Written Testimony of

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Before the

Committee on Finance

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Good morning. My name is Alexander Spitzer. Mr. Chairman, I am grateful for this opportunity to share with the Committee my personal views on international tax policy as it relates to U.S. operations of multinational firms and, in particular, any impediments in the tax code that may serve as a barrier to attracting international investment into the U.S. manufacturing base.

I am Senior Vice President - Taxes for Nestlé USA and have held the top tax job in the company for the last 18 years. Also, from 1996-2002, I served as President of the Organization for International Investment (OFII).

As you may know, OFII is the leading business association in Washington representing the interests of U.S. subsidiaries of multinational firms – companies such as Shell, Rolls-Royce, Sony and Philips Electronics. OFII supports the notion that U.S. economic policy should provide non-discriminatory treatment for U.S. subsidiaries of foreign firms. The most recent example of exactly the type of policy we support occurred just a few weeks ago in this very room when you and some of your colleagues made a special effort to ensure that U.S. shareholders owning stock in foreign-based firms, such as Nestlé, would pay tax on dividends from those companies at the ***same*** tax rate as dividends from a domestic company. As an employee-shareholder in Nestlé, I want to thank you for your efforts to ensure that we were not punitively treated under the bill.

As the top tax executive for a major U.S. subsidiary of a Swiss-based multinational and as long-time President of the inbound investment community's leading association, I believe that I have a unique perspective to offer the Committee today. Thank you for inviting me.

<u>Nestlé in the United States</u>

Nestlé, a Swiss public company, is the world's largest food company and is 140 years old. For more than 100 years (well before the U.S. enacted the current federal income tax), Nestlé has been investing in American factories, jobs and businesses and manufactures in the U.S. a large range of products including Baby Ruth, Butterfinger, Nestlé Crunch, PowerBar, Poland Spring Water, Hot Pockets, Taster's Choice coffee, Coffee-mate, Libby's Juicy Juice, Häagen-Dazs Ice Cream, Friskies pet food and many more. We have a total of 43,000 employees at 73 manufacturing facilities, 6 distribution centers and numerous sales offices around the country in 33 states, supporting a $2.5 billion annual payroll. Nestlé's U.S. manufactured product sales for 2002 approximated $18.0 billion, including $600 million in exports. This March, *Fortune* magazine named

Nestlé USA “America’s Most Admired Food Company” for the sixth consecutive year. Whether it is the 1,600 employees in Springville, Utah making Stouffer’s Lean Cuisine or the 1,000 across Iowa making Carnation Instant Breakfast or Purina Dog Chow, Nestlé makes a significant contribution to the U.S. economy.

U.S. Subsidiaries Provide Key Contributions to the U.S. Economy

Nestle is not alone in making important contributions, as U.S. government data on all U.S. subsidiaries clearly demonstrate.

Providing jobs: In 2000, 6.4 million American workers were employed by U.S. subsidiaries of foreign firms, accounting for 13.8 percent of all U.S. manufacturing jobs and 5.6 percent of the overall private industry workforce. Over the last five years, U.S. subsidiaries’ employment has increased by more than 30 percent. These jobs are distributed across a range of industries, with 43 percent of the jobs in manufacturing.

Paying high wages: U.S. subsidiaries of foreign companies support an annual payroll of $330 billion. In 2000, compensation per employee was 15.4 percent, or $6,830 higher at U.S. subsidiaries than at all private-sector businesses in the U.S. In part, higher wages reflect the high productivity of U.S. subsidiaries.

Contributing to U.S. export growth: In 2000, U.S. subsidiaries exported a record $165.3 billion of merchandise. Their merchandise exports accounted for 21 percent of all goods exported by the U.S. that year. And, except for 1987, they have accounted for more than 20 percent of the U.S. total for every year since 1980.

Investing in plant and equipment: U.S. subsidiaries have established deep roots in this country and continue to make very substantial investments that will make them even more productive. They invested $148.8 billion in new plant and equipment in 2000, twice the amount of just five years ago.

Contributing to U.S. R&D activity: In 2000, U.S. subsidiaries invested $30.2 billion in R&D activities in the United States, performed by U.S. doctors, scientists and engineers. Their share of all privately-funded U.S. industrial R&D has risen by $12.7 billion from five years ago.

