationship between foreign direct investment (FDI) by U.S. multinationals and the level of exports from the U.S. parent company.[13] A recent study based on 14 OECD countries found that "each dollar of outward FDI is associated with $2 of additional exports and with a bilateral trade surplus of $1.7."[14] These studies support the conclusion that if U.S. investment abroad were curtailed, exports would be lower.

While some believe U.S. investment abroad drains jobs and production from the United States, the economic evidence points to the opposite conclusion—U.S. investment abroad increases employment at home.[15] This complementary relationship between the foreign and domestic operations of U.S. multinationals means that U.S. workers need not be harmed by investment abroad.[16] The foreign operations of U.S. companies also are associated with higher wages of domestic workers. Holding constant other factors that affect wages, domestic companies pay domestic workers 5-15 percent less than U.S. multinationals pay their domestic workers; moreover, the wage differential, in percentage terms, is greater for lower-paid production workers than for higher-paid non-production workers.[17] Thus, U.S. multinationals appear to promote a more equal distribution of income by paying higher wage premiums to traditionally lower-paid workers.

The relationship between the ability of U.S. companies to compete abroad and their ability to provide employment opportunities at home was noted by the Council of Economic Advisers in the 1991 Economic Report to the President:

> In most cases, if U.S. multinationals did not establish affiliates abroad to produce for the local market, they would be too distant to have an effective presence in that market. In addition, companies from other countries would either establish such facilities or increase exports to that market. In effect, it is not really possible to sustain exports to such markets in the long run. On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs. Indeed, U.S. direct investment abroad stimulates U.S. companies to be more competitive internationally, which can generate U.S. exports and jobs. Equally important, U.S. direct investment abroad allows U.S. firms to allocate their resources more efficiently, thus creating healthier domestic operations, which, in turn, tend to create jobs.[18]

Treasury's anti-hybrid initiatives would make it even more expensive for American companies to compete abroad, and thus would hinder export promotion and wage growth at home, contrary to the Chairman's policy goals.

C. Capital Mobility and Revenue Effects

Concerns have also been raised that the use of hybrid branch arrangements by U.S. multinationals may adversely affect U.S. tax revenue collections. We believe this concern is unwarranted and that the likely effect of hybrid arrangements rather is to increase U.S. tax collections.

With respect to past equity investments in foreign subsidiaries, any transaction (including a hybrid branch) that reduces foreign income tax cannot adversely affect U.S. tax revenues; indeed, U.S. tax revenues ultimately will increase due to lower foreign tax credits when this income is distributed.

Some have argued that the use of hybrid branch arrangements will increase future foreign investment at the expense of U.S. tax revenues. However, we are unaware of any credible economic analysis supporting this view, and would note the following points.

First, the rate of return on assets invested abroad historically has been higher than the return on assets invested domestically, and these higher returns ultimately will be subject to U.S. tax. The most recent Commerce Department data show that the return on assets (earnings before interest and taxes as a percent of assets) of nonfinancial U.S. majority-owned foreign affiliates was 9.8 percent in 1995 as compared to 7.6 percent for domestic corporations. Moreover, high-profit foreign operations increase domestic share values, thereby boosting capital gains tax revenues when shares are sold.

Second, recent econometric analysis of U.S. multinational corporations by Prof. Jason Cummins and Kevin Hassett supports the view that a reduction in foreign taxes increases worldwide output, which increases employment and investment in the United States.[19] Thus, to the extent the use of hybrid branch arrangements encourages foreign investment by lowering foreign tax burdens—as Treasury contends—there would be an increase in domestic economic activity and associated tax revenues.

Finally, as a practical matter, it is unlikely that the use of hybrid branches has any material effect on the decision by U.S. companies to invest abroad. These arrangements depend on the tax laws in a limited number of foreign countries, which can change their tax rules. Thus, even absent Notices 98-11 and 98-35, it would be foolhardy for a U.S. company to make a long-term investment abroad, rather than at home, based on the foreign tax benefits associated with hybrids.

D. Conclusions

The Multinational Tax Coalition believes the economic evidence strongly supports the following conclusions:

- U.S. investment abroad increases exports and wages at home;
- Imposing limits on the ability of U.S. companies to reduce their foreign tax burdens through the use of hybrid branches ultimately will reduce U.S. tax revenues;
- Imposing limits on the ability of U.S. companies to reduce their foreign tax burdens through the use of hybrid branches will exacerbate the anti-competitive aspects of U.S. international tax rules; and
- Failure to address the complex and burdensome U.S. international tax rules will inevitably cause U.S.-headquartered companies to lose world market share, to the detriment of the U.S. economy.

While America's trade policy is strongly pro-export, our tax policy often inhibits the export of capital—even though foreign direct investment is essential to the export of U.S. merchandise. If a foreign country were to unilaterally reduce its tariff barriers on U.S. exports, U.S. policymakers would rightly applaud such a market opening. By contrast, Treasury frowns upon foreign government policies that allow U.S. capital invested abroad to pay lower foreign taxes through the use of hybrid branch arrangements; indeed, Treasury seeks to impose additional tax on U.S. companies that avail themselves of such foreign income tax relief. Treasury's anti-hybrid policy is akin to imposing a tax on U.S. exports in response to a reduction in foreign tariffs.

V. RECOMMENDATION

As discussed above, the Multinational Tax Coalition believes the positions to be taken by the Treasury Department in regulations to be issued under Notice 98-35 are contrary to sound and longstanding tax policy principles and would impede the ability of U.S. companies to compete in global markets. In the event that Treasury does not rethink these positions, we respectfully would urge the Congress to take legislative action to reverse these initiatives and to prevent these regulations from

taking effect. The Multinational Tax Coalition stands ready to work with the Congress to reach a resolution of these issues.

ENDNOTES

[1] Following the issuance of Notice 98-11, the Administration on February 2, 1998, unveiled in its FY 1999 budget submission a legislative proposal that would have granted Treasury broad authority to issue regulations to address tax avoidance involving use of hybrid entities and transactions that achieve results "inconsistent with the purposes" of U.S. tax law. This proposal was not acted upon by the Congress, and was not re-proposed in the Administration's FY 2000 budget submission.

[2] S. Rpt. 105-174, 105th Cong., 2d Sess., at 110.

[3] Id, at 113-14.

[4] See, e.g., Rev. Rul. 89-101, 1989-2 CB 67, and *Betty M. Ellis v. Commissioner,* 50 T.C.M. 1202 (1985).

[5] As of 1990, half of the 24 member countries of the OECD operated territorial tax systems. Organization for Economic Cooperation and Development, *Taxing Profits in a Global Economy: Domestic and International Issues,* 1991.

[6] Organization for Economic Cooperation and Development, Controlled Foreign Company Legislation, 1996.

[7] Price Waterhouse LLP, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues,* Financial Executives Research Foundation, 1996.

[8] Sijbren Cnossen, *Reform and harmonization of the company tax systems in the European Union,* Research Memorandum 9604, Research Centre for Economic Policy, Erasmus University, Rotterdam, 1996. In announcing the hearing, Chairman Roth specifically queried whether the United States should strive for integration in order to address the long-term competitiveness of U.S. companies.

[9] Organization for Economic Cooperation and Development, *Taxing Profits in a Global Economy:* Domestic and International Issues, 1991.

[10] Hoover's Handbook of World Business, 1998 Edition.

[11] See, John Loffredo, "Testimony before the Senate Finance Committee," March 11, 1999. Mr. Loffredo testified, "DaimlerChrysler Corporation, now a subsidiary of a German company, has minimized the possibility of paying additional tax — on its foreign operations. This should help the operations of the company to continue to compete on a global scale. However, there are many U.S. companies which have foreign operations and they are put at a competitive disadvantage in the global economy, just because they are competing against companies who do not have to follow the way the U.S. tax system taxes foreign operations."

[12] Matthew J. Slaughter, *Global Investments: American Returns,* Emergency Committee on Foreign Trade, 1998.

[13] Robert E. Lipsey, "Outward Direct Investment and the U.S. Economy," in M. Feldstein, J. Hines, Jr., and G. Hubbard (eds.), *The Effects of Taxation on Multinational Corporations,* University of Chicago Press, 1995. See also, Robert E. Lipsey and Merle Weiss, "Foreign Production and Exports in Manufacturing Industries," *Review of Economics and Statistics,* pp. 488-494 and "Foreign Production and Exports of Individual Firms," *Review of Economics and Statistics,* pp. 304-308. See, OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalization, 1998, p. 50.

[15] See, David Riker and Lael Brainard, "U.S. Multinationals and Competition from Low Wage Countries," NBER Working Paper No. 5959, March 1997; and Mathew J. Slaughter, "Production Transfer within Multinational Enterprises and American Wages," mimeo., March 1998.

[16] See, OECD, Open Markets Matter: The Benefits of Trade and Investment Liberalization, 1998, pp. 73-76.

[17] Mark Doms and Bradford Jensen, "Comparing Wages, Skills, and Productivity Between Domestic and Foreign Owned Manufacturing Establishments in the United States," mimeo., October 1996.

[18] U.S. Council of Economic Advisers, Economic Report of the President, 1991, p. 259.

[19] Jason G. Cummins and Kevin Hassett, "Structural Estimates of Factor Substitution from Firm-Level Panel Data on Multinational Corporations," International Tax Policy Forum and American Enterprise Institute, February 19, 1999.

Statement of the National Association of Manufacturers

[Submitted by Michael E. Baroody, Senior Vice President, Policy/Communications & Public Affairs Division]

I. INTRODUCTION

The National Association of Manufacturers (NAM) appreciates this opportunity offered by Chairman Roth to present its views on international taxation and potential reform. The NAM is the nation's largest national broad-based industry trade group. Its 14,000 member companies and subsidiaries, including approximately 10,000 small manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. The NAM has long advocated international tax simplification, which would greatly improve the international competitiveness of U.S. manufacturers and the U.S. economy overall.

The NAM thanks the Senate Finance Committee for scheduling these hearings. Although there are many opportunities to improve the international provisions of the Internal Revenue Code (IRC), we have been asked to confine our discussion to the following two areas: (1) accelerating the effective date of the 10/50 company changes included in the 1997 Tax Relief Act and (2) combating continuing Administration efforts to limit the ability of U.S. multinationals to earn foreign tax credits for taxes paid to foreign governments on oil and gas income.

II. ACCELERATING THE EFFECTIVE DATE OF 10/50 COMPANY CHANGES

Until 1997, a separate foreign tax credit (FTC) limitation (i.e., a separate "basket") was required to be computed for dividends received from each "noncontrolled Section 902 corporation." A "noncontrolled Section 902 corporation" is a foreign corporation that satisfies the stock ownership requirements of IRC section 902(a), yet is not a controlled foreign corporation (CFC) under IRC section 957(a). More simply stated, these are companies in which U.S. shareholders own at least 10, but no more than 50, percent of the foreign corporation, hence the name "10/50 company."

This rule imposed a tremendous compliance burden on multinationals by requiring extensive, separate bookkeeping. Additionally, it severely constrained the ability of U.S.-based multinationals to use their FTCs in the most efficient manner to alleviate double taxation. Only foreign taxes directly associated with a 10/50 company's dividends could be credited against the U.S. tax on that 10/50 company's income, i.e., excess FTCs from other sources could not offset FTC shortfalls of 10/50 companies, and excess FTCs generated by 10/50 companies could not offset shortages incurred by other companies, even other 10/50 companies. This is a deviation from the general rules, which allow "look-through" treatment, as in the case of CFC dividends. Furthermore, there is no tax accounting or policy reason for differentiating between income earned by noncontrolled corporations versus CFCs.

Look-through rules allow dividend income to be recharacterized in accordance with the underlying sources of the payor corporation's income. Thus, dividends associated with overall limitation income would be eligible for inclusion in the overall limitation income basket. Under the rules in place before 1998, however, taxpayers were not allowed to "look-through" dividends received from 10/50 companies, even though 10/50 company dividends are generally derived from overall limitation income and would otherwise be eligible for inclusion in the overall limitation income basket under the look-through rules.

The 1997 Tax Relief Act corrected this inequity by eliminating separate baskets for 10/50 companies. Instead, 10/50 companies are treated just like CFCs, and taxpayers can utilize look-through rules for recharacterizing dividend income in accordance with the underlying sources of the payor corporation's income. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits (E&P) generated before the year 2003, and dividends from E&P accumulated after the year 2002.

The ongoing requirement to use two sets of rules on dividends before the year 2003 has been a concern of taxpayers, members of Congress, and the Administration. Thus, to address the complexity created by this much-delayed effective date, the Administration has, as part of both its FY1999 and FY2000 budget proposals, recommended accelerating the effective date of the 1997 Tax Act change. The proposal would apply the look-through rules to all dividends received in tax years after 1998, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change would result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ven-

tures. It would also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. Finally, this proposal epitomizes the favored policy goal of simplicity in the tax laws and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S.-based multinationals.

III. TAXES ON FOREIGN OIL AND GAS INCOME

In order to adequately and fairly protect against double taxation of foreign source income, the tax law must contain the general principle of allowing a full, effective foreign tax credit. To help accomplish this, the complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated. In at least one area, however, the Administration's budget moves in the opposite direction. One such proposal would limit the ability of U.S.-based multinationals to earn and use foreign tax credits (FTCs) for taxes paid to foreign governments on oil and gas income.

This selective attack on a single industry's ability to alleviate double taxation is not justified. U.S.-based oil companies are already at a competitive disadvantage under current law since most of their foreign-based competition pay little or no home country tax on foreign oil and gas income. The proposal would increase the risk of such income being subject to double taxation, which would severely hinder U.S. companies in the global oil and gas exploration, production, refining and marketing arenas.

Under the Administration's proposal, all foreign oil and gas income (FOGI) would be trapped in a new, separate FOGI basket under IRC section 904(d). In addition, the proposal provides that in those situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country (so-called "dual capacity taxpayers"), such taxpayers would be able to claim a credit for foreign taxes under IRC section 902 only if the foreign country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under that generally applicable income tax.

The Administration's proposal would further tilt the playing field against the U.S. petroleum industry's foreign exploration and production efforts and would increase (or make prohibitive) the U.S. tax burden on foreign petroleum industry operations. In short, it would both chill new investment in foreign exploration and production projects and unfairly change the economics of past investments.

Foreign tax credits are the bedrock mechanism to ensure that the foreign source income of U.S.-based multinationals is not double taxed under the U.S. system of taxation based on worldwide income. While this particular proposal is aimed only at the oil and gas industry, the NAM is gravely concerned that it would set a precedent for eroding general tax fairness principles on an industry-by-industry basis. Such a trend would not only be bad tax policy, but would result in broader, deleterious economic consequences for the manufacturing sector as a whole.

IV. CONCLUSION

Complex U.S. tax laws governing foreign source income place multiple, overlapping tax burdens on income earned from overseas sales and investment. With only 4 percent of the world's population located in the United States, access to foreign markets is crucial to the success of U.S.-based companies and to the growth of the U.S. economy. To this end, our trade and tax policy must be in concert. Freer trade through increased treaty relationships and elimination of trade barriers on the one hand must be combined with sensible tax policy on the other. Whenever commercial activities take place across sovereign borders, the income generated is at risk of coming under the taxing jurisdiction of two or more countries. If every such country had an unmitigated right to tax this income, little or nothing would be left for those engaging in the commerce, and such commerce would severely decline. Many countries recognize the need to avoid double taxation by taxing only income earned within their borders (territorial system). Some countries, such as the United States, choose to tax the worldwide income of their citizens. In these countries, mechanisms such as foreign tax credits and deferral are designed to eliminate duplicative taxation. Over the years, however, these basic principles have been eroded in a variety of ways, such as by creating a multitude of separate foreign tax-credit baskets and restricting or eliminating deferral in certain circumstances or for certain industries. It is only through full restoration of these basic principles that we can ensure avoidance of double taxation of U.S.-based companies. Attention to the two issues discussed above would be a good start.

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

[SUBMITTED BY FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY]

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is appreciative of the opportunity to present its views on the impact on international competitiveness of certain of the foreign provisions of the Internal Revenue Code of the United States.

The NFTC is an association of businesses with some 550 members, originally founded in 1914 with the support of President Woodrow Wilson and 341 business leaders from across the U.S. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. International tax reform is, of course, of substantial interest to NFTC's membership.

The founding of the Council was in recognition of the growing importance of foreign trade and investment to the health of the national economy. Since that time, expanding U.S. foreign trade and investment, and incorporating the United States into an increasingly integrated world economy, has become an even more vital concern of our nation's leaders. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Even this fact in and of itself does not convey the full importance of exports to our economy and to American-based jobs, because it does not address the additional fact that many of our smaller and medium-sized businesses do not consider themselves to be exporters although much of their product is supplied as inventory or components to other U.S.-based companies who do export. Foreign trade is fundamental to our economic growth and our future standard of living. Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets.

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit.

There is general agreement that the U.S. rules for taxing international income are unduly complex, and in many cases, quite unfair. Even before this hearing was announced, a consensus has emerged among our members conducting business abroad that legislation is required to rationalize and simplify the international tax provisions of the U.S. tax laws. For that reason alone, this effort by the Senate, which focuses the spotlight on U.S. international tax policy, is valuable and should be applauded.

FUNDAMENTAL CHANGES IN THE ECONOMIC UNDERPINNINGS OF OUR INTERNATIONAL TAX SYSTEM

The compromise embodied in a significant portion of our present international tax system was shaped in the global economic environment of the early 1960s a world economy that has changed almost beyond recognition as the 20th century draws to a close. Because economic arguments advanced against the backdrop of the 1962 economy are the foundation upon which subpart F was erected, the balance that was struck in 1962 may no longer be appropriate. The same is true for other provisions of our international tax system that were constructed with far different bases in mind.

We highlight below five areas that have witnessed the most conspicuous changes in the global economy in recent decades, and note some of the ramifications of these changes for U.S. international tax policy in the 21st century.

Cross-Border Direct Investment

In the 1960s, the United States accounted for more than 50 percent of cross-border direct investment. By the mid-1990s, that share had dropped to about 25 percent. Similarly, of the world's 20 largest corporations (ranked by sales), 18 were U.S.-headquartered in 1960. By the mid-1990s, that number had dropped to eight. The 21,000 foreign affiliates of U.S. multinationals now compete with about 260,000 foreign affiliates of multinationals headquartered in other nations.[1] The declining dominance of U.S.-headquartered multinationals is dramatically illustrated by the recent acquisitions of Amoco by British Petroleum and the acquisition of Chrysler

by Daimler-Benz. These two mergers have the effect of converting U.S. multinationals to foreign-headquartered companies.

Ironically, despite the decline of U.S. dominance of world markets, the U.S. economy is far more dependent on foreign direct investment than ever before. In the 1960s, foreign operations averaged just 7.5 percent of U.S. corporate net income. By contrast, over the 1990-97 period, foreign earnings represented 17.7 percent of all U.S. corporate net income.

At the end of the 20th century, tax policymakers confront an economy in which U.S. multinationals face far greater competition in global markets, yet rely on these markets for a much larger share of profits and sales, than was the case when subpart F was adopted in 1962. In light of these changed circumstances, the effects of tax policy on the competitiveness of U.S. companies operating abroad is potentially of far greater consequence today than was the case in 1962.

The U.S. Market

In 1962, U.S. companies focused their manufacturing and marketing strategies in the United States, which at the time was the largest consumer market in the world. U.S. companies generally could achieve economies of scale and rapid growth selling exclusively into the domestic market. In the early 1960s, foreign competition in U.S. markets generally was inconsequential.

The current picture is completely different. First, U.S. companies now face strong competition at home. Since 1980, the stock of foreign direct investment into the United States has increased by a factor of six (from $126 billion to $752 billion in 1997), and imports have tripled as a share of GDP from an average of 3.2 percent in the 1960s to an average of over 9.6 percent over the 1990-97 period.

Second, foreign markets frequently offer greater growth opportunities than the domestic market. For example, from 1986 to 1997, foreign sales of S&P 500 companies grew 10 percent a year, compared to domestic sales growth of just 3 percent annually.[2]

From the perspective of the 1960s, there was little apparent reason for U.S. companies to direct resources to penetrating foreign markets, since U.S. companies could achieve growth and profit levels that were the envy of their competitors with minimal foreign operations. By contrast, in today's economy, competitive success requires U.S. companies to execute global marketing and manufacturing strategies with the result that provisions of our system that view foreign operations as presumptively tax-motivated have become increasingly outmoded.

International Trade

Over the last three decades, the U.S. share of the world's export market has declined. In 1960, one of every six dollars of world exports originated from the United States. By 1996, the United States supplied only one of every nine dollars of world export sales. Despite a 30 percent loss in world export market share, the U.S. economy now depends on exports to a much greater degree. During the 1960s, only 3.2 percent of national income was attributable to exports, compared to 7.5 percent over the 1990-97 period.

Foreign subsidiaries of U.S. companies play a critical role in boosting U.S. exports by marketing, distributing, and finishing U.S. products in foreign markets. U.S. Commerce Department data show that in 1996 U.S. multinational companies were involved in 65 percent of all U.S. merchandise export sales.[3]

In the 1960s, the foreign operations of U.S. companies were sometimes viewed as disconnected from the U.S. economy or, worse, as competing with domestic production and jobs. In today's highly integrated global economy, economic evidence points to a positive correlation between U.S. investment abroad and U.S. exports.

Foreign Portfolio Investment

In 1962, policymakers would scarcely have taken note of cross-border flows of portfolio investment. As recently as 1980, U.S. portfolio investment in foreign private sector securities amounted to only $62 billion 85 percent less than U.S. direct investment abroad. By 1997, U.S. portfolio investment abroad had increased over 2,200 percent to $1.4 trillion 40 percent more than U.S. direct investment abroad. Similarly, foreign portfolio investment in U.S. private securities increased over 2,300 percent from $90 billion in 1980 to over $2.2 trillion in 1997.

The Kennedy Administration's 1962 proposal to tax currently U.S. CFCs' income was motivated in large part by a desire to ensure that foreign direct investment not flow offshore for tax reasons. At the time, U.S. direct investment abroad exceeded private portfolio investment by a factor of 6.5 to 1. It is, therefore, not surprising that the Administration focused much of its attention on the taxation of direct investment abroad in 1962.

In the current economic environment, however, it is far from clear that imposing current U.S. tax on U.S. CFCs is necessary or sufficient to achieve an efficient worldwide allocation of investment.[4] If foreign subsidiaries fund incremental investment through securities sold to portfolio investors, then efficiency in the allocation of capital rests on the taxation of portfolio investment.

Market Integration

The liberalization of and investment climates around the world has contributed to the explosive pace of economic integration. An alphabet soup of regional trade agreements (NAFTA, ASEAN, etc.) has complemented the original multilateral agreement, GATT. Accompanying these trade agreements are hundreds of bilateral investment treaties (BITs) that reduce barriers to foreign direct investment flows. UNCTAD reports that there was a three-fold increase in BITs in the five years to 1997.[5]

A consequence of market integration is that U.S. companies and their foreign competitors increasingly do not view their businesses as operating in separate country markets, but rather in regional markets where national boundaries often have little economic significance. In this environment, the distinctions in subpart F between economic activities conducted within and outside a foreign subsidiary's country of incorporation have in many cases become artificial. When there is a high degree of economic integration between national markets, tax rules that treat these markets separately are as arbitrary as distinctions between a company's transactions with customers in different cities in the same country.

Conclusions on Global Economic Changes

In the decades since subpart F was enacted in 1962, the global economy has grown more rapidly than the U.S. economy. By almost every measure income, exports, or cross-border investment the United States today represents a smaller share of the global market. At the same time, U.S. companies have become increasingly dependent on foreign markets for continued growth and prosperity. Over the last three decades, sales and income from foreign subsidiaries have increased much more rapidly than sales and income from domestic operations. To compete successfully both at home and abroad, U.S. companies have adopted global sourcing and distribution channels, as have their competitors.

Accordingly, with a U.S. economy that is now less dominant in foreign markets, but at the same time more dependent on those markets, U.S. international tax rules that are out of step with those of other major industrial countries are more likely to hamper the competitiveness of U.S. multinationals than was the case in the 1960s. The growing economic integration among nations especially the formation of common markets and free trade areas raises questions about the appropriateness of U.S. tax rules regarding "base" companies that transact business across national borders with affiliates. Finally, the eclipsing of foreign direct investment by portfolio investment calls into question the importance of tax policy focused on foreign direct investment for purposes of achieving an efficient global allocation of capital.

THE COUNCIL BELIEVES THAT WE MUST RE-EVALUATE CURRENT INTERNATIONAL TAX POLICIES

The foreign competition faced by U.S.-based companies has intensified as the globalization of business has accelerated. At the same time, U.S.-based multinationals increasingly voice their conviction that the Internal Revenue Code places them at a competitive disadvantage in relation to multinationals based in other countries. In 1997, the NFTC launched an international tax policy review project, at least partly in response to this growing chorus of concern. The project is presently divided into two parts, the first dealing with the United States' anti-deferral regime, subpart F, the second dealing with the foreign tax credit. The two parts are in turn divided into two phases. In both, an analytical report examining the legal, economic and tax policy aspects of the U.S. rules will be followed by legislative and policy recommendations based on the analytical report. Our present testimony is in part based upon the findings described in our report from this first phase of the part dealing with subpart F.

The NFTC is concerned that this and previous Administrations, as well as previous Congresses, have often turned to the international provisions of the Internal Revenue Code to find revenues to fund domestic priorities, in spite of the pernicious effects of such changes on the competitiveness of United States businesses in world markets. The Council is further concerned that such initiatives may have resulted in satisfaction of other short-term goals to the serious detriment of longer-term growth of the U.S. economy and U.S. jobs through foreign trade policies long consistent in both Republican and Democratic Administrations, including the present one.

The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many other nations upon their companies. Some of these differences, noted in the sections that follow, may make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:

The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally are less complex and provide for "deferral"[6] subject to less significant limitations under their tax statutes or treaties than their U.S. counterparts. Importantly, many of our trading partners have systems that more closely approximate "territorial" systems of taxation.

The United States has more complex rules for the limitation of "deferral" than any other major industrialized country. In particular, we have determined that: (1) the economic policy justification for the current structure of subpart F has been substantially eroded by the growth of a global economy; (2) the breadth of subpart F exceeds the international norms for such rules, adversely affecting the competitiveness of U.S.-based companies; and (3) the application of subpart F to various categories of income that arise in the course of active foreign business operations should be substantially narrowed.

The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex.

The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In many cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation. We further address one of the more significant anomalies, that of the allocation and apportionment of interest expense, later in this testimony.

The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies—in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.

As noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country.

That result is not without some merit. The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government—traits which may lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system may simply be ahead of development along similar lines in other countries—many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on.

With this thought preliminarily in mind, we studied the anti-deferral regimes of Canada, France, Germany, Japan, the Netherlands, and the United Kingdom and compared them in significant respects with that of the United States. (We are presently making a similar study of the foreign tax credit systems of our trading partners.) These countries were selected because they constitute, together with the United States, the home countries of the bulk of the largest corporations in the

world (412 out of the top 500). Thus, corporations based in these countries tend to be the most significant competitors of U.S. companies that conduct business abroad. The comparison focused on the application of each country's rules to specific categories of income:

Active financial services income;

Receipt by an active CFC of dividends from an active CFC in another country;

Receipt by a holding company CFC of dividends from an active CFC in another country;

Receipt by an active CFC of interest from an active CFC in another country;

Receipt by a holding company CFC of interest from an active CFC in another country;

Receipt by an active CFC of royalty payments from a CFC in another country;

Receipt by a holding company CFC of royalty payments from a CFC in another country;

Oil related income;

Sales income from property purchased from related parties in another country and sold to unrelated parties in another country;

Sales income from property purchased from related parties in another country and sold to related parties in another country;

Services income performed for a related party outside the country of incorporation; and

Investment in home country property.

Most of the compared jurisdictions have complex anti-deferral regimes. Some have regimes that, in many ways, mimic the U.S. rules. In virtually every scenario considered, however, the U.S. imposed the severest regime, although in a few scenarios a minority of the other countries might impose a comparable rule. The French rules were found to be closest to the U.S. rules, although they too were narrower in several respects. However, the rules of the other countries were all narrower than the U.S. rules in significant respects. This comparison is important not because it implies that the United States should join a "race to the bottom" but because it demonstrates that the rest of the developed world has not joined in a "race to the top."

U.S. government officials have increasingly criticized suggestions that U.S. taxation of international business be relaxed. Their criticism either directly or implicitly accuses proponents of such relaxation of advocating an unwarranted reaction to "harmful tax competition," by joining a race to the bottom. The idea, of course, is that any deviation from the U.S. model indicates that the government concerned has yielded to powerful business interests and has enacted tax laws that are intended to provide its home-country based multinationals a competitive advantage. It is seldom, if ever, acknowledged that the less stringent rules of other countries might reflect a more reasonable balance of the rival policy concerns of neutrality and competitiveness. U.S. officials seem to infer from the comparisons that what is being advocated is that the United States should adopt the lowest common denominator so as to provide U.S. businesses a competitive advantage. Officials contend this is a "slippery slope" since foreign governments will respond with further relaxations until each jurisdiction has reached the "bottom."

The inference is unwarranted. The CFC regimes enacted by these countries all were enacted in response to and after several years of scrutiny of the United States' subpart F regime. They reflect a careful study of the impact of subpart F and, in every case, embody some substantial refinements of the U.S. rules. Each regime has been in place for a number of years, giving the government concerned time to study its operation and conclude whether the regime is either too harsh or too liberal. While each jurisdiction has approached CFC issues somewhat differently, as noted, each has adopted a regime that, in at least some important respects, is less harsh than the United States' subpart F rules. The proper inference to draw from the comparison is that the United States has tried to lead and, while many have followed, none has followed quite as far as the United States has gone. A relaxation of subpart F to the highest common denominator among other countries' CFC regimes would help redress the competitive imbalance created by subpart F without contributing to a race to the bottom.

The reluctance of others to follow the U.S. may in part also be attributable to recognition that the U.S. system has required very significant compliance costs of both taxpayer and the Internal Revenue Service, particularly in the international area where the costs of compliance burdens are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of international income by other countries.[7] Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.[8] Lower compliance costs and simpler sys-

tems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their American counterparts.

Short of fundamental reform—a reform in which the United States federal income tax system is eliminated in favor of some other sort of system—there are many aspects of the current system that could be reformed and greatly improved. These reforms could significantly lower the cost of capital, the cost of administration, and therefore the cost of doing business for U.S.-based firms. For example, the NFTC strongly supported the International Tax Simplification for American Competitiveness Act of 1998, S. 2231 (105th Cong., 2nd Sess.), introduced by Mr. Hatch (R-UT), Mr. Mack (R-FL), and Mr. Baucus (D-MT) of this Committee. The NFTC continues to support similar efforts in the 106th Congress.

The NFTC is prepared to make recommendations for broader reforms of the Code to address the anomalies and problems noted in our review of the U.S. international tax system, and would enjoy the opportunity to do so.

Against this background, the NFTC would also address two other areas that illustrate problems with significant impact on our members, that of the allocation and apportionment of interest expense in the determination of the foreign tax credit; and (2) repeal of Code Section 907, which adds unnecessary complexity and imposes undue administrative hardships on oil companies.

Allocation of Interest Expense

Prior to January 3, 1977, when Treasury issued its final Regulation § 1.861-8, there essentially was no requirement to allocate and apportion U.S. interest expense to foreign-sourced income. Moreover, even under these 1977 regulations, opportunities were available to minimize the impact of interest allocation. For example, interest could be allocated on a separate company basis. Thus, corporate structures could be organized so that U.S. debt could be carried only by companies in an affiliated group that had domestic source income, eliminating any allocation of interest to foreign sourced income.

The 1986 Tax Reform Act required that allocation of interest now be made on a consolidated group basis. It also eliminated the optional gross income method for allocating interest, and required that earnings and profits of more than ten percent owned subsidiaries be added to their stock bases for purposes of allocating interest under the asset-tax basis method. Also in 1986, while advancing the concept of "fungibility," Congress nevertheless failed to allow an offset for interest expense incurred by foreign affiliates. Although such a "worldwide fungibility" provision was included in the Senate-passed version of the bill in 1986, it was dropped in Conference. Similarly, a subgroup/tracing exception approved by the Senate was also dropped from the final 1986 Act. While these fungibility and subgroup/tracing provisions have appeared in later tax bills (see e.g., H.R. 2948 ("Gradison Bill") introduced in 1991 and H.R. 5270 ("Rostenkowski Bill") introduced in 1992), they have never been enacted.

The NFTC strongly suggests that Congress fix the inequitable interest allocation rules currently existing in the law. They are extremely costly and particularly anticompetitive for multinational corporations. By failing to take into account borrowings of foreign affiliates, the law results in a double allocation of interest expense. Moreover, these rules operate to impede a U.S. corporation's ability to utilize the foreign tax credit for purposes of mitigating double taxation. It is simply unfair that U.S. multinationals with U.S. subsidiaries operating solely in the U.S. market, where the subsidiary incurs its debt on the basis of its own credit, must nevertheless allocate part of that interest expense against wholly unrelated foreign generated income.

One solution, of course, is simply to reinstate and codify the pre-1986 Act interest allocation rules permitting interest expense to be allocated on a separate company basis. However, due to the strong criticism of the rules in 1986, this approach is unlikely to succeed. We, therefore, suggest an alternative approach of advancing the provisions that were passed by the Senate in connection with the 1986 Act. Recall that under the earlier Senate version, interest expense of foreign affiliates would be added to the total interest expense "pot" to be allocated among all affiliates. Thus, this approach allows adoption of the "worldwide fungibility" concept of allocating interest, as opposed to the "water's edge" approach of current law. We also suggest the inclusion of an elective "subgroup" or tracing rule that allows interest expense to be allocated based on a subgroup consisting of only the borrower and its direct and indirect subsidiaries. This approach allows interest that should be specifically allocated to a particular domestic operation to remain identified with such operation, a much more equitable approach than under current law.

Repeal of Code Section 907

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the foreign tax credit ("FTC") was introduced in 1918. As the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC is intended to prevent the same income from being taxed twice. The FTC is designed to allow a dollar for dollar offset against U.S. tax for income taxes paid to foreign taxing jurisdictions. Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (other than certain "passive" or "subpart F" income). Any foreign income taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10 percent of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

As a result of the 1986 Tax Reform Act, the overall limitation is computed separately for various "separate limitation categories." These categories or "baskets" include, in addition to a general limitation income basket, separate baskets for passive income, high withholding tax interest, financial services income, shipping income, income from each noncontrolled section 902 company (i.e., so-called "10/50 companies"), dividends from DISCs, distributions from FSCs, among others. Thus, separate special limitations have been imposed for income: (1) whose foreign source can be manipulated; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, the separate limitation categories prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

Present law treats Foreign Oil and Gas Extraction Income ("FOGEI") and Foreign Oil Related Income ("FORI") as generally falling into the general limitation income category. FOGEI is defined as income derived outside the U.S. from the extraction of minerals from oil or gas wells, or the sale or exchange of assets used by a taxpayer in such a business. FORI is defined as the refining or processing of extracted oil or gas into their primary products, the transportation and distribution of such products, and the sale of assets used in those activities. See section 907(c)(1) & (2). For purposes of computing the overall limitation, FOGEI and FORI are generally treated like any other foreign active business income (absent other limitations such as section 907).

An additional separate limitation on FOGEI is imposed under section 907. This limitation restricts the cross crediting of FOGEI credits against tax on FORI or other non-FOGEI types of income. When section 907 was originally enacted in 1975, Congress was concerned that oil industry taxpayers were paying amounts to foreign governments that were ostensibly "taxes" but were in reality "disguised royalties." The issue arose from the fact that, in foreign countries, the sovereign usually retains the right to its natural resources in the ground. Thus, a major concern was whether payments made to foreign governments were for grants of specific economic benefits, versus general taxes. Congress wanted to limit the FTC to that amount of the "government take" which was perceived to be a tax payment, and not a royalty. Moreover, Congress was concerned about the development of high tax rate regimes by "OPEC," since these tax rates were often greatly in excess of the U.S. income tax rate. Thus, once the tax component was identified, Congress wanted to prevent oil companies from using excess FOGEI credits to shield U.S. tax on certain low-taxed "other" income, such as passive income or shipping income.

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries typically vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly, or through a state owned enterprise (e.g., a license or a production sharing contract). Because of this apparent direct or indirect economic identity of "taxing sovereign" and "grantor of mineral exploitation rights," the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "specific economic benefits" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department developed the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, are considered royalties). The regula-

tions also include a "safe harbor" election (see Treas. Reg. § 1.901-2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

Congress has repeatedly attempted to address the issue of "tax versus royalty" in legislative proposals from 1969 through 1979 through various rate reductions. However, once these dual capacity taxpayers regulations were finalized in 1983, the issue appears to have been resolved as evidenced by Congress' lack of further legislative proposals. Thus, since the genesis of section 907 was an attempt to limit creditability for oil and gas taxes to the tax element of payments to the host countries, and since the dual capacity taxpayer regulations now provide an adequate safeguard in limiting the creditability of such taxes, there is no reason to retain section 907 in the Internal Revenue Code.

In summary, any prior concerns by Treasury or Congress that petroleum companies were generating FTCS for payments that are in reality "disguised royalties" have been adequately addressed in subsequent legislation or rulemaking. First, as a result of Treasury Decision 7918, 1983-2 C.B. 113, the so-called "dual capacity taxpayer" regulations have been in effect and working smoothly for over 15 years, allowing taxpayers (and the IRS) to determine how to separate payments to foreign governments into their income tax element and "specific economic benefit" element. See Treas. Reg. § 1.901-2A. Second, the 1986 Tax Act fragmented foreign source income into various FTC "baskets," restricting taxpayers from offsetting excess FTCs from high-taxed FOGEI against taxes from low-taxed categories of income, such as passive or shipping income.

Moreover, compliance with the rules under section 907 is extremely complicated and time consuming for both taxpayers and the IRS. Distinctions must be made as to various items of income and expense to determine whether they properly fall under the FOGEI category or the FORI category. Painstaking efforts are often needed to categorize and properly account for thousands of income and expense items, which must then be explained to IRS agents upon audit. Ironically, such efforts typically result in no or little net tax liability changes, since most oil companies have, for years, had excess FTCs to offset both their FOGEI and FORI income categories. As a result, oil industry taxpayers, which already must deal with depressed world oil prices, also must incur large administrative costs to comply with a section of the Code that results in little or no revenue to the Treasury.

Finally, section 907 clearly increases the cost for U.S. companies of participating in foreign oil and gas development. Ultimately, this will adversely affect U.S. employment by hindering U.S. companies in their competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. The loss of any major foreign project to a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations. By contrast, foreign oil and gas development by U.S. companies assures utilization of U.S. supplies of hardware and technology, ultimately resulting in increased U.S. job opportunities.