Tax Payments of U.S. Subsidiaries

Consistent with their significant economic activity in the United States, U.S. subsidiaries are also significant taxpayers in the United States. Appended to my statement is a statistical review that goes into some detail regarding different facets of U.S. subsidiaries' robust and material contribution to the U.S. tax base. The appendix is drawn from a recent White Paper produced by OFII and it relies on the most recent IRS data. The highlights of the data are:

- U.S. subsidiaries' tax payments have grown from $6 billion in 1991 to $28 billion in 2000, accounting for 14% of all corporate tax payments.

- The effective U.S. corporate tax rate (measured as a percentage of assets) of U.S. subsidiaries is comparable to that of all U.S. corporations.
- U.S. subsidiaries' long-term debt has declined as a share of assets and is similar to that of all U.S. corporations.

The statistics above and in the appendix demonstrate that U.S. subsidiaries are paying tax at the same levels as all other corporate taxpayers.

Some allege that foreign firms have a tax advantage in the U.S. tax code and that this "advantage" has lead to a disproportionate number of U.S. companies being acquired by foreign firms. In my professional experience, the assertion of a tax advantage is false and M&A data regarding U.S. acquired companies prove that foreign firms are not dominating U.S. mergers and acquisitions.

- Between 1998-2001, U.S.-based companies' acquisition of U.S.-based companies totaled $4.2 trillion, compared with $993.1 billion in foreign acquisitions of U.S.-based firms, or about 24 percent.[1]
- Of the top ten U.S. M&A deals announced in 2002, only two involved foreign-based firms purchasing U.S. based companies.[2]

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[1] *Mergers & Acquisitions, The Dealmaker's Journal,* various issues.
[2] *The Daily Deal,* January 23, 2003

It is also worth noting that foreign direct investment is a two-way street. As of 2002, the value of foreign direct investment in the U.S. was $1.3 trillion and the value of U.S. direct investment abroad was $1.5 trillion.[3]

Competitiveness of U.S. Operations of Multinational Companies

In today's global economy, successful businesses are in a constant search for growth – often tapping into markets other than their own. To do this, competitive international firms must understand the unique needs in all of their markets, constantly innovate, operate at maximum efficiency to keep prices competitive, and create value for shareholders.

Investment in the United States by foreign-based firms directly benefits the U.S. economy by supporting high-wage jobs, increasing U.S. productivity through the transfer of firm-specific technology and know-how and expanding the domestic capital stock. The benefits of inward investment to host countries have been confirmed repeatedly in the academic literature. A recent survey of this literature by Prof. Robert Lipsey concludes:[4]

> "Within host countries, it has been abundantly shown that foreign-owned firms pay higher wages than domestically-owned firms. . . . Productivity comparisons between foreign-owned and domestically-owned firms or establishments almost always find that the foreign-owned firms have higher productivity levels. . . . If regions or countries encouraging inward investment are interested in encouraging high-wage plants, foreign investors seem to meet that desire."

[3] Preliminary 2002 data, Balance of Payment and Direct Investment Position data, U.S. Department of Commerce.

In the past, competitiveness has been defined in stark, "us vs. them" terms. I would urge you to reject this easy formulation. In today's global markets, we cannot put national flags on firms. This is dramatically illustrated in a recent study by James Glassman of the American Enterprise Institute that finds Americans, on average, own over 20 percent of the shares of the 100 largest (measured by U.S. sales) foreign-owned publicly-traded companies in the United States.[5] Policy makers should examine the economic benefits that flow from each kind of international business profile without regard to where a business happens to have its legal place of incorporation. The point is that the competitiveness of the U.S. tax *SYSTEM* as it affects all U.S.-based business activity, ***not*** the competitiveness of a particular form of business organization, should be the goal. In this way we will maximize the economic well-being of Americans.

Substantive Tax Issues Affecting Inbound Investment

My comments in this area will focus on examples of tax policies uniquely impacting U.S. subsidiaries – some policies are constructive and others have the potential to be harmful. Certain aspects of U.S. tax law, such as the advance pricing agreement program and U.S. bilateral tax treaties, are moving in the right direction. Other aspects of U.S. tax law, such as the so-called "earnings stripping" rules (Section 163(j)), are not.

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[4] Robert E. Lipsey, "Home and Host Country Effects of FDI," 2003 (in press).