IN CONCLUSION

In particular, our study has led us so far to four broad conclusions:

U.S.-based companies are now far less dominant in global markets, and hence more adversely affected by the competitive disadvantage of incurring current home-country taxes with respect to income that, in the hands of a non-U.S. based competitor, is subject only to local taxation; and

U.S.-based companies are more dependent on global markets for a significant share of their sales and profits, and hence have plentiful non-tax reasons for establishing foreign operations.

Changes in U.S. tax law in recent decades have on balance increased the taxation of foreign income.

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit.

These two incompatible trends decreasing U.S. dominance in global markets set against increasing U.S. taxation of foreign income are not claimed by us to have any necessary causal relation. However, they strongly suggest that we must re-evaluate the balance of policies that underlie our international tax system.

Again, the Council applauds the Chairman and the Members of the Committee for beginning the process of reconsideration of the international tax system of the United States. These tax provisions significantly affect the national welfare, and we believe the Congress should undertake careful modification of them in ways that will enhance the participation of the United States in the global economy of the 21st Century. We would enjoy the opportunity to work with you and the Committee in further defining both the problems and potential solutions. The NFTC would hope to make a contribution to this important business of the Committee.

ENDNOTES

[1] UNCTAD, World Investment Report (1997).
[2] U.S. Firms Global Progress is Two-Edged, Wall Street Journal, August 17, 1998.
[3] U.S. Bureau of Economic Analysis, Survey of Current Business (September, 1998).
[4] See Daniel J. Frisch, The Economics of International Tax Policy: Some Old and New Approaches, Tax Notes (April 30, 1990); Gary C. Hufbauer, Taxation of International Income: Blueprint for Reform, (Institute for International Economics, 1992). See also R. Glenn Hubbard, U.S. Tax Policy and Foreign Direct Investment: Incentives, Problems, and Reform, in Tax Policy and Economic Growth (American Council for Capital Formation, 1995), for a further discussion of this view.
[5] UNCTAD, World Investment Report (1997).
[6] The foreign income of a foreign corporation is not ordinarily subject to U.S. taxation, since the United States has neither a residence nor a source basis for imposing tax. This applies generally to any foreign corporation, whether it is foreign-owned or U.S.-owned. This means that in the case of a U.S.-controlled foreign corporation (CFC), U.S. tax is normally imposed only when the CFC's foreign earnings are repatriated to the U.S. owners, typically in the form of a dividend. However, subpart F of the Code alters these general rules to accelerate the imposition of U.S. tax with respect to various categories of income earned by CFCs. It is common usage in international tax circles to refer to the normal treatment of CFC income as "deferral" of U.S. tax, and to refer to the operation of subpart F as "denying the benefit of deferral." However, given the general jurisdictional principles that underlie the operation of the U.S. rules, we view that usage as somewhat inaccurate, since it could be read to imply that U.S. tax "should" have been imposed currently in some normative sense. Given that the normative rule imposes no U.S. tax on the foreign income of a foreign person, we believe that subpart F can more accurately be referred to as "accelerating" a tax that would not be imposed until a later date under normal rules.
[7] See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," in National Tax Policy in an International Economy: Summary of Conference Papers, (International Tax Policy Forum: Washington, D.C., 1994).
[8] Id.

STATEMENT OF NEU HOLDINGS CORP.

[SUBMITTED BY RICHARD W. NEU]

We appreciate your efforts to examine the international tax policy of the United States and its impact on the competitiveness of the U.S. economy. Your leadership on this challenging issue is welcomed by those U.S. industries that compete internationally.

General Ore International Corporation Limited (GOIC Ltd.) is one of the largest American-controlled industrial shippers of iron ore and liquid petroleum products in world markets, and it is one of the last corporations, privately-owned by U.S. citizens, that operates foreign-flag vessels. Nevertheless, GOIC Ltd. is a very small operator compared to its international competitors.

Our continued success is dependent upon our ability to compete fairly and openly in the international market. However, burdensome U.S. tax policies have hindered our ability to compete. Shipping income earned by GOIC Ltd. is subject to taxation under Subpart F of the Internal Revenue Code whether or not that income is reinvested in the business.

Subpart F, enacted in 1962, imposes taxes on certain U.S.-owned businesses operating abroad that are more onerous than if those businesses were operating in the United States. As originally enacted, U.S.-controlled foreign shipping companies were not subject to Subpart F and were taxed no differently than their competi-

tors—their earnings were not taxed until they were repatriated. In 1975 this changed. Congress amended Subpart F to limit the deferral of foreign-flag shipping income so that income not reinvested into shipping operations was taxed currently. As a result, the industry and the tax revenues it produced began to decline.

In 1986, Congress eliminated the deferral for reinvested income. Now the income from the U.S.-controlled foreign fleet is subject to U.S. tax whether or not those revenues are actually realized. This places companies like ours at a competitive disadvantage relative to our competitors, which are not subject to these taxes. Further, the United States cannot compete effectively in international markets with its major trading partners that have adopted tax policies and incentives to support their international shipping industries and, through them, their exports.

Extending Subpart F to shipping income has devastated the U.S.-controlled foreign shipping industry. Before 1975, U.S.-owned foreign-flag shipping companies controlled 25 percent of the world's fleet. Because of the tax burdens imposed by Subpart F, that number has declined to less than 5 percent today. This anti-competitive tax regime has reduced new ship acquisition, and it has resulted in U.S. owners becoming minority owners in the vessels they once owned and operated.

The U.S. government has gained nothing from extending Subpart F to shipping income. While the tax imposed upon this industry was originally designed to generate revenues, it has cost the U.S. Treasury millions of dollars. Shipping industry tax revenues have decreased from approximately $90 million a year before 1975 ($250 million in today's dollars) to less than $50 million today. See enclosed analysis by KPMG Company. In addition, U.S. national security is eroding with the declining sealift capability.

Recently, legislation has been introduced in the House of Representatives by Congressman Clay Shaw (R-FL) that would exclude shipping income from Subpart F. The bill encourages growth in the U.S.-controlled fleet and restores the ability of U.S. citizens to be active competitors in the global market. Under the proposed legislation, taxes would be deferred, not exempted, and would eventually be paid into the U.S. Treasury when repatriated.

We encourage the Finance Committee to hold a hearing that focuses on taxation of the international shipping industry and to consider introducing legislation similar to the House bill. We urge you to level the playing field and allow U.S.-controlled enterprises to once again be viable competitors in the international market.

The United States must take action to restore its competitive opportunities with its foreign trading partners. Without immediate action, the United States risks losing the few remaining U.S.-controlled shipping companies to countries whose tax laws are more favorable. We look forward to working with you and the Finance Committee to address this very important issue.

Thank you for your attention to this matter.

Attachment.

ESTIMATED REVENUE EFFECT OF RESTORING THE EXCLUSION FOR NON-OIL RELATED SHIPPING INCOME FROM SUBPART F

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ESTIMATED REVENUE EFFECT OF RESTORING THE EXCLUSION FOR NON-OIL RELATED SHIPPING INCOME FROM SUBPART F

Since 1975, changes in the tax treatment of shipping income earned by controlled foreign corporations ("CFCs") of U.S. parent corporations have increased the tax burden imposed on shipping income. In consequence, the number of ships and tonnage owned by CFCs has declined. The increased tax burden results from treating CFC shipping income as foreign base company income under subpart F of the Internal Revenue Code.

Barents Group LLC of KPMG Peat Marwick LLP was asked to estimate the federal revenue impact of a legislative proposal that would restore the exclusion for non-oil related shipping income from subpart F. In preparing this study, we have collected data regarding industry trends that show significant declines in the number of foreign-flag ships owned by CFCs and the income generated by CFCs. The economic consequences of tax law changes have been (a) a reduction in new construction, (b) the "decontrolling" of shipping income through sales of ships and CFCs to foreign corporations not controlled by U.S. parents, and (c) a decline in subpart F shipping income.

This report begins with a brief discussion of current law and the legislative proposal being analyzed. We then discuss industry trends that show continuing declines in the economic activity of CFCs in the shipping industry. This section is followed by a discussion of our revenue estimating methodology and the results of our analysis. Attached are a worksheet showing the full calculations used in developing the revenue estimate and a detailed listing that describes the foreign-flag fleet.

In brief, we find that the proposal would reduce tax collections by $26 million over the FY 1998 through 2002 period and by $46 million over the FY 1998 through 2007 period.

Current law

The Tax Reduction Act of 1975 required that shipping income be treated as foreign base company income under subpart F received by CFCs of U.S. parent corporations, except to the extent that profits were reinvested in shipping operations. The Tax Reform Act of 1986 repealed the profit reinvestment exception and made certain other modifications.

Proposal

The legislative proposal we are analyzing would repeal the provisions enacted in both 1975 and 1986 for non-oil related shipping income for taxable years beginning after December 31, 1997.

Industry trends

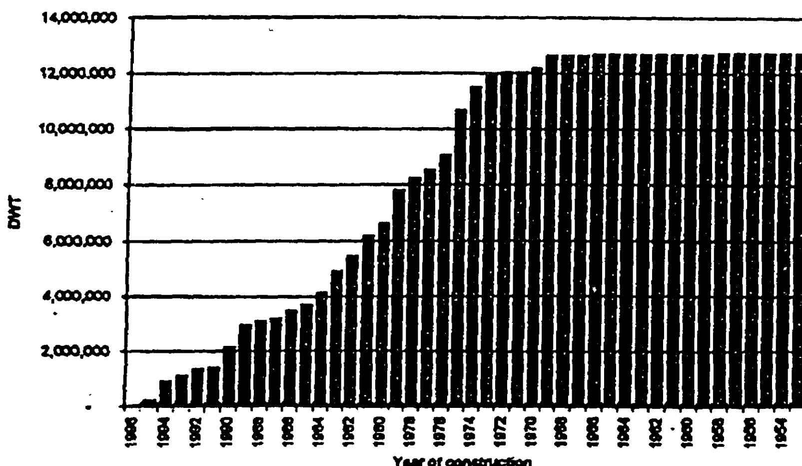
Two sources of data are available for forecasting subpart F income: (a) MARAD data on foreign flag ships controlled by U.S. companies, and (b) data on the net income of U.S.-controlled foreign subsidiaries collected through 1995.

MARAD data

The most recent data on foreign flag vessels controlled by U.S. companies is available from the U.S. Department of Transportation Maritime Administration ("MARAD") for the fleet as of July 1, 1996. We have found that the average age of the CFC foreign-owned fleet is increasing as new construction falls. The current average age of ships in this fleet is 15.9 years. As shown in Figure 1 and the attached table, only 27.4 percent of the entire deadweight tonnage ("DWT") of this fleet has been constructed since 1986, when the subpart F treatment was tightened, while 71.9 percent of the fleet was constructed between 1975 and the end of 1986. This slow rate of new construction, coupled with transfers to non-U.S. controlled owners increases the average age of the fleet and reduces the taxable income affected by the proposed legislation.

Figure 1

CUMULATIVE DWT OF U.S.-OWNED FOREIGN-FLAG FLEET BY YEAR OF CONSTRUCTION

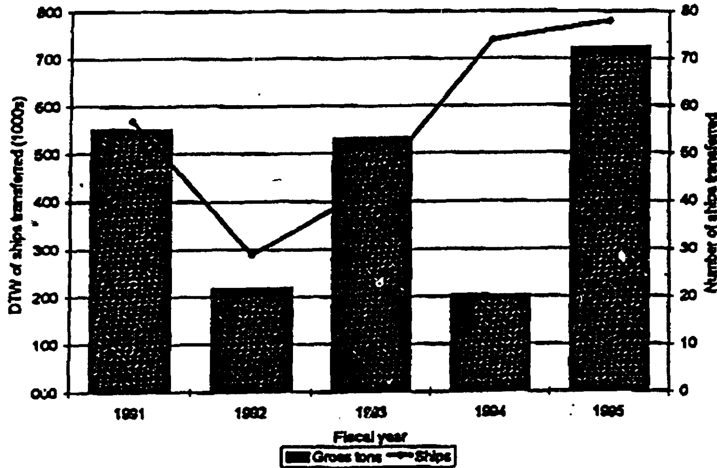


In the 10 years between 1987 and 1996, an annual average of 320 thousand DWT were built each year, while in the 11-year period from 1976 through 1986, an annual average of 532 thousand DWT were built.

Figure 2 provides data on the transfer of foreign-flag ships to non-U.S. control. While the data are volatile, the trend is again reasonably clear that both the number of ships transferred and the aggregate tonnage of transferred ships is increasing.

Figure 2

TRANSFERS OF FOREIGN FLEET SHIPS TO NON-U.S. CONTROL
(Vessels of 1,000 Gross Tons and Over)



Department of Commerce data

As illustrated in Table 1 and Figure 3, Department of Commerce data on net income (after tax) earned from direct investment abroad show that water transportation income has generally declined over the past five years.[1] The annualized average rate of decline is 13 percent. The Gulf War may have resulted in oil tanker income being unusually high in 1991, so we have also computed an annual rate of decline over the 1992-1995 period of 7 percent. In either case, there appears to be a general downward trend in industry net income.

[1] *U.S. Direct Investment Abroad: Detail for Historical-Cost Position and Related Capital and Income Flows, 1995*, Survey of Current Business, September 1996, p. 127.

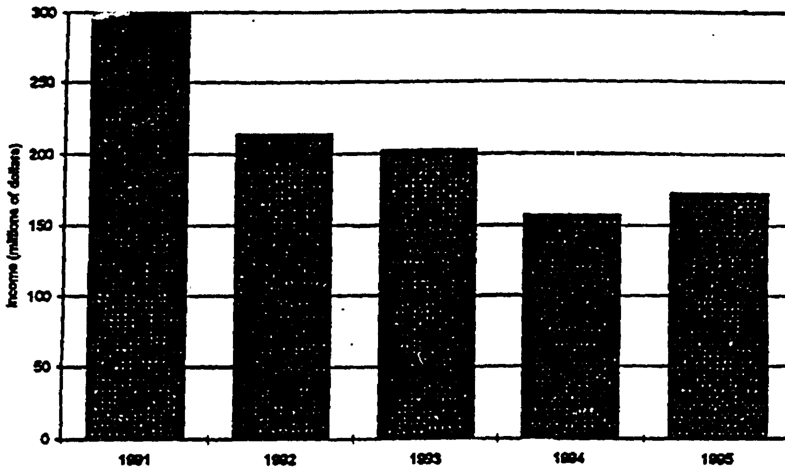
Table 1

Net Income from U.S. Direct Investment Abroad for Water Transportation Industry
(Millions of dollars)

	1991	1992	1993	1994	1995
Net income	300	214	203	157	172
Percent change		-28.7%	-5.1%	-22.7%	9.6%

Figure 3

U.S. INCOME FROM DIRECT INVESTMENT ABROAD
IN WATER TRANSPORTATION INDUSTRY



Estimating methodology

The revenue effect of the proposal is estimated as the difference between the tax collections under current law foreign base company treatment and the tax collections under the proposal when dividends are repatriated and subject to tax. Both current law tax collections and tax collections under the proposal will be offset by available foreign tax credits. The first requirement, therefore, is to develop a forecast of current law tax collections on non-oil foreign base company shipping income. We begin by developing estimates for 1992, the most recent year for which IRS data are available. Using these

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same data, we then estimate tax collections under the proposal – still at 1992 income levels. The difference between the two estimates is the revenue effect of the proposal as if it had been in effect during 1992. This amount must then be adjusted to reflect income earned over the 1998 through 2007 period and be converted from calendar year to Federal Government fiscal year receipts.

Current law tax collections

Current tax collections on foreign base company income depend on the shipping income actually earned by CFCs. We asked the SOI Division of the Internal Revenue Service to tabulate the most recent actual data available (1992) from Form 5471. As shown in Table 2, below, Subpart F income reported by all water transportation CFCs in 1992 was $187 million. Of this amount, $112 million was reported by non-oil-related industries.[3] Of this amount, $4 million was previously excluded subpart F income withdrawn from qualified investments. We have been advised that under current law there is no recapture of this income if the subsidiary ceases to be a CFC, which results from the decontrol methodologies currently being used. In addition, because the exclusion for subpart F income attributable to qualified investments was repealed by the 1986 Act, this recapture of previously excluded income is likely to become insignificant in future years, and we have chosen to exclude it from our analysis. If it were to be included, our revenues estimates would not be significantly changed.

While the subpart F income reported on Form 5471 reflects the income attributable to the U.S. parent filing the return, other items reflect the financial results for the entire company. This distinction will not matter where the CFC is 100-percent owned by the parent. We asked the SOI Division to multiply other amounts by the parent's actual percentage of ownership to avoid a potential understatement of the estimated revenue loss. That is, if earnings & profits ("E&P") and foreign tax credits were to be overstated due to the inclusion of other ownership interests, estimated tax collections under the legislative proposal could be overstated.

[3] We asked the SOI Division to consider oil & gas extraction (minor industry code 1330) and petroleum refining (minor industry code 2910) industries as "oil-related" for this purpose. This will overstate oil-related income to the extent that some companies included have daily crude oil production below the 1,000 barrels per day threshold specified in Section 954(g)(2). It will understate oil-related income to the extent that some companies in other industries (e.g., chemical manufacturing) have significant oil production. We assume these two potential errors are offsetting.

Table 2

IRS Statistics on CFC Income in the Water Transportation Industry, 1992

	Oil related	Non-oil related	Total
Subpart F income			
Total subpart F income	75,172,667	108,182,912	183,355,579
Previously excluded subpart F income withdrawn from investments	0	4,040,244	4,040,244
Total reported subpart F income	75,172,667	112,223,156	187,395,823
Other amounts multiplied by U.S. parent's ownership share			
Current year E&P	46,251,832	186,470,561	232,722,393
Accumulated prior year E&P	-582,149,974	1,090,718,173	508,568,199
Distributions out of current E&P	9,998,803	76,812,213	86,811,016
Distributions out of accumulated E&P	4,659,736	87,794,125	92,453,861
Total distributions from E&P	14,658,539	164,606,338	179,264,877
Dividends paid to U.S. parent	5,000,000	140,461,138	145,461,138
Taxes paid (schedule E) multiplied by percent of parent ownership	36,305,418	9,167,490	45,472,908

Before we can estimate current law tax collections, we must estimate an effective marginal tax rate. We do this using 1992 corporation income tax return data from Form 1120 – the basic corporation income tax return. These data show that most includable income from CFCs reported by water transportation parent companies is from companies with taxable income. As a result, we would expect a relatively high marginal tax rate. We compute this rate by assuming that all companies with net income pay tax at the highest statutory marginal tax rate of 35-percent, and all companies without net income pay tax at a zero marginal tax rate. The resulting tax rate is 31.9 percent.[3]

Foreign taxes paid by non-oil related water transportation CFCs in 1992 were $9 million. Because little tax is generally imposed on international shipping income, we assume none of the resulting foreign tax credits are subject to limitation.

The net effect of these data, as shown in Table 3, is that the current law U.S. tax liability on foreign base company income earned by CFCs is equal to approximately $27 million.

[3] In 1992, water transportation companies reported $38,218,000 of includable income from CFCs. Companies with net income reported $34,846,000, and companies with net losses reported $3,372,000. The weighed average marginal tax rate of 31.9 percent is therefore equal to ((0.0 x $3,372,000 + 0.35 x $34,846,000) / $38,218,000).