[5] James K. Glassman, "America's Reciprocal Stock Portfolio: How U.S. Investors Invest in 'Foreign' Companies that Invest in the United States," *American Enterprise Institute*, (July 2001).

The Advance Pricing Agreement Program

The United States has led the way in allowing taxpayers to negotiate "advance pricing agreements" (APAs) with the IRS and, in certain cases, other countries, to resolve transfer pricing disputes without costly and uncertain litigation. The APA program is utilized significantly by both U.S.- and foreign-based multinationals. In 2002, 49 of the 85 APAs executed involved U.S. subsidiaries of foreign parent companies, based on the latest IRS announcement and APA report dated March 31, 2003. The APA process should be encouraged as a preferred alternative dispute resolution program, and be given the highest priority at the IRS with respect to resolving disputes and providing certainty in this area.

Double Taxation Treaties

U.S. bilateral tax treaties are important for several reasons. Such agreements serve to avoid international double taxation and prevent tax avoidance and evasion. Such agreements also serve to remove barriers to trade and investment between two countries as a result of overlapping tax jurisdictions. These agreements promote cross-border mutual investment by foreign-based companies operating in the United States and by U.S.-based companies operating abroad, creating greater economic activity.

The United States has an extensive tax treaty network program with countries throughout the world. The efforts of the Treasury Department and the Senate in updating and expanding this tax treaty network – most recently with new tax treaties and protocols with Australia, Mexico, and the United Kingdom – should be applauded.

In addition, the Treasury Department's efforts to update many existing treaties should be fully supported, including those with some of our major European and Asian trading partners.

Section 163 (j) -- Earnings Stripping

The United States currently has rules that limit the ability of U.S. subsidiaries to deduct interest paid to foreign related parties (for the purposes of these rules, certain unrelated third party debt is considered related party debt when guaranteed by a foreign affiliate company). These rules are generally referred to as the earnings stripping rules. In response to the debate on corporate inversion transactions, several proposals were put forward by the Administration and Members in the House to significantly further restrict ***all*** U.S. subsidiaries' ability to deduct interest paid to foreign related parties – not just inverted companies. Any legislation to further restrict the deductibility of interest expense should be limited to identified abusive practices, consistent with the understanding of the intent of this Committee and the Senate to limit any further changes to the earnings stripping rules with respect to only certain inverted companies.

The clear evidence based on recent IRS data on U.S. corporations is that there are no identifiable problems with the earnings stripping rules that justify drastic changes to these rules across the board. The data shows that U.S. subsidiaries of foreign-based companies essentially are indistinguishable from other U.S. companies as measured by the amount of U.S. taxes paid and long-term debt as a percentage of assets.

Certain proposed changes to the earnings stripping rules, beyond inverted structures, would have grave consequences. These changes could result in a reduction in new domestic investment by foreign-based companies, at a time when the U.S. economy needs such investment and related jobs the most. These changes would have other serious side effects, including significant tax treaty conflicts and inappropriate double taxation that is inconsistent with U.S. tax policy. The proposed changes could also lead to potential retaliation abroad with similar draconian regimes that would adversely impact U.S.-based companies operating abroad.

The IRS's Administration of the Tax Law Must be Nondiscriminatory

The IRS must have the resources and directives to be more international in its focus and to enforce the arm's length standard in an <u>unbiased</u> fashion, whether the investment is inbound or outbound. There need to be verifiable procedures in place to assure the fair and nondiscriminatory enforcement of the arm's length standard already in place for both inbound and outbound companies. In my experience, IRS field agents sometimes take unreasonable – and wildly different positions – based on whether a taxpayer is an inbound or outbound investor. While some of this IRS zeal is understandable as a negotiating position, sometimes it goes beyond that and becomes two different standards – one for inbound transactions and one for outbound transactions.

Conclusion

This hearing is not the first to explore the link between tax policy and positive economic activity. However, it is unique in its focus on "U.S. tax policy and the competitiveness of U.S. -based operations." The emphasis on U.S.-based operations is one that I particularly support because policymakers must answer a very simple question: "How does tax policy benefit the United States?" Does it create, support or eliminate jobs? Competitiveness MUST relate to "U.S. operations" because, if properly considered, it relates to the competitiveness of our system, our workers and our nation.