Table 3

Calculation of Current Law Tax, 1992

Subpart F income	108,182,912
Effective tax rate	0.319
Tax before FTC	34,523,251
Less FTC	9,167,490
Net tax after FTC	25,355,761

Tax collections under proposal

Under the proposal, income currently treated as foreign base company income would be subject to tax when repatriated rather than in the current year. In a 1976 study (i.e., covering a period before shipping income was included as foreign base company income), the U.S. Treasury Department figures indicate that 39 percent of earnings and profits ("E&P") was repatriated currently and the balance was deferred. While this relationship is similar to the result we find using 1992 data for all shipping income, there is a difference in the relationships for oil and non-oil related shipping income. Table 4 shows that 41.2 percent of non-oil related current year E&P was distributed, while 21.6 percent of oil-related current year E&P was distributed.

Table 4

IRS Statistics on CFC Income in the Water Transportation Industry, 1992

	Oil related	Non-oil related	Total
Amounts multiplied by U.S. parent's ownership share			
Current year E&P	46,251,832	186,470,561	232,722,393
Distributions out of current E&P	9,998,803	76,812,213	86,811,016
Distributions as percentage of current E&P	21.6%	41.2%	37.3%

A high proportion of total non-oil related income was distributed as taxable earnings to U.S. parents. Total distributions were $253 million: subpart F income of $112 million, plus actual dividends paid to U.S. parents of $140 million. This total significantly exceeded current year E&P of $186 million. Reported distributions from prior years' E&P were $77 million. This result could occur because of the $1,091 million accumulated E&P balance at the beginning of the year. Thus, total current and prior year E&P available for distribution was $1,277 million. From these statistics, we conclude that the most reasonable relationship to use in estimating taxable distributions following enactment

of the proposal is one based on the percentage of distributions from current E&P, or 41.2 percent. We assume distributions from prior year E&P will remain the same under the proposal as under current law.

In 1992, the non-oil related E&P of water transportation CFCs was $186 million. Dividend payments under the proposal are, therefore, estimated to be $73 million. Using the same 31.9 percent marginal tax rate, as described above, results in a tax before the foreign tax credit of $23 million. Subtracting $9 million for foreign tax credits results in a net tax liability of $14 million. These calculations are shown in Table 5.

Table 5

Calculation of Tax under Proposal, 1992

Current year E&P	186,470,561
Assumed dividend rate	0.412
Dividends paid	76,812,213
Effective tax rate	.319
Tax before FTC	24,512,257
Less FTC	9,167,490
Net tax after FTC	15,344,767

Change in tax

The net difference between current law tax liability and tax liability under the proposal is $10 million, at 1992 income levels. This amount must be adjusted to reflect the effective date of the proposal and the change in non-oil related foreign base company shipping income since 1992. Because the proposal would be effective for taxable years beginning after December 31, 1997, the first year forecasted is 1998.

Using the 7 percent average annual rate of decline in net income reported by the Commerce Department, as described above, results in a 1998 revenue effect of $7 million. As shown in Table 6, this amount declines to $3 million by 2007.

The calendar year liability estimates are converted to fiscal year receipts by assuming that 60 percent of tax payments for any given tax year occur by the September 30 end of the Federal Government's fiscal year. The remaining 40 percent is assumed to be collected in the following fiscal year. The fiscal year numbers, also provided in Table 6, show that the proposal would reduce tax receipts by $26 million over the FY 1998-2002 period and by $46 million over the FY 1998-2007 period.

Table 6

Calculation of Change in Tax under the Proposal

	Calendar year tax liability ($ millions)	Fiscal year tax receipts ($ millions)
1998	-6.5	-4
1999	-6.0	-6
2000	-5.6	-6
2001	-5.2	-5
2002	-4.8	-5
2003	-4.5	-5
2004	-4.2	-4
2005	-3.9	-4
2006	-3.6	-4
2007	-3.4	-3
FY 1998-2002		-26
FY 1998-2007		-46

Conclusion

Data from MARAD and the Department of Commerce show that shipping income potentially affected by the proposal is declining at a steady rate. While there may also be non-tax reasons for this decline, it is clear that tax collections from the current treatment of shipping income as foreign base company income is likely to continue to decline in future years. As a result, the proposal to restore the exclusion for non-oil related shipping income from subpart F will lose a relatively modest amount of revenue over the budget score-keeping period.

RESTORE EXCLUSION FOR NON-OIL RELATED SHIPPING INCOME FROM SUBPART F

1. SOI Form 5471 data on water transportation CFCs, 1992	Non-oil related	Total
Subpart F income	108,182,912	183,355,579
Previously excluded subpart F income withdrawn from investments	4,040,244	4,040,244
Total reported subpart F income	112,223,156	187,395,823
Current year E&P (adjusted by SOI to reflect parent's share)	186,470,561	232,722,393
Taxes paid (adjusted by SOI to reflect parent's share)	9,167,490	45,472,908

2. SOI Form 1120 data for water transportation parent corporations, 1992	
Includable CFC income reported, total	38,218,000
Includable CFC income reported, returns with net income	34,846,000
Effective marginal rate assuming 35% rate for firms with net income	31.9%

3. Computation of current law tax liability, 1992	
Tax before FTC (subpart F income multiplied by tax rate)	34,523,251
Less FTC	9,167,490
Net tax on subpart F income under current law	25,355,761

4. Computation of tax liability under proposal, 1992	
Reported current year E&P	186,470,561
Dividends paid out of current E&P (exclusive of subpart F income)	76,812,213
Distributions as percentage of current E&P	41.2%
Tax on dividends paid before FTC	24,512,257
Less FTC	9,167,490
Net tax on dividends paid under proposal	15,344,767

5. Change in tax liability, 1992	-10,010,994

6. Projected revenue effect	
Assumed growth rate (based on Commerce data)	-7.0%
Fiscal year split	60%

	Calendar year tax liability ($ millions)	Fiscal year receipts ($ millions)
1998	-6.5	-4
1999	-6.0	-6
2000	-5.6	-6
2001	-5.2	-5
2002	-4.8	-5
2003	-4.5	-5
2004	-4.2	-4
2005	-3.9	-4
2006	-3.6	-4
2007	-3.4	-3
Fiscal years 1998-2007		-46
Fiscal years 1998-2002		-26

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FOREIGN FLAG MERCHANT SHIPS OWNED BY NON-OIL RELATED U.S. COMPANIES AS OF JULY 1, 1996

Name	Type	YrBuilt	Owner	FirmType	DWT	Flag	Age	Weighted age
Marlin	Containership	1996	APL	shipping		Marshall Islands	1	0
PathfinderII	Containership	1996	Sea-Land	shipping	59,940	Marshall Islands	1	59940
APLKOr~ Carrier	Containership	1995	APL	shipping		Marshall Islands	2	0
APLPhilippines	Containership	1995	APL	shipping		Marshall Islands	2	0
APLSingapore	Containership	1995	APL	shipping		Marshall Islands	2	0
MT.Cabrite	Containership	1995	APL	shipping		Marshall Islands	2	0
Tarpon	Containership	1995	APL	shipping		Marshall Islands	2	0
SentinelII	Other Tanker	1995	Fairfield	shipping	11,668	Panama	2	23336
APLJapan	Containership	1995	Sea-Land	shipping	59,840	Marshall Islands	2	119680
ProspectorII	Containership	1995	Sea-Land	shipping	59,840	Marshall Islands	2	119680
SaintLucia	Containership	1995	Sea-Land	shipping	48,151	Marshall Islands	2	96302
BandarSea	Freighter	1994	Dole	Food	10,400	Liberia	3	31200
CypressPass	Freighter	1994	Dole	Food	10,288	Liberia	3	30864
DolphinIV	Freighter	1994	Dole	Food	10,400	Liberia	3	31200
SerenaSky	Freighter	1994	Dole	Food	10,288	Liberia	3	30864
SerenaStar	Bulker	1994	OMI Corp.	shipping	72,800	Singapore	3	218400
AcadiaForest	Tanker	1994	Overseas	shipping	96,173	Liberia	3	288519
Amazon	Tanker	1994	Overseas	shipping	94,798	Liberia	3	284394
BaliSea	Tanker	1994	Overseas	shipping	94,813	Liberia	3	284439
ChevronAtlantic	Tanker	1994	Overseas	shipping	94,847	Liberia	3	284541
CypressTrail	Tanker	1994	Overseas	shipping	96,173	Liberia	3	288519
Spruce	Tanker	1994	Overseas	shipping	94,872	Liberia	3	284616
ChevronCopenhagen	Other Tanker	1993	Eagle Sun	oil-other	48,817	Liberia	4	195268
ChevronFeluy	Other Tanker	1993	Eagle Sun	oil-other	48,857	Liberia	4	195428
ChevronEdinburgh	RO/RO	1993	Nicor Inc.	shipping	7,430	Panama	4	29720
ChevronSouthAmerica	Bulker	1993	OMI Corp.	shipping	73,657	Singapore	4	294628
CharlesB.Renfrew	RO/RO	1992	Nicor Inc.	shipping	7,450	Panama	5	37250
ChevronMariner	Tanker	1992	OMI Corp.	shipping	99,195	Norway(NIS)	5	495975
CondoleezzaRice	Tanker	1992	OMI Corp.	shipping	141,720	Liberia	5	708600
GeorgeH.Weyerhaeuse	Cruiseship	1992	Renaissance	shipping	681	Liberia	5	3405
ChevronPacific	Cruiseship	1992	Ulysses	cruise	2,700	Panama	5	13500
JamesN.Sullivan	Tanker	1991	OMI Corp.	shipping	29,998	Liberia	6	179988
JohnYoung	Cruiseship	1991	Renaissance	shipping	645	Liberia	6	3870
KennethT.Derr	Cruiseship	1991	Renaissance	shipping	645	Liberia	6	3870
SamuelGinn	Cruiseship	1991	Renaissance	shipping	645	Liberia	6	3870
BayRidge	Tanker	1990	OMI Corp.	shipping	29,998	Liberia	7	209986
Constitution	Bulker	1990	OMI Corp.	shipping	72,136	Panama	7	504952
Guardian	Tanker	1990	OMI Corp.	shipping	146,251	Liberia	7	1023757
ChevronEmployeePride	Bulker	1990	Overseas	shipping	122,760	Hong Kong	7	859320
CoastalGolden	Tanker	1990	Overseas	shipping	258,076	Liberia	7	1806532
Independence	Bulker	1990	Overseas	shipping	122,829	Hong Kong	7	859803

CaribeTrader	Cruiseship	1990	Renaissance	shipping	2,420	Liberia	7	16940
MarCaribe	Cruiseship	1990	Renaissance	shipping	2,420	Liberia	7	16940
Patriot	Cruiseship	1990	Renaissance	shipping	796	Liberia	7	5572
TropicalMist	Tanker	1989	OMI Corp.	shipping	29,997	Liberia	8	239976
DoleAfrica	Tanker	1989	Overseas	shipping	135,134	Liberia	8	1081072
DoleAmerica	Tanker	1989	Overseas	shipping	40,085	Liberia	8	320680
DoleAsia	Tanker	1989	Overseas	shipping	39,710	Liberia	8	317680
DoleEuropa	Tanker	1989	Overseas	shipping	39,673	Liberia	8	317384
ProgressCarrierl	Tanker	1989	Overseas	shipping	258,076	Liberia	8	2064608
RioGuayas	Bulker	1989	Overseas	shipping	64,282	Liberia	8	514256
TropicalMorn	Tanker	1989	Overseas	shipping	135,134	Liberia	8	1081072
TropicalSky	Bulker	1989	Overseas	shipping	64,282	Liberia	8	514256
TropicalStar	Cruiseship	1989	Renaissance	shipping	433	Liberia	8	3464
NorthernStar	Car Carrier	1988	Central Gulf	shipping	12,763	Liberia	9	114867
PolarEagle	Car Carrier	1988	Central Gulf	shipping	12,763	Liberia	9	114867
Cartagena	Tanker	1988	OMI Corp.	shipping	29,999	Liberia	9	269991
SantaMarta	Tanker	1988	OMI Corp.	shipping	29,996	Liberia	9	269964
TropicalEstoril	Tanker	1988	OMI Corp.	shipping	29,994	Liberia	9	269946
ArticSun	Tanker	1988	Overseas	shipping	39,451	Liberia	9	355059
PetroFife	Bulker	1987	Gypsum	shipping	19,075	Bermuda	10	190750
PetroAberdeen	Car Carrier	1987	Marine Transport	shipping	11,676	Marshall Islands	10	116760
PetroAvon	Tanker	1987	Overseas	shipping	64,140	Liberia	10	641400
BahiaBlanca	Freighter	1986	Dole	Food	11,998	Liberia	11	131978
Bayway	Freighter	1986	Dole	Food	11,998	Liberia	11	131978
PetroClyde	Freighter	1986	Dole	Food	11,998	Liberia	11	131978
PetroMorsey	Freighter	1986	Dole	Food	11,998	Liberia	11	131978
PalmBeach	Freighter	1986	Fairfield	shipping	6,553	Panama	11	72083
PetroFawley	Freighter	1986	Fairfield	shipping	6,530	Panama	11	71830
Formosa	Tanker	1986	Overseas	shipping	64,239	Liberia	11	706629
PetroMilfordHaven	Tanker	1986	Overseas	shipping	64,000	Liberia	11	704000
PetroTyne	Tanker	1986	Overseas	shipping	64,000	Liberia	11	704000
SanLOre Carrierrizo	Other Tanker	1985	Fairfield	shipping	7,087	Panama	12	85044
Gascogne	Bulker	1985	PLM International	shipping	43,479	Liberia	12	521748
Alsace	Containership	1985	Sea-Land	shipping	47,171	Marshall Islands	12	566052
Yoshino	Containership	1985	Sea-Land	shipping	59,964	Marshall Islands	12	719568
NewHidaka	RO/RO	1985	Seaboard	shipping	11,294	Panama	12	135528
RioNegro	Bulker	1985	Skaarup	shipping	37,916	Vanuatu	12	454992
RioGrande	Other Tanker	1985	Stolt-Nielsen	oil	6,757	Liberia	12	81084
Visahakit7	Freighter	1984	Fairfield	shipping	6,788	Japan	13	88244
Visahakit5	RO/RO	1984	Nicor Inc.	shipping	9,793	St. Vincent	13	127309
A.G.Farquharson	Other Tanker	1984	OMI Corp.	shipping	29,992	Liberia	13	389896
ImperialAcadia	Tanker	1984	OMI Corp.	shipping	66,800	Liberia	13	868400
Visahakit8	Other Tanker	1984	OMI Corp.	shipping	29,974	Liberia	13	389662
Parentis	Bulker	1984	PLM International	shipping	41,373	Bahamas	13	537849

Picardie	Bulker	1984	PLM International	shipping	28,168	Hong Kong	13	368158
ImperialSt.Clair	Containership	1984	Sea-Land	shipping	47,171	Marshall Islands	13	613223
Languedoc	Containership	1984	Sea-Land	shipping	47,171	Marshall Islands	13	613223
LeBrave	Containership	1984	Sea-Land	shipping	12,085	Liberia	13	157105
ImperialBedford	Bulker	1984	Vulica	shipping	65,402	Bahamas	13	850226
Visahakit6	Bulker	1984	Vulica	shipping	67,044	Bahamas	13	871572
GoldenYone	Combo Freighter	1983	Coscol	shipping	129,017	Liberia	14	1806238
OtaruRex	Freighter	1983	Fairfield	shipping	7,079	Panama	14	99106
CoralGables	Bulker	1983	Maru Shipping	shipping	69,420	Panama	14	971880
AkashiRex	RO/RO	1983	Nicor Inc.	shipping	2,563	St. Vincent	14	35882
GoldenCraig	RO/RO	1983	Nicor Inc.	shipping	2,563	St. Vincent	14	35882
SunbeltDbde	RO/RO	1983	Nicor Inc.	shipping	9,889	St. Vincent	14	138846
Geneva	Bulker	1983	OMI Corp.	shipping	43,583	Singapore	14	610162
Nassau	Tanker	1983	OMI Corp.	shipping	322,446	Liberia	14	4514244
Africa	Bulker	1983	Overseas	shipping	65,224	Liberia	14	913136
Hawaii	Freighter	1983	PLM International	shipping	5,223	Bahamas	14	73122
Kaohsiung	Freighter	1983	PLM International	shipping	5,223	Bahamas	14	73122
Kawasaki	Bulker	1983	PLM International	shipping	28,126	Singapore	14	393764
Keiyo	Bulker	1983	PLM International	shipping	38,110	Panama	14	533540
Westernport	Freighter	1983	PLM International	shipping	5,223	Bahamas	14	73122
A.V.Kastner	Containership	1983	Sea-Land	shipping	12,066	Panama	14	168924
GypsumKing	Containership	1983	Sea-Land	shipping	12,083	Liberia	14	169162
OAhuRex	Containership	1983	Sea-Land	shipping	12,067	Panama	14	168938
Calina	Ore Carrier	1982	ALCOA	metal	47,503	Liberia	15	712545
HelenB.	Ore Carrier	1982	ALCOA	metal	47,535	Liberia	15	713025
MarineAtlantic	RO/RO	1982	Central Gulf	shipping	22,256	Singapore	15	333840
Savonetta	RO/RO	1982	Central Gulf	shipping	22,256	Singapore	15	333840
MarinePacific	Bulker	1982	Crowley	shipping	6,412	Indonesia	15	96180
ScandinavianDawn	Freighter	1982	Fairfield	shipping	6,395	Panama	15	95925
Kentucky	Bulker	1982	Overseas	shipping	138,500	Hong Kong	15	2077500
TheEmpress	Tanker	1982	Overseas	shipping	29,994	Liberia	15	449910
WestVirginia	Bulker	1982	Overseas	shipping	138,500	Hong Kong	15	2077500
BillieFay	Bulker	1982	PLM International	shipping	38,110	Panama	15	571650
SeawindCrown	Bulker	1982	PLM International	shipping	63,284	Hong Kong	15	949260
RegalEmpress	Combo	1982	Premier	shipping	7,000	Liberia	15	105000
Secona	Ore Carrier	1981	ALCOA	metal	47,560	Liberia	16	760960
SaudiSplendour	Bulker	1981	Central Gulf	shipping	140,832	Singapore	16	2253312
D'Artagnan	Tanker	1981	Marine Transport	shipping	81,279	Panama	16	1300464
Falcon	Freighter	1981	Marine Transport	shipping	11,683	Liberia	16	186928
Athos	Tanker	1981	OMI Corp.	shipping	65,755	Liberia	16	1052080
Saucon	Tanker	1981	OMI Corp.	shipping	65,689	Liberia	16	1051024
Alcides	Tanker	1981	Overseas	shipping	31,000	Liberia	16	496000
Astral	Tanker	1981	Overseas	shipping	31,302	Liberia	16	500832
Swift	Bulker	1981	Overseas	shipping	65,592	Liberia	16	1049472