I hope that Members of the Committee will reject the simplistic "us vs. them" concept of competitiveness. As I have outlined above, U.S. subsidiaries support millions of American jobs and therefore are appropriately part of today's discussion of "the competitiveness of U.S. operations." As you move forward in considering reforms to the tax system, I urge you to do so in a non-discriminatory way that maximizes job-creating investment in the United States. Thank you for thoughtfully framing this discussion. I am happy to answer any questions.

APPENDIX

STATISTICAL INFORMATION ON U.S. SUBSIDIARIES

This appendix provides recent statistical information and analysis on U.S. subsidiary tax payments and indebtedness. It is largely drawn from an April 7, 2003 white paper prepared by the Organization for International Investment, "Budget Proposal on Related Party Interest Expense."

I. Overview

Recent IRS statistical data show that U.S. subsidiaries tax payments, effective tax rates, and levels of long-term indebtedness are very similar to those of other U.S.-based companies. The IRS tabulates information from income tax returns filed by U.S. corporations for U.S. subsidiaries of foreign-based companies ("U.S. subsidiaries") as well as all U.S. corporations. By comparing tax return information of U.S. subsidiaries and all U.S. corporations, it can be determined whether U.S. subsidiaries pay less tax, are more highly leveraged, borrow more heavily from shareholders, or pay higher interest rates than all U.S. corporations. For this purpose, we analyzed tax return data for 1991 through 2000, the most recent year for which data are available from the IRS.[6]

II. Recent IRS Data (1991-2000)

The most recent publicly available IRS data on U.S. subsidiaries and all U.S. corporations show[7]:

- U.S. subsidiary tax payments have grown from $6 billion in 1991 to $28 billion in 2000, accounting for 14% of all corporate tax payments.

- The effective U.S. corporate tax rate (measured as a percent of assets) of U.S. subsidiaries is comparable to that of all U.S. corporations.

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[6] IRS tabulations of corporate income tax returns for any calendar year include fiscal year returns that have at least six months of overlap with the calendar year. For example, IRS data for 2000 includes returns with fiscal years ending after June 30, 2000, and before July 1, 2001.

[7] Data discussed in this section are from U.S. corporate income tax returns filed with the IRS that are collected and reported by the SOI Division. Comparisons are made using the most recent data available. The most recent aggregate data are for tax year 2000, and the most recent data showing industry detail are for 1999. These figures compare U.S. subsidiaries of foreign parents having 50 percent or more foreign ownership with data for all taxable U.S. corporations. Taxable U.S. corporation data are from all corporate tax returns filed with IRS, less those of S-corporations, which operate in pass-through form.

- U.S. subsidiaries' long-term debt has declined as a share of assets and is similar to that of all U.S. corporations,

- U.S. subsidiaries' loans from shareholders are a small and stable fraction of company financing,

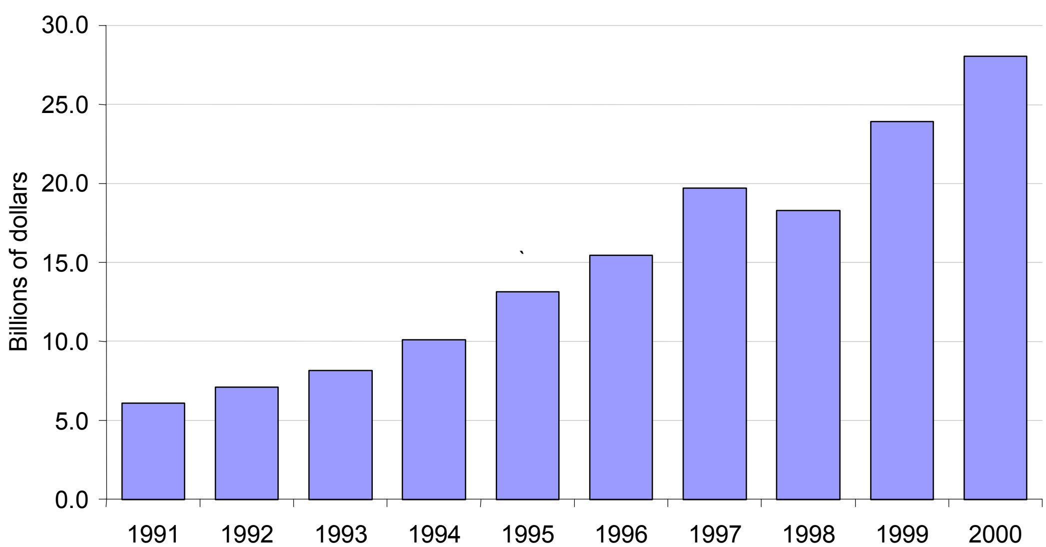
- Over 75 percent of interest paid by U.S. subsidiaries to related parties is received by residents of OECD countries.