SylvanArrow	Tanker	1981	Overseas	shipping	79,999	Liberia	16	1279984
SaudiGlory	Other Tanker	1981	PLM International	shipping	22,255	Liberia	16	356080
Wabasha	Other Tanker	1981	PLM International	shipping	22,305	Liberia	16	356880
Aladdin	Bulker	1981	Seaboard	shipping	9,124	Liberia	16	145984
Eagle	Bulker	1981	Seaboard	shipping	9,122	Liberia	16	145952
Hawk	Bulker	1981	Seaboard	shipping	9,101	Liberia	16	145616
Sachem	Ore Carrier Carrier	1981	Skaarup	shipping	30,187	Panama	16	482992
Elsberg	Tanker	1980	Marine Transport	shipping	81,279	Panama	17	1381743
TropicMist	Freighter	1980	Marine Transport	shipping	11,733	Liberia	17	199461
Wapello	RO/RO	1980	Nicor Inc.	shipping	2,530	St. Vincent	17	43010
TropicTide	Tanker	1980	OMI Corp.	shipping	86,648	Liberia	17	1473016
TropicPalm	Tanker	1980	Overseas	shipping	81,278	Panama	17	1381726
Flinders	Bulker	1980	PLM International	shipping	26,814	Liberia	17	455838
Lubchem	Containership	1980	Sea-Land	shipping	9,809	Panama	17	166753
Tasman	Containership	1980	Sea-Land	shipping	33,117	Marshall Islands	17	562989
TropicJade	Containership	1980	Sea-Land	shipping	30,240	Marshall Islands	17	514080
TropicSun	Containership	1980	Sea-Land	shipping	9,809	Panama	17	166753
Winamac	Containership	1980	Sea-Land	shipping	9,663	Panama	17	164271
AbuLoujaine	Bulker	1980	Seaboard	shipping	8,991	Liberia	17	152847
CecileErickson	RO/RO	1980	Seaboard	shipping	10,208	Panama	17	173536
TropicKey	Bulker	1980	Seaboard	shipping	8,991	Liberia	17	152847
Wanata	RO/RO	1980	Seaboard	shipping	10,208	Panama	17	173536
Patricia	Tanker	1979	Coscol	shipping	224,428	Liberia	18	4039704
MaritimeMosaic	Tanker	1979	Marine Transport	shipping	404,531	Liberia	18	7281558
WilomiYukon	Tanker	1979	Marine Transport	shipping	404,531	Liberia	18	7281558
Colorado	Tanker	1979	Overseas	shipping	96,920	Liberia	18	1744560
Elbe	Tanker	1979	Overseas	shipping	32,109	Liberia	18	577962
Limar	RO/RO	1979	Seaboard	shipping	12,169	Panama	18	219042
MaritimeOMI	Bulker	1979	Seaboard	shipping	8,944	Liberia	18	160992
WilomiAlta	RO/RO	1979	Seaboard	shipping	12,169	Panama	18	219042
Danube	Freighter	1978	Dole	Food	6,596	Liberia	19	125324
Trent	Freighter	1978	Fairfield	shipping	12,730	Liberia	19	241870
Alma	RO/RO	1978	Nicor Inc.	shipping	2,536	St. Vincent	19	48184
Nile	RO/RO	1978	Nicor Inc.	shipping	4,810	St. Vincent	19	91390
Tiber	Tanker	1978	OMI Corp.	shipping	268,038	Liberia	19	5092722
Pagoda	Containership	1978	Sea-Land	shipping	15,417	Bahamas	19	292923
Paulina	Containership	1978	Sea-Land	shipping	15,417	Bahamas	19	292923
Sokolica	Containership	1978	Sea-Land	shipping	15,417	Bahamas	19	292923
General	Bulker	1978	Seaboard Flour	shipping	8,986	Liberia	19	170734
Promise	Ore Carrier Carrier	1978	Skaarup	shipping	26,607	Liberia	19	505533
Czantoria	Bulker	1978	York	shipping	61,345	Liberia	19	1165555
Atlantis	Combo	1977	ALCOA	metal	15,000	Liberia	20	300000
WhiteSea	Combo	1977	ALCOA	metal	15,000	Liberia	20	300000
Eclipse	Freighter	1977	Dole	Food	6,596	Liberia	20	131920

Elaine	Tanker	1977	Kurz	shipping	156,313	Liberia	20	3126260
Columbia	Bulker	1977	Maru Shipping	shipping	30,853	Panama	20	617060
Volga	Bulker	1977	PLM International	shipping	26,779	Bahamas	20	535580
Delphina	Bulker	1977	Serviocean	shipping	17,661	Panama	20	353220
Shirley	Bulker	1976	Gypsum	shipping	18,314	Bermuda	21	384594
Excelsior	Other Tanker	1976	International Shipping	cruise	13,114	Grand Cayman	21	275394
PacificHunter	Bulker	1976	Kedma	shipping	34,410	Liberia	21	722610
Exemplar	Tanker	1976	Kurz	shipping	154,934	Liberia	21	3253614
Lucy	Tanker	1976	Overseas	shipping	132,594	Panama	21	2784474
Diane	Tanker	1976	PLM International	shipping	59,650	Bahamas	21	1252650
Jostelle	Tanker	1976	PLM International	shipping	59,580	Bahamas	21	1251180
RuthM	Bulker	1976	Serviocean	shipping	11,680	Panama	21	245280
Neptune	Bulker	1976	York	shipping	61,374	Liberia	21	1288854
NorthernLion	Containership/Barge	1975	Central Gulf	shipping	8,172	Liberia	22	179784
Haight	Bulker	1975	Gypsum	shipping	18,317	Bermuda	22	402974
Courier	Tanker	1975	OMI Corp.	shipping	146,104	Liberia	22	3214288
LoriE.	Tanker	1975	OMI Corp.	shipping	154,719	Liberia	22	3403818
Suzanne	Other Tanker	1975	OMI Corp.	shipping	49,882	Liberia	22	1097404
Ulloa	Tanker	1975	OMI Corp.	shipping	145,649	Liberia	22	3204278
VenusV	Tanker	1975	OMICorp.	shipping	155,702	Liberia	22	3425444
Ania	Tanker	1975	Overseas	shipping	128,300	Panama	22	2822600
Esplanade	Tanker	1975	Overseas	shipping	122,933	Hong Kong	22	2704526
Matilde	Bulker	1975	Overseas	shipping	122,970	Hong Kong	22	2705340
Olympia	Tanker	1975	Overseas	shipping	269,085	Liberia	22	5919870
Pluto	Tanker	1975	Overseas	shipping	130,286	Panama	22	2866292
CaribbeanSky	Bulker	1975	PLM International	shipping	26,541	Liberia	22	581902
MaryAnn	Tanker	1975	PLM International	shipping	58,700	Liberia	22	1291400
EasternLion	Bulker	1975	Serviocean	shipping	27,213	Panama	22	598686
PacificRuby	Bulker	1975	Serviocean	shipping	11,711	Panama	22	257642
Rebecca	Freighter	1975	Serviocean	shipping	11,750	Panama	22	258500
SeaLeader	Freighter	1974	Dole	Food	9,375	Liberia	23	215625
SeaAdventure	Tanker	1974	OMI Corp.	shipping	154,605	Liberia	23	3555915
RenaissanceThree	Tanker	1974	Overseas	shipping	269,117	Liberia	23	6189691
Steuart	Tanker	1974	Overseas	shipping	269,117	Liberia	23	6189691
SeaPioneer	Freighter	1974	Serviocean	shipping	10,077	Panama	23	231771
Union	Tanker	1974	York	shipping	130,286	Liberia	23	2996578
Sea-LandMeteor	Bulker	1973	Kedma	shipping	26,976	Liberia	24	647424
Sea-LandMotivator	Bulker	1973	Kedma	shipping	34,186	Liberia	24	820464
SantaPaula	Tanker	1973	Overseas	shipping	269,164	Liberia	24	6459936
Sea-LandPride	Bulker	1973	Overseas	shipping	117,955	Hong Kong	24	2830920
Sea-LandRacer	Freighter	1973	Skaarup	shipping	11,526	St. Vincent	24	276624
AfricanCamellia	Containership/Barge	1972	Central Gulf	shipping	44,799	Liberia	25	1119975
Sea-LandNavigator	Freighter	1972	Dole	Food	10,800	Ecuador	25	270000
Oahu	Combo	1972	Premier	shipping	2,352	Bahamas	25	58800

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LaTrinity	Containership	1972	Sea-Land	shipping	28,200	Marshall Islands	25	705000
SeaboardStar	RO/RO	1971	Crowley	shipping	5,811	Panama	26	151086
SeaboardExpress	Combo	1971	International Shipping	cruise	2,750	Bahamas	26	71500
Polar	Combo	1970	International Shipping	cruise	1,014	Bahamas	27	27378
Zodiak	Bulkar	1970	York	shipping	128,803	Liberia	27	3477681
Constellation	Containership	1969	Central Gulf	shipping	449,635	Liberia	28	12598380
GoldBondTrailblazer	Freighter	1968	Dole	Food	7,519	Liberia	29	218051
MelvinH.Baker	Freighter	1968	Dole	Food	5,354	Liberia	29	155266
Wonfu	Cruiseship	1968	International Shipping	cruise	962	Bahamas	29	27898
Taboga	RO/RO	1967	Crowley	shipping	3,165	Grand Cayman	30	94950
StarAfica	Other Tanker	1967	Marine Transport	shipping	15,661	Liberia	30	469830
StarJapan	Cruiseship	1966	International Shipping	cruise	1,584	Bahamas	31	49104
StarBergen	Ore Carrier	1966	New York	cement	18,658	Vanutu	31	578398
StarOhio	Combo	1965	Premier	shipping	8,738	Bahamas	32	279616
Oceanbreeze	Other Tanker	1964	Marine Transport	shipping	10,947	Liberia	33	361251
SeaBreezel	Other Tanker	1964	Marine Transport	shipping	10,822	Liberia	33	360426
RoyalMajesty	Cruiseship	1961	International Shipping	cruise	6,500	Panama	36	234000
BernardoQuintanaA.	Cruiseship	1958	Ulysses	cruise	5,671	Panama	39	221169
W.H.Blount	Ore Carrier	1957	Morton International	shipping	5,588	St. Vincent	40	223520
Hexagram	Cruiseship	1956	Carnaval	cruise	4,036	Panama	41	165476
Minerva	Ore Carrier Carrier	1956	Skaarup	shipping	17,939	Liberia	41	735499
Samson	Cruiseship	1955	Ulysses	cruise	7,005	Liberia	42	294210
Leon	Cruiseship	1953	International Shipping	cruise	7,860	Bahamas	44	345840
Total					12,752,117		15.6	203,278,148
Total weighted average life							15.9	

STATEMENT OF THE OVERSEAS SHIPHOLDING GROUP, INC.

[SUBMITTED BY PATTON BOGGS LLP, DONALD V. MOOREHEAD]

I. INTRODUCTION AND SUMMARY

This statement is submitted by Overseas Shipholding Group, Inc. ("OSG") for inclusion in the record of hearings conducted by the Committee on Finance on March 11, 1999 concerning the need to reform the provisions of the Internal Revenue Code of 1986, as amended (the "Code") governing international taxation.

OSG, a Delaware corporation listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OSG is the largest independent owner of unsubsidized U.S.-flag bulk tonnage, including over 10% of the unsubsidized U.S.-flag fleet. The company also has a substantial presence in the foreign trades. OSG charters its ships to commercial shippers and to U.S. and foreign governmental agencies for the carriage of bulk commodities, principally petroleum and related products, grain, coal, and iron ore.

In 1986, Congress adopted a new tax rule that severely penalized U.S. shipowners and undermined their ability to compete in international markets. Specifically, the inclusion of foreign base company shipping income in the "Subpart F" provisions of the Code subjects shipping income earned by foreign subsidiaries of U.S. corporations to current U.S. taxation. This represented a departure from the general U.S. tax rules applicable to international subsidiaries of U.S. corporations. Given the capital intensive and highly competitive nature of the international bulk shipping trades, current taxation places materially greater tax burdens on U.S. shipowners than are imposed on our principal competitors.

This tax change has had a measurable effect on the vitality of the U.S.-owned international shipping fleet, which has declined substantially. Moreover, the pace of that decline is likely to accelerate over time. OSG respectfully urges Congress to restore the prior law taxation, at least for shipping companies that have both U.S. and foreign-flag fleets. Exclusion from Subpart F would place OSG and other U.S.-based companies on the same tax footing as other U.S. multinational corporations engaged in active, capital-intensive businesses around the globe as well as our primary foreign competitors.

II. THE COMPETITIVE ENVIRONMENT AND TAXATION OF SHIPPING

A. Shipping Operations of OSG.

OSG operates in both worldwide and domestic markets. Ownership of a diversified fleet, with vessels of different flags, types and sizes, provides operating flexibility and permits maximum usefulness of vessels. For a variety of business reasons, each of OSG's vessels is owned by a separate corporate subsidiary, many of which are organized in foreign countries.

Competition in the foreign bulk shipping markets is extremely keen. Demand generally is dependent upon international economic conditions, as well as on world oil production and consumption, steel production and grain shipments. Charter rates are determined by market forces and are highly sensitive to changes in supply or demand. Any change in costs, including taxes, can have a direct and adverse impact if it is borne by some but not all carriers.

The economic viability of the international flag fleet has special importance to OSG and other shipowners operating in both domestic and international trades. For them, income from the international flag fleet can provide support for the U.S.-flag fleet when domestic markets are under pressure.

B. Taxation of U.S.-Controlled Shipping Income.

Under tax principles of long-standing application, the United States generally does not tax the income earned abroad by separately incorporated controlled foreign subsidiaries of U.S. corporations until such income is repatriated (e.g., as a dividend by the foreign subsidiaries to the U.S. parent corporation). The "Subpart F" provisions of the Code are an exception to this general tax principle and only apply current taxation to narrowly defined types of income. Under the Subpart F exception, which was first enacted in 1962, the principal U.S. shareholders of a U.S. controlled foreign corporation ("CFC") are taxed on the "Subpart F income" of the CFC in the year such foreign income is earned. Subpart F treats such income as if it had been paid by the CFC as a current dividend to those U.S. shareholders whether or not such income is then (or ever) in fact repatriated. If Subpart F income is repatriated by the CFC in a subsequent year, it is classified as "previously taxed" and is not subject to what would otherwise be a second U.S. tax.

From 1962 until the enactment of the Tax Reduction Act of 1975, foreign shipping income was not classified as Subpart F income. Therefore, in accordance with the generally applicable U.S. tax principle of deferral, the income attributable to the foreign operations of the effectively U.S. controlled foreign flag (EUSC) fleet continued to be subject to U.S. tax only when and to the extent it was actually or constructively repatriated to the United States[1]. In the Tax Reduction Act of 1975, Congress redesignated the foreign shipping income of a CFC as Subpart F income, but provided that such foreign shipping income would not be subject to the basic Subpart F current taxation rule if and to the extent such income was reinvested by the CFC in its foreign shipping operations. When the 1975 legislation was enacted, the "reinvestment rule" was acknowledged to be necessary given the capital-intensive nature of the foreign shipping business and the importance to the nation of a viable U.S.-owned maritime fleet.

Consequently, notwithstanding the redesignation of foreign shipping income as Subpart F income in 1975, for all practical purposes the general U.S. tax principle of deferral continued to apply to the foreign income of the CFC which was attributable to EUSC fleet operations where such income was reinvested in those foreign shipping operations.

The repeal of the reinvestment rule (and the resulting elimination of tax deferral) in the Tax Reform Act of 1986 consummated a fundamental tax law change initiated in 1975 that reversed more than half a century of U.S. tax policy. As explained below, these changes have had and will continue to have a severe adverse effect on the long-term viability of the EUSC fleet. Moreover, repeal does not conform to the tax policies of other key countries; it was not needed to protect the U.S.-flag merchant marine fleet from deterioration; it is not in the national interest; and it is not sound tax policy.

III. SEVERE ADVERSE EFFECTS OF THE 1975 AND 1986 ACT

The international shipping business is capital intensive and highly competitive. The capital intensive nature of the business requires an almost continual reinvestment of a high percentage of income to remain economically viable. The acceleration of the timing of U.S. taxation imposes a substantially higher cost of capital on the EUSC fleet (i.e., reinvestments must be financed for the first time with after-tax dollars). This is particularly significant because many "home countries" of the international flag vessels with which the EUSC fleet competes do not impose current taxes on the unrepatriated income of international shipping subsidiaries.

U.S. investors in the EUSC fleet effectively now pay a "premium" on investments in that fleet because those investments must be made with after-tax dollars, while a substantial portion of their foreign controlled competitors still invest with pretax dollars. Over time, these premiums on investments in the EUSC fleet would require EUSC vessels to command higher charter rates than their competition in order to maintain overall rates of return that are comparable to those earned by their foreign controlled competitors. To the extent such comparatively higher charter income cannot be obtained—and it is clearly not possible to do so—the overall economic posture of the EUSC fleet will continue to be eroded.

The responses to the current taxation of foreign company shipping income include using joint ventures with foreign persons or other techniques to avoid the majority U.S. ownership that will trigger the application of the Subpart F exception, or relocating to another country, such as Canada. As these or other similar options are pursued, there is an increased likelihood that a well-maintained EUSC fleet, both in terms of numbers of vessels and their state of repair, will be unavailable for requisition by the United States when the need arises. Indeed, these results have already materialized. To cite a single example, one of OSG's principal U.S.-based competitors has now reincorporated offshore after nearly a decade of seeking Congressional relief from the 1986 legislation.

IV. RESTORATION OF THE EXCLUSION OF FOREIGN BASE COMPANY SHIPPING INCOME FROM SUBPART F

In light of the severe adverse consequences to the EUSC fleet of the 1975 and 1986 tax law changes (and the importance of the EUSC fleet to the nation), Congress should restore the prior law for companies operating a qualified U.S.-flag fleet.

Eliminating foreign base company shipping income from Subpart F would not constitute a special tax break or insulate companies like OSG from the rigors of international competition. The deferral of U.S. tax on unrepatriated earnings is the general norm of U.S. tax policy. The current inclusion rule of Subpart F is the exception to the historic principle of deferral. The income from the EUSC fleet, with its substantial required investment in tangible assets, differs from other types of income

covered by the Subpart F exception. Restoration of the prior law would be consistent with the general scheme of U.S. taxation applicable to the active business operations of many other U.S. controlled foreign corporations.

Moreover, returning to pre-1975 law would promote cross-border tax equality between the U.S. owners of the EUSC fleet and many of the foreign owners of the foreign vessels with which the EUSC fleet competes. In short, from a tax policy perspective, restoration of the prior rule would simply give the affected U.S. owners of foreign shipping corporations parallel treatment with the U.S. owners of many other types of controlled foreign corporations and with major foreign-based shipping competitors.

For the reasons set forth in this statement, Congress should reinstate the exclusion for shipping income earned abroad, at least by U.S. operators with dual-flag fleets. Healthy EUSC operations can provide a source of financial strength to weather difficult market conditions by the U.S. merchant marine industry; and the health of both is critically important to the national interest.

ENDNOTES

[1] "Effectively U.S.-controlled" foreign-flag vessels are typically owned by foreign subsidiaries of the U.S. corporations and are generally flagged under the laws of "open registry" countries that permit the United States to exercise control over the vessels in time of war or other national emergency.

Statement of Patton Boggs LLP, Donald V. Moorehead

FOREIGN PERSONAL HOLDING COMPANIES

I. Introduction

This statement is submitted for inclusion in the record of hearings conducted by the Committee on Finance with respect to the need for reform of the provisions of the Internal Revenue Code of 1986 as amended (the "Code") governing international taxation. For the reasons set forth below, we recommend that the foreign personal holding company provisions of the Code be modified to apply look-through rules (similar to those in section 1296(c) of the Code) in determining whether a foreign corporation is a foreign personal holding company.

II. Explanation of Proposal

The foreign personal holding company rules were enacted in 1937 to eliminate the opportunity for deferral of U.S. taxes with respect to foreign corporations that have substantial amounts of "passive" income and are controlled directly or indirectly by a small number of U.S. persons. The passive foreign investment company ("PFIC") provisions of the Code were enacted in 1986 to close perceived gaps in the then existing anti-deferral regime, including the opportunity for deferral for investments in passive foreign corporations that are more than 50 percent owned by person not subject to U.S. tax.

The PFIC and foreign personal holding company rules have much in common. They are both aimed at investment companies, they both take on "all or nothing" approach and neither is intended to apply to corporate parents of operating groups. The foreign personal holding company provisions were aimed at the "incorporated pocketbook" (H. Rep. No. 1546, 75th Cong., 1st Sess., p.20) and "[r]eal operating companies" were not intended to be included as p. 37, Aug. 5, 1937. Similarly, Congress did "not intend foreign corporations owning the stock of subsidiaries engaged in active businesses to be classified as PFICs." Pub. L. 99-514, 1986 U.S. Cod of Admin. News 4728.

For purposes of the PFIC rules, this policy of excluding corporate groups engaged in active businesses is implemented by the subsidiary look-through rule of section 1296(c), which allows foreign corporations owning at least 25 percent of another foreign corporation to characterize the dividends, etc., it receives from such a subsidiary by reference to the character of the subsidiary's income. The absence of a comparable rule under the foreign personal holding company provisions produces results that are difficult to justify in terms of tax policy; namely, dividends received by a foreign parent from its operating subsidiaries will be treated as operating income of the foreign parent under the PFIC rules, but as passive income of the foreign parent under the foreign persona holding company rules if the operating subsidiary country of incorporation is different from that of the parent.

The PFIC look-through principles should be substituted for the present related company dividend and interest provision contained in section 552(c) of the Code. The current provision is patterned after a comparable provision in subpart F aimed

at a different problem: selective tax avoidance by operating multinational corporations. As enacted in 1962 and strengthened thereafter, the subpart F rules are intended to eliminate the benefits of deferral for certain types of income (whether or not "passive" in the strict sense) that is shifted to tax havens through controlled foreign corporations. Given this purpose, subpart F is both specific and selective, with special rules for active leasing, branches, relative rates of tax, etc. This is marked contrast to the "all or nothing" approach of the PFIC and foreign personal holding company rules. In such "all or nothing" cases, the object should be to determine the overall economic nature of the group as either an investment enterprise of an operating enterprise.

In prior years, legislation has been introduced that would rectify this disparate treatment by folding the foreign personal holding company provisions into the PFIC rules. If Congress retains the foreign personal holding company rules, those rules should be amended to incorporate the look-through principles of section 1296(c). This result would be consistent with the growing trend in the tax laws to focus on economic realities rather than legal structure. See sections 864(e), 904(d) and 7701(f) of the Code.

Application of the PFIC look-through rules to personal holding companies, as opposed to rules patterned on subpart F, would accomplish the same objective in a strikingly similar context. If the overall economic character of a corporate group is "investment," the PFIC and foreign personal holding company rules should apply. If that overall economic character is "operating," and the "passive" income is really dividends and interest from operating subsidiaries, neither the PFIC nor the foreign personal holding company rules should apply.

STATEMENT OF PATTON BOGGS LLP, DONALD V. MOOREHEAD

FOREIGN TAX CREDIT "STACKING" RULES

This statement is submitted for inclusion in the record of the hearings held by the Committee on Finance on March 11, 1999 concerning possible changes to the provisions of the Internal Revenue Code of 1986, as amended (the "Code") governing international taxation. For the reasons summarized in this statement, Congress should amend the Code to provide that, with respect to any taxable year, foreign tax credits carried forward from prior taxable years shall be taken into account before foreign tax credits earned in the current year are applied. Such a change was included in the bipartisan international tax simplification bill introduced in the 105th Congress and would be consistent with sound considerations of tax policy.

U.S.-based businesses are subject to U.S. tax on their worldwide income. Thus, 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. Depending the character of such income (e.g., active or passive) and the manner in which a U.S.-based business structures its international operations, the U.S. tax on "foreign source income" will be payable either in the year the income is earned or it will be deferred until the income is repatriated.

To reduce the potential for the actual double taxation of foreign source income, most foreign income, withholding and similar taxes are creditable against the U.S. tax on such foreign source income. U.S.-based corporations generate foreign tax credits directly under section 901 of the Code (e.g., foreign withholding taxes on income received from abroad and foreign income taxes paid on the profits of international operations conducted branches of U.S. corporations). They also generate foreign tax credits indirectly under section 902 of the Code (e.g., foreign income taxes paid on international operations conducted through foreign subsidiaries). In the latter case, a dividend from a foreign subsidiary carries with it an appropriate portion of the foreign income taxes paid by the subsidiary.

It is generally accepted that the foreign tax credit is critical to American international competitiveness and in prior years Congress has wisely rejected proposals to convert the foreign tax credit to a tax deduction. At the same time, however, Congress has imposed various limitations on the foreign tax credit. The principal limitation permits foreign taxes to be credited against U.S. tax liability only in proportion to ratio of taxable foreign source income to worldwide taxable income. In principle, this "general limitation" is intended simply to prevent the use of foreign taxes as a credit against U.S. taxes on U.S. source income. This general limitation applies both to direct credits under section 901 and indirect credits under section 902.

When the amount of otherwise creditable foreign taxes exceeds the amount creditable under the "general limitation," a U.S. taxpayer has "excess credits." U.S.-based corporations generate excess foreign tax credits for a variety of reasons. For

example, they may conduct operations in foreign countries that have tax rates higher than the applicable U.S. tax rate (e.g., 35 percent in the case of corporations). As a further example, excess credits may be generated when foreign source taxable income is reduced artificially as the result of the allocation of U.S. interest expense (or certain other expenses) to foreign source income.

Under current law, such excess credits may be carried back to the two preceding taxable years and then forward to the five succeeding taxable years. The excess credits may be used in any year during this carryover period, but only if and to the extent the taxpayer has "excess limitation" for that year. The actual use of excess credits during the carryover period is limited by the application of the so-called "stacking" rule of section 904(c). Under this stacking rule, excess credits generated in one year may be used in a carryover year only after the credits generated in that carryover year have first been fully utilized. The stacking rule thus increases the likelihood that otherwise valid credits for foreign taxes actually paid on foreign source income subject to U.S. tax will not be used during the carryover period and will thus expire before they can be used.

The proposed 1998 "International Tax Simplification for American Competitiveness Act" (S. 2231 and H.R. 4173) sought to remedy this problem. Specifically, section 206 of that proposed legislation would have amended section 904(c) of the Code to provide that, with respect to any taxable year, foreign tax credits would be applied in the following order: (1) credits from carryovers to that taxable year, (2) credits earned in that taxable year, and (3) credits from carrybacks to that taxable year. This sensible result, which is consistent with the prior treatment of Congress of excess investment tax credits, would assure that U.S.-based businesses would be more likely to be able to utilize fully the credits they earn for foreign taxes paid prior to expiration of the carryover period for such credits. In addition, this revision to the stacking rules would reduce the incentive that U.S.-based businesses now have to engage in transactions designed principally to enable them to use their excess foreign tax credits before they expire.

STATEMENT OF SEABOARD MARINE

[SUBMITTED BY BRUCE BRECHEISEN, VICE PRESIDENT, FINANCE; AND RALPH L. MOSS, DIRECTOR, GOVERNMENT AFFAIRS]

Thank you for the opportunity to present the view of Seaboard Corporation regarding the critical issue of international tax reform initiatives. Seaboard Marine, a wholly-owned subsidiary based in Miami, is one of the few remaining U.S.-owned shipping lines. Our company is one of the nation's premier carriers to the Carribean Basin, Central America and the West Coast of South America. Additionally, Seaboard Marine is the largest carrier operating out of the Port of Miami, the world's leading shipping port to the Caribbean Basin and Central America.

Seaboard competes internationally with carriers from around the world. Our ability to compete, however, is significantly hampered because of oppressive and repressive U.S. tax and regulatory policy. These rules and regulations favor foreign shippers at the expense of the U.S. maritime industry, creating a lopsided playing field. The imposition of punitive taxes on U.S.- owned international shipping companies has decimated the maritime industry. Specifically, the current provisions of Subpart F of the Internal Revenue Code have made it virtually impossible for Seaboard Marine and other U.S.-owned shipping companies to remain competitive in the global marketplace. As one of the last remaining U.S.-owned shipping lines, we are asking for your assistance in reforming U.S. tax law by restoring the exclusion for shipping income from Subpart F of the Internal Revenue Code. If the restoration of the exclusion for shipping income from Subpart F does not occur, the effect on Seaboard Marine will continue to be devastating. Seaboard Marine employs more than 500 U.S. citizens, and generates revenues in excess of $300 million. In South Florida, as you know, seaports are the engines that drive the local economy. In many parts of Florida, trade is a larger part of the economy than tourism. Additionally, Seaboard Marine tangentially affects the employment of thousands of other American workers who are necessary to the inherent capital-intensive nature of the marine shipping industry.

These ancillary businesses include trucking, warehousing, banking and manufacturing industries, and freight forwarders. Moreover, the vast portion of the capital assets that Seaboard Marine utilizes in its business are produced in the United States, such as flat racks, refrigeration equipment, chassis and forklifts. For Seaboard Marine, the loss of Subpart F protection has meant not only decreased revenues, but also a disincentive to reinvest and expand.

If this disincentive were eliminated, the industries upon which the maritime industry depends for goods and services also would benefit. Finally, Seaboard Marine provides a critical trade link to key countries in Latin America, such as Guatemala, Honduras, El Salvador, Nicaragua and the Dominican Republic. For these countries, the United States is the principal source of trade, of which Seaboard Marine plays a major role. The U.S.' ability to maintain its dominance in this important trade zone will be enhanced by the reinstitution of Subpart F protections for our industry. Besides the specific implications for Seaboard Marine, the ramifications of current Subpart F provisions are far-reaching for the U.S. maritime industry. It is not incorrect or an exaggeration to say that the American maritime industry faces extinction if the current provisions of Subpart F are not amended and corrected.

Alarmingly, the U.S.-controlled fleet has declined from representing more than twenty- five (25) percent of the world fleet in 1975, when Subpart F was first altered, to less than five (5) percent today. American carriers' share of the market of the U.S. import/export cargoes fell by half between 1990 and 1996, according to the U.S. Maritime Administration. Equally striking is that in 1975, U.S. carriers owned nearly 22 million of the 85 million gross registered tonnage in the world flag-of-convenience fleet. This accounted for approximately 26 percent of the world fleet. By 1996, however, the world-flag-of-convenience fleet had almost tripled, to 241 million tons, while U.S. carrier ownership fell almost by half. The downfall of the American shipping industry is directly attributable to the devastating income tax burden that the U.S. government imposes upon it. American carriers pay income tax at a base rate of 36 percent. Most foreign carriers, however, pay little or no income tax.

A study conducted by Crowley Maritime illustrates the disparity of the tax ramifications between U.S. and foreign shippers. The Crowley study found that on average, the foreign carriers sampled received a net tax credit in 1996, while American carriers sampled paid more than 45 percent of their profits to the U.S. government in taxes in 1996; 43 percent in 1997. With this tax disparity in mind, there is little wonder why the American shipping industry is struggling for survival.

Before the protection of Subpart F was stripped away, the once-proud U.S.-owned fleet controlled a quarter of the world's fleet. Hundreds of millions of dollars were generated in annual tax revenues as a result of the voluntary repatriation of earnings. The associated infrastructure generated billions of additional dollars of taxable economic activity. After the 1975 alteration to Subpart F, the once significant U.S.-owned fleet was forced to expatriate to remain competitive. Related industries, such as insurance brokerage, ship management, surveying, chartering, technical consultancies, etc., who serviced the maritime industry, followed.

Conversely, foreign shippers have a taken advantage of a favorable tax regime both in the U.S. and abroad. This has a given them a great advantage and thus a stranglehold on the industry. Consequently, the economic leadership of the United States in this critical sector of the economy has been lost. This has been painfully demonstrated and made obviously recent international maritime transactions.

In 1997, for example, the American President Lines, a bastion of the American maritime industry for more than 100 years, was sold to Neptune Orient Lines Ltd. of Singapore. Shortly thereafter, Lykes Steamship Company, another prominent old-line shipper, sold its assets to Canadian Pacific Ltd. In short, these venerable lines fell into foreign hands because of the repressive and noncompetitive tax burdens the U.S. government placed on the lines' American owners. The elimination of the exclusion for shipping income from Subpart F of the Internal Revenue Code is thus illogical. The current provisions of Subpart F do not achieve the objective for which they were created. This repressive tax burden has not generated the tax revenues which were expected. Instead of increasing the tax revenue from the 1975 level of slightly more than $200 million to a projected revenue of almost $800 million in 1998, the revenue has, in fact, plummeted to (approx.) a meager $50 million. The decline of the maritime industry has additionally weakened the national defense, threatened existing maritime jobs and prevented the creation of new job opportunities. America's national defense is weakened because the military has historically relied upon the U.S. fleet to meet its marine transportation requirements. We must now depend upon ships under foreign ownership.

The current provisions of Subpart F threaten thousands of U.S. maritime jobs, and prevent the creation of countless others because of the disincentive for American investment or reinvestment in shipping enterprises. Relieving the onerous burden that Subpart F presently imposes on the U.S. maritime industry not only would secure existing American jobs, but would no doubt be conducive to the creation of new job opportunities. Currently, Congressmen Clay Shaw (R-Fla.) and William Jefferson (D-La.) have introduced legislation that would restore the Subpart F exemption and allow tax-deferred revenue to be reinvested in U.S. flag shipping. As one of the last surviving players in the American maritime industry, Seaboard Marine

urges you to give close and careful scrutiny to the ramifications of the Shaw-Jefferson legislation. Without the repeal of the repressive provisions of the current Subpart F legislation, the extinction of the U.S. maritime industry is inevitable. Seaboard Marine appreciates the opportunity to contribute to this vital tax and trade debate. Our industry has been made to suffer by repressive taxation. It is time to halt and correct this crippling of a vital American industry.

STATEMENT OF THE TAX COUNCIL

[SUBMITTED BY ROGER LEMASTER, EXECUTIVE DIRECTOR]

The Tax Council appreciates the opportunity to present its views before the Senate Finance Committee on the issue of international tax reform, and its impact on the international competitiveness of U.S. businesses and workers. The Tax Council is an association of senior level tax professionals representing over one hundred of the largest corporations in the United States, including companies involved in telecommunications, manufacturing, energy, electronics, transportation, utilities, consumer products and services, retailing, accounting, banking, and insurance. We are a nonprofit, business supported organization that has been active since 1967. We are one of the few professional organizations that focus exclusively on federal tax policy issues for businesses. In general, we support sound federal tax policies that encourage both capital formation and capital preservation in order to increase the real productivity of the nation.

The Tax Council applauds the Finance Committee for scheduling these important hearings. Although there is a great deal that needs to be done in the area of international tax reform, we would like to specifically address a proposal that has resurfaced many times over the last few years, namely, changing the rules on the carryback of foreign tax credits ("FTCs"). Just last summer, we wrote you to express our concern with changing these rules in conjunction with the comprehensive trade bill approved by your Committee (S. 2400). As you know, that bill included as a revenue offset a provision modifying the carryback period for FTCs. Specifically, Sec. 7002 reduced the carryback period for FTCs from 2 years to 1 year and, at the same time, extended the FTC carryforward period from five to seven years.

This proposal was identical to a provision in last year's Senate budget bill, (S. 949), as well as a provision in "The Parent and Student Savings Account PLUS Act" (S. 1133) that was initially introduced by Senator Coverdell on February 12, 1998 and subsequently became part of Congressional Bill H.R. 2646. The provision was also used as a "pay for" (before being dropped in Conference) in the legislation on The Reform and Reorganization of the Internal Revenue Service.

Although such a proposal would certainly result in increased revenue for the government (almost $1.6 Billion over 1999-2002 and almost $3.2 Billion over 1999-2007; see JCX-55-98), it is not sound tax policy and would not achieve the objective of retaining U.S. jobs and keeping the American economy strong. Moreover, one argument supporting this provision is that it would simplify tax administration. However, it will actually cause highly inequitable results and harm U.S. multinationals in efforts to successfully compete against foreign-based companies.

When companies invest overseas, they often receive favorable local tax treatment from foreign governments, at least in the early years of operation. For example, companies are often granted rapid depreciation write-offs, and low or even zero tax rates, for a period of years until the new venture is up and running. This results in a low effective tax rate in those foreign countries for those early years of operation. For U.S. tax purposes, however, those foreign operations must utilize much slower capital recovery methods and rates, and are still subject to residual U.S. tax at 35 percent. Thus, even though those foreign operations may show very little profit from a local standpoint, they may owe high incremental taxes to the U.S. government on repatriations or deemed distributions to the U.S. parent.

However, once such operations are ongoing for some length of time, this tax disparity often turns around, with local tax obligations exceeding residual U.S. taxes. At that point, the foreign operations generate excess FTCs but, without an adequate carryback period, those excess FTCs will just linger and expire. Extending the carryforward period will not alleviate the problem, because the operation will likely continue to generate excess FTCs in comparison with the U.S. residual tax situation, resulting in additional FTCs for eventual expiration.

The U.S. tax system is based on the premise that FTCs help alleviate double taxation of foreign source income. By granting taxpayers a dollar-for-dollar credit against their U.S. liability for taxes paid to local foreign governments, the U.S. government allows its taxpayers to compete more fairly and effectively in the inter-

national arena. However, by imposing limits on carrying back excess FTCs to earlier years, the value of these FTCs diminish considerably (if not entirely in many situations). Thus, the threat of double taxation of foreign earnings becomes much more likely.

As noted in the past by the Joint Committee on Taxation, one of the purposes of allowing the carryback and carryover of FTCs is to address timing differences between U.S. tax rules and foreign tax rules. Income may be subject to tax in one year under U.S. rules and in another tax year under applicable foreign rules. The carryback and carryover of FTCs helps insure that foreign taxes will be available to offset U.S. taxes on the income in the year in which the income is recognized for U.S. purposes. Thus, shortening the carryback period and increasing the carryforward period would have the likely effect of reducing the present value of FTCs and, therefore, increasing the effective tax rate on foreign source income. A single year is not a sufficient carryback period if the intent is to allow taxpayers to use the foreign tax credit mechanism to offset double taxation of foreign earnings. (Rather, the carryback period should be extended to something longer, e.g., 3 years, 5 years, or even an infinite period, to truly protect against double taxation of foreign earnings.)

In summary, reducing the FTC carryback period from two years to one year will greatly increase the costs of doing business overseas for U.S. multinationals, resulting in a competitive disadvantage versus foreign-based companies. Higher business taxes for U.S. companies may result in higher prices for goods and services sold to U.S. consumers, stagnant or lower wages paid to American workers in those businesses, reduced capital investment leading, perhaps, to work force reductions or decreased benefits, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

An extended carryback period for foreign tax credits allows companies to remain strong economic engines for our country and fill even larger roles in the health and future of American workers. What happens to corporate America affects the livelihood of all Americans, either directly or indirectly. In order that U.S. multinationals may better compete with foreign-based multinationals, Congress should endeavor to make the U.S. tax code more friendly, not more costly. Thus, the carryback period for FTCs should not be reduced from two years to one.

Thank you for allowing us to contribute our thoughts on this very important issue to our members.

Statement of the Tax Executive Institute, Inc.

[SUBMITTED BY LESTER D. EZRATI, INTERNATIONAL PRESIDENT]

Dear Senator Roth:

You recently outlined five criteria for reforming the system of international taxation and later this week the Senate Finance Committee will hold the first in a series of hearings on international tax reform, including the elimination of unnecessary complexity. Tax Executives Institute is developing its comments in respect of your call for action and intends to file those comments soon. I want to take this opportunity, however, to alert you to an issue that we believe merits immediate consideration. I am referring to the future of the IRS's advance pricing agreement (APA) program a program in which you have expressed an interest in facilitating and promoting.

The APA program is designed to forestall contentious and expensive transfer pricing disputes between taxpayers and the IRS. A voluntary venture, it is one of the IRS's success stories of the 1990s and furthers one of your stated goals the elimination of unnecessary complexity in the tax law. Each APA specifies a methodology negotiated between the specific taxpayer and the IRS (and, at times, a foreign country) for the taxpayer to use in determining its intercompany pricing and thereby assure compliance with section 482 of the Code. The information set forth in an APA the method by which a company determines its profit margins is highly fact specific and involves sensitive financial and commercial information. Almost 200 APAs have been negotiated since the program began in 1991 and the program has been used as a model by the international community as a means of minimizing double taxation of income and settling costly transfer pricing disputes.

Since its inception until January 8, 1999, the IRS treated the APAs and their supporting documentation as tax return information that was not subject to disclosure. On that date in conjunction with a suit filed by the Bureau of National Affairs for release of the APAs under the Freedom of Information Act the IRS notified BNA that the agency now takes the position that APAs constitute "written determina-

tions" under section 6110 of the Code and therefore may be publicly released in a redacted form. TEI believes that the IRS's concession is ill-conceived and we have filed a brief amicus curiae in the case. (For your information, a copy of the brief is enclosed.)

As a professional association dedicated to the development and implementation of sound tax policy, TEI is concerned that the release of the APAs even in redacted form will adversely affect the APA program. Taxpayers submitted the pricing information to the IRS with the understanding that the information would be subject to the same confidentiality restrictions as tax returns. Companies' legitimate privacy interests will be compromised by the release of the APA background documents and their ability to compete effectively in the marketplace could be harmed. Moreover, the very redaction process that accompanies release of the information would be extremely difficult, burdensome, and time-consuming.

More important, the knowledge that such information will be released in the future will discourage taxpayers from seeking APAs. TEI believes that the APA program represents the best way for companies to resolve transfer pricing controversies and avoid costly and time-consuming audits and litigation. At a time when the IRS is seeking more taxpayer-friendly ways of doing business, programs such as the APA program should actively be encouraged, rather than jeopardized by a mistaken interpretation of the law.

Enclosure.

IN THE UNITED STATES DISTRICT COURT FOR THE

DISTRICT OF COLUMBIA

BUREAU OF NATIONAL AFFAIRS, INC., Plaintiff	)	NO. 1:96-cv-376 (HHK) (JMF)
v.	)	NO. 1:96-cv-2820 (HHK) (JMF)
INTERNAL REVENUE SERVICE, et al., Defendants.	)	NO. 1:98-cv-1473 (HHK) (JMF)

MEMORANDUM OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN OPPOSITION TO PLAINTIFF BUREAU OF NATIONAL AFFAIRS, INC.'S MOTION FOR SUMMARY JUDGMENT

Tax Executives Institute, Inc. (hereinafter "TEI" or "amicus") respectfully submits this brief as amicus curiae in opposition to plaintiff Bureau of National Affairs, Inc.'s motion for summary judgment. TEI files this brief to assist the Court in consideration of BNA' s motion by presenting compelling arguments against that motion that defendant Internal Revenue Service has not fully presented.

STATEMENT OF THE CASE

BNA seeks the release under the Freedom of Information Act, 5 U.S.C. § 552, and Section 6110 of the Internal Revenue Code ("the Code") of Advance Pricing Agreements ("APAs") between taxpayers and the Internal Revenue Service (the "IRS"). Each APA specifies a methodology negotiated and settled between the specific taxpayer and the IRS (and, in the case of bilateral and multilateral APAs, foreign taxing authorities) for the taxpayer to use in determining its intercompany transfer pricing and thereby assure that the methodology complies with Section 482 of the Code. Transfer pricing is a very complex application of a relatively

simple provision of the tax law to a taxpayer's unique factual situation. The negotiation and settlement of transfer pricing are vital to the determination of the tax liabilities of many corporations and in assuring that multinational corporations are neither subject to double taxation nor able to avoid tax obligations.

The APAs at issue here were entered into pursuant to Rev. Proc. 91-22[1] or Rev. Proc. 96-53,[2] which provide, among other things, that the agreements themselves and the information the taxpayer supplies to the IRS in conjunction with their negotiation constitute "return information" under Section 6103 of the Code (26 U.S.C. § 6103). Section 6103 mandates that "return information" may not be publicly disclosed by the IRS.

From the inception of this litigation until January 8, 1999, the IRS consistently asserted that APAs are subject to the protections of Section 6103. On that date, after BNA filed its motion for summary judgment, the IRS notified BNA that the agency now takes the position that APAs constitute "written determinations" under Section 6110 of the Code. Shortly thereafter, the IRS sent letters to taxpayers that were parties to APAs, informing them of this change in position and the IRS's intent to disclose the APAs pursuant to Section 6110 after redacting certain information. As a result of this unfounded concession made by the IRS, the Court now is considering a schedule for review and production of APAs under the terms of Section 6110. TEI respectfully suggests that, before this path is pursued, the Court should resolve whether the documents at issue, in fact, fall within the narrow bounds of Section 6110 or whether, as TEI contends, APAs consist entirely of return information protected from disclosure under Section 6103. Such a decision is necessary to preserve the privacy rights of taxpayers that are parties to APAs.

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[1] Rev. Proc. 91-22, 1991-1 C.B. 526.

[2] Rev. Proc. 96-53, 1996-2 C.B. 375.

INTEREST OF AMICUS

TEI is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 and currently has approximately 5,000 members who are employed by 2,800 of the leading corporations in the United States and Canada. The members of TEI come from a cross-section of the business community in North America and represent companies that are vitally interested in the effective enforcement of the Code's transfer pricing rules.

TEI is dedicated to promoting the uniform, systematic, and equitable interpretation and enforcement of the tax laws. It is also dedicated to reducing the costs and burdens of tax administration and compliance to the benefit of both the government and taxpayers.

TEI has many members who are officers or employees of corporations that are parties to APAs. These corporations have found APAs to be very useful because they permit the negotiation and settlement of complex tax liability issues based upon the unique circumstances of each taxpayer through a means that can be fully relied upon by the taxpayer, the government, and, in many cases, foreign taxing authorities. TEI believes that the APA program represents the best way for many companies to resolve transfer pricing disputes and thereby avoid costly and time-consuming audits or litigation. TEI and its members fear that public disclosure of APAs would significantly decrease the desirability of entering into these agreements in the future and, therefore, would deprive both taxpayers and governments of this valuable method of settling tax liability issues. TEI members also believe that legitimate privacy interests and expectations will be compromised by the disclosure sought by BNA.

ARGUMENT

A. APAs Are Tax Return Information And May Not Be Publicly Disclosed

1. Section 6103 Prohibits Public Disclosure Of Tax Return Information

In the aftermath of the Watergate scandal (and the Nixon Administration's attempted abuse of the IRS and taxpayers), Congress revised Section 6103 of the Code to assure that taxpayer information is kept confidential by the IRS. *See Church of Scientology v. IRS*, 484 U.S. 9, 16 (1987) ("One of the major purposes in [the 1976 revisions of] § 6103 was to tighten the restrictions on the use of return information by entities other than [the IRS].") Although Congress has adopted certain exceptions to this general rule of privacy protection and non-disclosure, it is well-established that information subject to Section 6103 falls within FOIA Exemption 3 (5 U.S.C. § 552(b)(3)) concerning matters "specifically exempted from disclosure by statute." *See e.g., Church of Scientology v. IRS*, 792 F.2d 146, 150 (D.C. Cir.), en banc review of separate issue, 792 F.2d 153 (D.C. Cir. 1986), aff'd, 484 U.S. 9 (1987).

Under Section 6103, both returns and "return information" are protected. See 26 U.S.C. § 6103(a). Section 6103 defines "return information" in part, as follows:

> (A) a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

26 U.S.C. § 6103(b)(2)(A). Courts repeatedly have confirmed the broad scope of this statutory

language. *E.g.*, *Branch Ministries, Inc. v. Richardson*, 970 F. Supp. 11, 18 (D.D.C. 1997) ("[t]his language is extremely broad. . . ."); *Lehrfeld v. Richardson*, 954 F. Supp. 9, 13 (D.D.C. 1996), *aff'd*, 132 F.3d 1463 (D.C. Cir. 1998) ("'return information' is defined broadly by the statute to include almost any information compiled by the IRS in connection with its determination of a taxpayer's liability"). Furthermore, notwithstanding statutory language excluding from this definition "data in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer" (26 U.S.C. § 6103(b)(2)), the Supreme Court has ruled that return information does not lose its protection simply because identifying information could be redacted from it. *Church of Scientology*, 484 U.S. at 18 (holding that this exception to disclosure was intended to apply only to IRS statistical studies and similar matters). Accordingly, the IRS has no duty under FOIA to make such redactions and produce return information. *Id.*

2. APAs Are Return Information

APAs have been described in the parties' filings. As set forth in the November 2, 1998, declaration of Richard F. Barrett filed by the IRS in support of its November 4, 1998, motion for clarification (Barrett Decl. I), APAs are written agreements executed by and binding upon a taxpayer and the IRS. Barrett Decl. I ¶¶ 5; 8. In many cases, APAs also reflect agreements negotiated by the IRS and one or more foreign taxing authorities pursuant to a "competent authority agreement" made between the United States and its tax treaty partner in connection with the APA process. *Id* ¶ 9. APAs set forth the manner in which a transfer pricing methodology ("TPM") will be determined and applied by the taxpayer to ensure arm's-length pricing. *Id.* ¶ 5, *citing* Rev. Proc. 96-53, § 1, 1996-2 C.B. 375; Rev. Proc. 91-22, § 1, 1991 C.B. 526, 527.

The APA process includes negotiation and agreement regarding (1) the best basic method for determining arm's-length prices; and (2) how that method will be applied to the taxpayer's specific facts and circumstances. *Id.* ¶ 6, citing Rev. Proc. 96-53, § 2, at 375, and Rev. Proc. 91-

22 § 2, at 527. The process is highly fact-specific. *See id* at ¶ 7. The taxpayer submits extensive and highly sensitive financial and commercial information to the IRS in conjunction with APA negotiations. *See* Rev Proc. 96-53, § 5, 1996-2 C.B. 377. Some of this information received by the IRS is contained or reflected in the APA itself. *See* January 9, 1999, Declaration of Richard F. Barrett (Barrett Decl. II).

APAs are negotiated by a team of IRS personnel and the taxpayer's representatives. Each IRS APA team includes members from the IRS's local Examination Division (*e.g.*, revenue agents, international examiners, and industry economists) in addition to the IRS National Office APA staff. See Rev. Proc. 96-53, § 6.04, 1996-2 C.B. 380. The function of the IRS Examination Division members of an APA team is to scrutinize the detailed factual submissions made by the taxpayer and to analyze the factual circumstances of the taxpayer in order to support the IRS's negotiating position. The IRS Examination Division often develops an alternative, frequently opposing, position to that propounded by the taxpayer, and usually supports its alternative position with economic studies and analyses of the taxpayer's functions, risks, and operations.

The transfer pricing methodology agreed to in the APA (based in large part on the specific information supplied by the taxpayer and verified by the IRS) is used by the taxpayer in its determination of income and expenses, which, in turn, is used to determine tax liability. *See* Barrett Decl. II at ¶ 4. See also October 25, 1998, Declaration of Charles Triplett ("Triplett Decl.") (filed by BNA) at ¶4 (describing how transfer pricing issues are important in determining tax liability). Thus, APAs and the information provided to the IRS in conjunction with APA negotiations relate directly to the existence and amount of tax liability. APAs therefore constitute or reflect "data received by, recorded by, prepared by, furnished to and/or collected by the Secretary with respect to the determination of the existence or possible existence of the [taxpayer's tax] liability." Barrett Decl. I ¶ 10.

Not surprisingly, then, the procedures adopted by the IRS in 1991 and 1996 for negotiation of APAs specifically provided that APAs and supporting information would be subject to the

confidentiality provisions of Section 6103. Rev. Proc. 96-53, § 12, 1996-2 C.B. 375, 386; Rev. Proc. 91-22, § 11, 1991-1 C.B. 526, 534. In addition, amicus understands that many APAs contain provisions acknowledging this conclusion.

BNA makes four arguments to support its claim that APAs are not return information. None of these has merit. First, BNA claims that APAs cannot constitute return information because they are prospective in nature. As the IRS has noted, this assertion is factually incorrect; negotiation of an APA often is not completed until after one or more of the covered tax years has concluded, and the procedures applicable to APAs also include discretionary "roll back" provisions to even earlier years. *See* IRS memorandum at 14, Barrett Decl. II ¶ 13. *See also* Rev. Proc. 96-53, §§ 3.06 and 8, 1996-2 C.B. 376 and 382. Indeed, as part of the APA negotiation process, the IRS Examination Division examines the taxpayer's tax returns for the taxable years immediately preceding the years to which the APA will apply. Typically, the IRS will focus on the taxpayer's three preceding taxable years. If an APA agreement is reached, the approach taken in the APA is generally retroactively applied (*e.g.*, "rolled back") to these preceding years.[3] Furthermore, even if all APAs were solely prospective in nature, BNA's position is of no legal moment because nothing in Section 6103 requires that return information relate to current liability; Section 6103 (b)(2)(A) refers to the existence *or possible* existence of tax liability.[4]

Second, BNA asserts that APAs can be redacted to remove information identifying the taxpayers.[5] This argument was specifically rejected in *Church of Scientology*, which held that the

[3] The IRS's Examination Division has jurisdiction over the years preceding the APA term and, generally, exercises considerable influence over the APA negotiation process.

[4] BNA also asserts that TPMs are "formulas" and, therefore, not "data" within the scope of Section 6103. This assertion is factually incorrect. *See* Barrett Decl. II ¶ 12. Under Section 482, a taxpayer must identity and use comparables -- a fact negating the notion that TPMs are formulas. Moreover, the assertion is legally unfounded. The term "data" means information; a pricing formula or methodology certainly can be and is useful information in determining tax liability.

[5] BNA has asserted that even without redaction, some parts of APAs do not contain information that would identify the taxpayer involved. The IRS has demonstrated that this assertion is wrong as a matter of fact. Barrett Decl. II, ¶¶ 15, 16 & 20. See also Triplett Decl. ¶ 17. Likewise, in assessing whether individual APAs constitute "return information," it is not significant that the IRS has developed certain "boilerplate" provisions for APAs. The IRS already has disclosed a model APA setting forth some boilerplate provisions. See Notice 98-10, 1998-6 I.R.B. 9

redaction of identifying information would not deprive return information of its protected status and, moreover, that the IRS was under no duty to make such redactions. 484 U.S. at 18. See also Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d Sess. 316 (Dec. 29, 1976). BNA's argument, therefore, is without merit.

Third, BNA invokes the language of Section 6103(b)(2)(B). As the IRS has explained (memorandum at 15-16), however, BNA has misquoted the relevant language. Thus, this contention also is meritless.

Finally, BNA argues that the D.C. Circuit's decision in *Tax Analysts v. IRS*, 117 F.3d 607 (D.C. Cir. 1997), is controlling here. As TEI now shows, this argument is equally without merit.

3. <u>The D.C. Circuit's Decision In *Tax Analysts* Is Inapposite</u>

In *Tax Analysts*, plaintiffs sought disclosure of "Field Service Advice Memoranda" issued by the Office of Chief Counsel of the IRS in response to requests of field personnel of either the Office of Chief Counsel or the IRS seeking legal guidance. 117 F.3d at 608. The government conceded in that case that "among the primary purposes of FSAs is ensuring that field personnel apply the law correctly and uniformly." Id. at 609. As described by the D.C. Circuit, each FSA includes "a statement of issues, a conclusions section, a statement of facts, and a legal analysis section." *Id.* In ordering disclosure of the legal analysis section (but not the other portions) of FSAs, the court explained that FSAs are functionally equivalent to Technical Advice Memoranda, which are to be publicly disclosed under Section 6110 of the Code. *Id.* at 616. Furthermore, the Court held that the legal analysis portions of FSAs do not implicate the privacy concerns underlying Section 6103 and, accordingly, should not reasonably be considered "data" within the meaning of that statute. *Id.* at 615.

In stark contrast to FSAs, APAs contain no "legal analysis" section. Instead, they set forth: (1) the contractual rights and obligations of specific taxpayers; (2) a definition of the agreed-to

(attached as Exhibit E to Barrett Decl. I). Whether or not "boilerplate" terms are included in any specific APA is a matter for negotiation, and the individual APAs, therefore, remain taxpayer-specific.

TPM for that specific taxpayer; (3) an identification of the specific critical assumptions upon which the agreement was based; and (4) taxpayer-specific document retention requirements, accounting requirements, provisions for annual reporting, compensatory adjustments, covered transactions, and non-factual representations. Barrett Decl. I ¶ 8. All of this information clearly falls within the broad scope of Section 6103 because it is taxpayer-specific and unmistakably implicates the privacy concerns forming the basis for Section 6103. Thus, *Tax Analysts* -- which deals with a wholly different type of document -- has no bearing on the issue before the Court.

B. <u>APAs Are Not Written Determinations For Purposes of Section 6110</u>

Notwithstanding the application of Section 6103 to APAs, BNA seeks their disclosure pursuant to Section 6110 of the Code. While the IRS has shown in its memorandum opposing summary judgment (at 13-17) that Section 6103 applies to APAs, it nonetheless agreed to produce the APAs after making the redactions required under Section 6110. Section 6110, however, applies only in respect of written determinations. An examination of the language and history of Section 6110 makes manifest that APAs are not "written determinations" and, therefore, are not subject to its disclosure provisions.[6]

Like Section 6103, Section 6110 was enacted as part of the Tax Reform Act of 1976. In part, it codified what were then recent decisions by various courts compelling disclosure under FOIA of private letter rulings and Technical Advice Memoranda issued by the IRS. *See e.g.*

[6] The Court may question why, assuming trade secret and confidential commercial or financial material is redacted, disclosure pursuant to Section 6110 is troubling to TEI and its members. First, such disclosure undermines the taxpayer's legitimate confidentiality expectations. There may well be sensitive material that does not meet the technical requirements of confidential commercial or financial information pursuant to Section 6110(c)(4) that the taxpayer nonetheless reasonably expected to remain confidential pursuant to Section 6103 (and the terms of the APAs themselves). Second, Section 6110 requires disclosure not only of written determinations but also of "any background file document," which includes "any written material submitted in support" of the determination. In the case of APAs, voluminous material is provided by the taxpayer in the course of negotiations. While BNA has not yet requested this material, it is reasonable to assume that if BNA prevails in this litigation such a request will follow (if not by BNA, then by other parties). Not only are there confidentiality concerns with respect to this background material, but the very redaction process that would accompany such disclosure would be extremely difficult, burdensome, and time-consuming. All of this is troubling to because it could have a chilling effect on the APA process, which has been extremely useful to TEI's members, as well as to U.S. and foreign governments.

Fruehauf Corp. v. IRS, 522 F. 2d 284 (6th Cir. 1975), *vacated and remanded for reconsideration in light of 1976 Act*, 429 U.S. 1085 (1977).[7] Section 6110 provides for public disclosure of "written determinations" and defines that term as "a ruling, determination letter, technical advice memorandum or Chief Counsel advice." 26 U.S.C. § 61 10(b)(1). The reach of Section 6110 is limited to these specific categories of documents.

The Senate Report confirms that Section 6110 is of limited scope. For example, the report states that "IRS written determinations, *i.e.*, rulings, technical advice memoranda and determination letters, would generally be open to public inspection." S. Rep. No. 94-938 (Part II), 94th Cong., 2d Sess. 306 (1976), reprinted in 1976 U.S.C.C.A.N. 3735 (emphasis supplied). In other words, the list in Section 6110 was intended to be exclusive, not exemplary.[8] *See, e.g.*, *New v. Dept. of Veterans Affairs*, 142 F.3d 1259, 1265 (Fed. Cir. 1998) (use of "*i.e.*" in regulation refutes notion that item mentioned was exemplary rather than a limitation). Furthermore, the Committee noted that "a written determination would not be considered a ruling, technical advice memorandum or determination letter unless it recites the relevant facts, explains the applicable provisions of law, and shows the application of law to the facts." *Id.* at 3736.[9]

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[7] The legislative history of the 1976 Act shows that members of the Senate Finance Committee believed that the issue of access to these IRS rulings should be resolved by Congress, not the courts. S. Rep. No. 94-938 (Part II), at 306 (1976), reprinted in 1976 U.S.C.C.A.N. 3735. Accordingly, the 1976 Act included Section 6110 "providing an exclusive remedy with respect to disclosure of rulings and related material." *Id*

[8] The court in Tax Analysts did rely on Section 6110 to conclude that the legal analysis portion of FSAs (which, like APAs, did not exist at the time Section 6110 was enacted) did not constitute "return information" for purposes of Section 6103. Significantly, however, the D.C. Circuit did not hold that FSAs were subject to the provisions of Section 6110.

[9] The IRS has adopted this view in its own regulations under Section 6110. In particular, the IRS regulations define "ruling" for purposes of Section 6110, as follows:

> a written statement issued by the National Office to a taxpayer or to the taxpayer's authorized representative. . ., that interprets and applies tax laws to a specific set of facts. A ruling generally recites the relevant facts, sets forth the applicable provisions of law, and shows the application of the law to the facts.

26 C.F.R. § 301.6110-2(d).

In light of the statutory language and the legislative history of Section 6110, APAs cannot reasonably be considered written determinations under the statute. APAs are not "determinations" by the IRS; they are agreements negotiated between the IRS and a specific taxpayer. Indeed, the IRS procedures for APAs note that "[t]he APA process is designed to be a flexible problem solving process, based on cooperation and principled negotiations between taxpayers and the Service." Rev. Proc. 96-53, § 3.01, 1996-2 C.B. 376. Unlike IRS rulings or determination letters, APAs are not just "issued"[10] by the IRS, they are signed by and binding upon the taxpayer. APAs impose real obligations on the taxpayer, including annual reporting and record retention obligations. *See id.*, § 11. Conversely, APAs provide significant benefits to the IRS. See Triplett Decl., ¶ 7. Furthermore, unlike rulings, which can be revoked by the IRS for any reason (see 26 C.F.R. § 601.201(l)), APAs may be revoked only in cases of fraud, malfeasance, or disregard by the taxpayer. Rev. Proc. 96-53, § 11.05, 1996-2 C.B. 385.

Many APAs reflect agreements between the IRS and foreign taxing authorities that may result in transfer pricing methodologies different from any of the specific methods set forth in the regulations under Section 482. Barrett Decl. II ¶ 8. Thus, they cannot be characterized as reflecting a determination by the IRS.

Most critically, APAs lack the key characteristics of rulings described in the committee report and the IRS regulations: they contain no discussion of the applicable provisions of law, nor do they show the application of law to fact. Instead, they set forth a certain transfer pricing methodology (which is determined through negotiation) and provide that if that methodology is utilized by the taxpayer (and if the taxpayer complies with various recordkeeping and other requirements designed to assure that the IRS can verify its use), then the IRS will not challenge the use of that methodology in determining the taxpayer's tax liability.

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[10] BNA relies on the IRS's admission that APAs are "issued" in the sense that the IRS mails APAs to the taxpayer. See *IRS Responses to First Request for Admissions* (Ex. 6 to BNA Memorandum), Request No. 2. The regulation relied upon by BNA --26 C.F.R. § 301.6110-2(h)-- concerns the issue of finality. It does not support the notion that APAs are equivalent to the unilateral statements of the IRS that are the subject of Section 6110.

In their character as agreements between the IRS and the taxpayer reflecting a negotiated resolution of a tax liability issue, APAs closely resemble "closing agreements," which have been used for years by the IRS for resolution of tax liability issues.[11] The Senate Report specifically noted that:

> Additionally, the committee amendment would not require public disclosure of a closing agreement entered into between the IRS and a taxpayer which finally determines the taxpayer's tax liability with respect to a taxable year. (Where it is in the interest of a taxpayer and the IRS, a closing agreement may be made in order to provide certainty as to a person's past tax liability.) The committee understands that a closing agreement is generally the result of a negotiated settlement and, as such, does not necessarily represent the IRS view of the law. (Emphasis supplied.)

S. Rep. No. 94-938 (Part II), supra, at 306, reprinted in 1976 U.S.C.C.A.N. 3736. *See also General Explanation of the Tax Reform Act of 1976*, at 304-305 (containing nearly identical language).[12] Similarly, APAs are the result of negotiated settlements between the IRS and a taxpayer and, in some cases, foreign taxing authorities, and "do not necessarily represent the IRS view of the law." For this reason, APAs, unlike rulings, determination letters, and Technical Advice Memoranda, cannot be regarded as "secret law" of the IRS that ought to be publicly disclosed.

Furthermore, the ongoing involvement of examination personnel in the APA process and the common practice of "rolling back" the TPM to prior tax years make the negotiation of the APA analogous to an accelerated examination for which a settlement is reached pursuant to a closing agreement or the less formal IRS Form 870-AD, which also is regarded as return information by the IRS. This process is quite unlike the IRS National Office's issuance of written determinations within the scope of Section 6110.

[11] TEI is aware that the IRS has admitted that APAs are not, in fact, closing agreements. *See IRS Response to Plaintiff's First Set of Requests For Admission No. 41* (filed July 19, 1996). This admission does not, however, mean that the similarity between APAs and closing agreements should be ignored by the Court, just as the similarity between FSAs and TAMs was considered by the D.C. Circuit in Tax Analysts.

[12] See also H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 316(1975), *reprinted in* 1976 U.S.C.C.A.N. 3212 (also containing nearly identical language).

BNA argues that APAs must be written determinations because the IRS has admitted that it relies upon its authority to issue written determinations to enter into APAs. *See* IRS January 11, 1999 *Statement Of Material Facts As To Which There Exists a Material Issue* ¶ 69. The record shows, however, that the IRS also relied upon its "general authority to enter into agreements with taxpayers" when it entered into APAs. Triplett Decl., ¶ 9. Mr. Triplett further states that the IRS decided to use the name Advanced Pricing Agreement rather than "Advance Determination Ruling," in part "because the notion of an 'agreement' more appropriately characterized a document signed by both parties." Id. ¶ 10. Furthermore, the legislative history demonstrates Congress's intent not only that contracts between the IRS and taxpayers would not fall under the disclosure requirements of Section 6110, but also that not even all written determinations of the IRS would be subject to such disclosure.[13] As we have demonstrated, APAs lack key characteristics of Section 6110 material.

Finally, BNA's own argument is also internally inconsistent with respect to this issue. Just after it asserts that APAs are "rulings," BNA acknowledges that the *Tax Analysts* court did not hold that any portion of FSAs -- that are much more similar to traditional Section 6110 material than APAs -- were subject to Section 6110. In light of this, BNA asserts, not that APAs are "rulings," but that APAs are the "modern equivalents" of rulings. (BNA memorandum at 20). Amicus has already shown why *Tax Analysts* does not support disclosure of APAs.

Thus, APAs are not written determinations subject to disclosure under Section 6110. Because they are return information for purposes of Section 6103, they also may not be disclosed under FOIA. Accordingly, the Court should deny BNA's motion for summary judgment in its entirety. At minimum, the Court should provide interested taxpayers with the opportunity to intervene to address the issue of whether APAs are protected from disclosure.

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[13] The IRS's definition of "ruling" for purposes of Section 6110 differs from its general definition of "ruling" set forth in the regulation cited by the IRS when promulgating the APA procedures. The more general definition does not state that a ruling "recites" relevant facts or "shows" the application of fact to law. Compare 26 C.F.R. 310.6110-2(d) to 26 C.F.R. § 601.201.

C. **In The Event The Court Should Accept The IRS's Concession, The Court Should Adopt The Schedule For Disclosure Proposed By The IRS**

TEI has shown that APAs constitute return information protected from disclosure under Section 6103. TEI has further shown that BNA's claim and the IRS's concession that APAs are written determinations under Section 6110 is wrong. If the Court should be inclined to accept that concession, however, TEI believes that it is critical that the Court adopt the schedule for production set forth by the IRS.

As has been described to the Court in some detail, by their very nature, APAs reflect and contain highly sensitive competitive information, the disclosure of which would be very harmful to the taxpayers who entered into the APAs with the understanding that they would remain confidential. It is therefore critical that the affected taxpayers have adequate time to consider the redactions proposed by the IRS and the need for additional redactions.[14] As even BNA concedes, such taxpayers also should be given the opportunity to intervene to protect their interests with respect to redactions. Contrary to BNA's suggestion, the IRS's prior good faith assertion that APAs are protected from disclosure in their entirety pursuant to Section 6103 should not be used as a basis to deprive third parties who relied on that confidentiality adequate time to protect their interests. Nor should it be used as a basis for finding waiver of any legitimate argument for redactions under Section 6110(c). Taxpayers that are parties to APAs should not be penalized by the disclosure of their confidential information as a result of the actions of the IRS.[15]

In addition, TEI fully supports the IRS's assertion that tax treaties are properly considered statutory law for purposes of Exemption 3 of Section 6110. TEI will not repeat the compelling arguments made by the IRS in favor of this position. Instead, TEI notes that many

[14] Indeed, the use of a range of comparables to determine the pricing methodology may require more than a redaction process. To make the released information relevant may require the use of hypothetical numbers.

[15] The affidavits submitted by the IRS in its opposition to BNA's motion demonstrate that there are legitimate concerns about the confidentiality of information contained in the APAs. Clearly, APAs should not be disclosed without the taxpayers having had a fair opportunity to participate in the redaction process and, if necessary, defend specific redactions from their APAs.

taxpayers, including corporations whose employees and officers are members of TEI, have operations both in the United States and overseas and must comply with the tax laws of several jurisdictions. Key to this compliance is the coordination and cooperation of the United States and foreign taxing authorities in resolving complex issues and competing interests. If the Court were to ignore the confidentiality provisions included in these treaties (which, indisputably, have the force of law), such action may not only disrupt the negotiation and agreement of bilateral and multilateral APAs, but also harm the ongoing working relationship between the United States and its treaty partners. Thus, the confidentiality provisions of tax treaties should be respected, and material deemed confidential by those provisions should be subject to redaction under Section 6110(c). In any event, the Court should not permit any disclosure of information arguably subject to tax treaty confidentiality provisions without first giving the affected treaty partners the opportunity to express their views.

CONCLUSION

APAs are confidential return information shielded from public disclosure under 26 U.S.C. § 6103. The IRS's ill-conceived concession that the documents are written determinations under Section 6110 has no basis in fact or law, and should not be accepted in the face of the privacy concerns set forth in Section 6103. Instead, the Court should deny BNA's motion for summary judgment in its entirety and find that the confidentiality of the APAs should be maintained.

Respectfully submitted,

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CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that the foregoing MOTION OF TAX EXECUTIVES INSTITUTE, INC. FOR LEAVE TO FILE A MEMORANDUM AMICUS CURIAE IN OPPOSITION TO PLAINTIFF BUREAU OF NATIONAL AFFAIRS, INC.'S MOTION FOR SUMMARY JUDGMENT and MEMORANDUM OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN OPPOSITION TO PLAINTIFF BUREAU OF NATIONAL AFFAIRS, INC'S MOTION FOR SUMMARY JUDGMENT were caused to be served upon plaintiff's counsel and defendant's counsel on the 24th day of February, 1999, by hand delivering copies thereof to the following addresses:

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Statement of Tropical Shipping

[SUBMITTED BY RICHARD MURRELL, PRESIDENT AND CEO]

An unintended result of the 1986 and 1975 tax law changes has been the near complete removal of US investment from the Ocean Shipping industry leaving the cargo trades of the United States almost entirely in the hands of foreign owned and foreign controlled shipping companies. Overall US ownership of the world fleet has declined from 25% of world tonnage in 1975 when the first tax code change affecting shipping was enacted, to less than 5% today!

This unintended consequence has profound implications for the United States, as international trade and commerce of goods has historically been influenced by the national interests of the country of ultimate ship ownership.

Tropical Shipping is a US owned container shipping company (CFC) with a business focus on serving the Caribbean, the only region in the world, in which the United States has a balance of trade surplus. The exports to this region create numerous jobs throughout the US agricultural and manufacturing sectors as well as our own company's employment of over 500 people in the US.

The existence of the US balance of trade surplus with the Caribbean is no coincidence. This region is the last area in the world where US Shipping ownership dominates the carriage of general cargo and this contributes to the success and promotion of US exports. Our company, and our US owned competitors, are active every day putting Caribbean buyers in touch with US exporters as this is self serving for Tropical Shipping's long term interests.

Buying and operating ships is capital intensive. Our foreign-owned competitors have a great advantage in their accumulation of capital, as they are not taxed on a current basis and generally only pay tax when the dividends are repatriated.

US owners in this capital intensive and very competitive shipping industry, have sold out, gone out of business, and not invested in shipping because they just can not compete due to the unintended consequences of the US foreign tax code. It is simply this code that places US owners at a distinct disadvantage in the global commerce of ocean transportation. US owners can compete in all other respects.

In the containerized shipping industry, US owned participation in the carriage of US trade has steadily declined to an all time low of 14.2% of the container trade in 1998. The decline is not in the economic interest of the United States and weakens US exports contributing to fewer US based jobs. It will be a sad day indeed if all the ocean commerce created in the growing market of the Americas as a result of NAFTA and the FTAA ends up benefiting foreign owners with no chance for US investors to participate.

Please correct the tax code so that US investors can reasonably return and invest in the growing international shipping industry. H.R. 265 introduced by Congressman Shaw is an important response to this problem.

Statement of the U.S. Chamber of Commerce

[SUBMITTED BY WILLIAM T. SINCLAIRE, SENIOR TAX COUNSEL AND DIRECTOR OF TAX POLICY]

The U.S. Chamber of Commerce appreciates this opportunity to express its views to the Senate Finance Committee regarding a permanent moratorium on the ability of the U.S. Treasury Department to issue regulations for so-called "hybrid transactions."

The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, and 71 percent of our members have less than 10 employees. Yet, virtually all of the nation's largest companies are active members.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 10,000 members. In addition, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is also significant. We believe that global independence provides an opportunity, not a threat. In addition to the Chamber's 85 American Chambers of Commerce abroad, an ever increasing number of members are engaging in the export and import of both goods and services and have ongoing

investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

It is this international link that prompts our interest in communicating with the Finance Committee regarding the specific issue of a permanent moratorium on Treasury's ability to issue regulations dealing with hybrid transactions. We support S. 672, legislation introduced in the Senate by Senators John B. Breaux (D-LA) and Connie Mack (R-FL) on March 10, 1999. We also support H.R. 572, S. 672's companion legislation previously introduced in the House of Representatives on February 10, 1999, by Representatives Philip M. Crane (R-IL) and Robert T. Matsui (D-CA), and co-sponsored by eight fellow Ways and Means Committee members—i.e., Representatives Nancy L. Johnson (R-CT), John S. Tanner (D-TN), Amo Houghton, Jr. (R-NY), Wally Herger (R-CA), Sam Johnson (R-TX), J.D. Hayworth (R-AZ), Jim Ramstad (R-MN), and Jim McCrery (R-LA).

S. 672 and H.R. 572 would (1) prohibit the Treasury Department from issuing temporary or final regulations relating to the treatment of hybrid transactions under subpart F, part III, subchapter N, chapter 1 ("subpart F") of the Internal Revenue Code (the "IRC") pursuant to Internal Revenue Service (the "IRS") Notice 98-35, 1998-27 I.R.B. 35, or any other regulations reaching the same or similar result as such notice, (2) require retroactive withdrawal of any such regulations which were issued after the date of such notice and before the enactment of these bills, and (3) prohibit the modification or withdrawal of Treasury Regulation sections 301.7701-1 through 301.7701-3 in a manner which would alter the treatment of hybrid transactions under subpart F. In addition, the bills would require Treasury to study the tax treatment of hybrids under subpart F and to submit a report to the Ways and Means and Finance Committees, after at least one public hearing regarding such report.

S. 672 and H.R. 572 are identical to bills introduced in the 105th Congress, when both Houses expressed their concern over the policy changes to subpart F suggested by Treasury in Notice 98-11, 1998-6 I.R.B. 18. Last year, Ways and Means Committee Chairman Bill Archer (R-TX) and Ranking Member Charles B. Rangel (D-NY) wrote letters to Treasury expressing their concern with these policy changes as well as the means by which Treasury implemented them. Other members of Congress, including approximately 90 percent of the members of the Ways and Means Committee, wrote letters asking Treasury to withdraw the regulations in order for Congress to have an opportunity to review the issues.

Moreover, when the Finance Committee reported out the Internal Revenue Service Restructuring and Reform Bill of 1998, it contained a provision imposing a six-month moratorium on the enforcement of Notice 98-11 and the rules. However, the version of the IRS Restructuring and Reform Bill which passed the Senate provided it was the sense of the Senate that Treasury should withdraw Notice 98-11 and the regulations issued thereunder, and that the Congress, and not Treasury should determine the international tax policy issues relating to the treatment of hybrid transactions under subpart F. Nonetheless, the conference agreement did not include the Senate amendment because the conferees were aware Treasury had withdrawn Notice 98-11 and had announced its intention to withdraw the temporary and proposed regulations issued under the notice.

Although Treasury issued Notice 98-35 to withdraw Notice 98-11, Notice 98-35 still left Treasury with the option of issuing binding rules regarding hybrid transactions. Additionally, while the rules will not be finalized before January 1, 2000, they will be effective for certain payments made on or after June 19, 1998. The Notices present the issue of whether the Congress or Treasury should be determining the tax policy of the United States in the international arena. Because this goes to the heart of competing considerations underlying the current U.S. international tax regime, we believe Congress is the only proper forum for making policy decisions. Any change in long-standing and fundamental tax policies should be made through substantive statutes enacted prospectively by Congress, not Notices or regulations issued retroactively by Treasury.

The provisions of subpart F are linked to and have a direct impact on the competitiveness of U.S. businesses operating in the global marketplace. As is well known, Congress historically has moved with caution when making changes to those sections of the IRC relating to international tax. Unwarranted or injudicious action in this area can have a substantial adverse impact on U.S. businesses operating abroad. These proposed changes by Treasury would no doubt put U.S. companies at a competitive disadvantage in the world markets by subjecting them to more taxation by foreign governments. This raises the question of why Treasury is so concerned about helping to generate revenue for the coffers of other countries. Furthermore, Notice 98-35 is clearly at odds with changes made by Congress regarding subpart F in the Taxpayer Relief Act of 1997. Therefore, we ask the Finance Committee

to support S. 572 and prohibit Treasury from issuing new regulations relating to the tax treatment of hybrid transactions under subpart F.

The Chamber is fully supportive of the effort of the Finance Committee to further the debate regarding the competitiveness of U.S. industry in world markets. We stand ready to work with the Committee to achieve the laudable goals and objectives of the international tax reform hearings.