These findings are discussed below.

U.S. subsidiary tax payments have grown from $6 billion in 1991 to $28 billion in 2000

U.S. subsidiary tax payments have increased rapidly over the past decade, from $6 billion in 1991 to $28 billion in 2000 (see Figure 1). Taxes paid by U.S. subsidiaries accounted for 14 percent of all corporate income taxes in 2000, up from six percent in 1991.

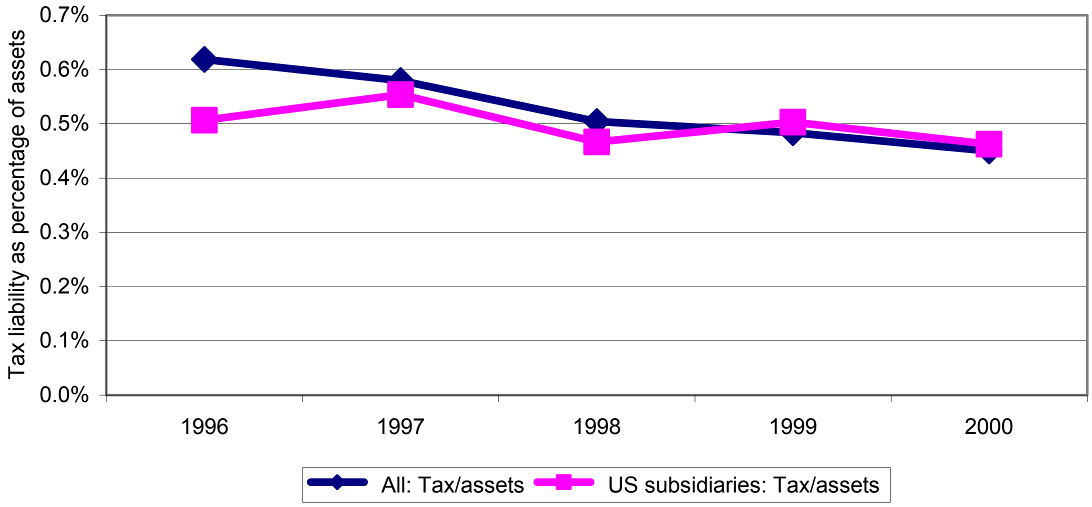
FIGURE 1: US SUBSIDIARY FEDERAL TAXES, 1991-2000



Effective tax rates of U.S. subsidiaries and all U.S. corporations are comparable

A key indicator of the extent to which earnings stripping may be a significant problem is whether U.S. subsidiary taxes are significantly lower than those of comparable U.S. companies. IRS data (see Figure 2) show that the effective tax rate of U.S. subsidiaries (measured as a percent of assets) is comparable to that of all U.S. corporations.[8]

FIGURE 2: COMPARISON OF EFFECTIVE TAX RATES ON TOTAL ASSETS, 1996-2000



[8] S Corporations are excluded from these data; however, it is not possible to exclude mutual funds (RICs) and Real Estate Investment Trusts (REITs).

U.S. subsidiary long-term debt has declined as a share of assets and is similar to that of all taxable corporations

Over the most recent five years, the long-term debt of U.S. subsidiaries generally has declined as a percent of total assets, from 16.2 to 14.7 percent (see Figure 3). These same U.S. subsidiary data may be compared with the long-term debt of all taxable U.S. corporations. While U.S. subsidiary debt is a somewhat higher share of assets, recent trends indicate that this gap has narrowed significantly, from three percentage points to one percentage point (see Figure 4).

FIGURE 3: US SUBSIDIARIES LONG-TERM DEBT AS A PERCENTAGE OF TOTAL ASSETS, 1996-2000

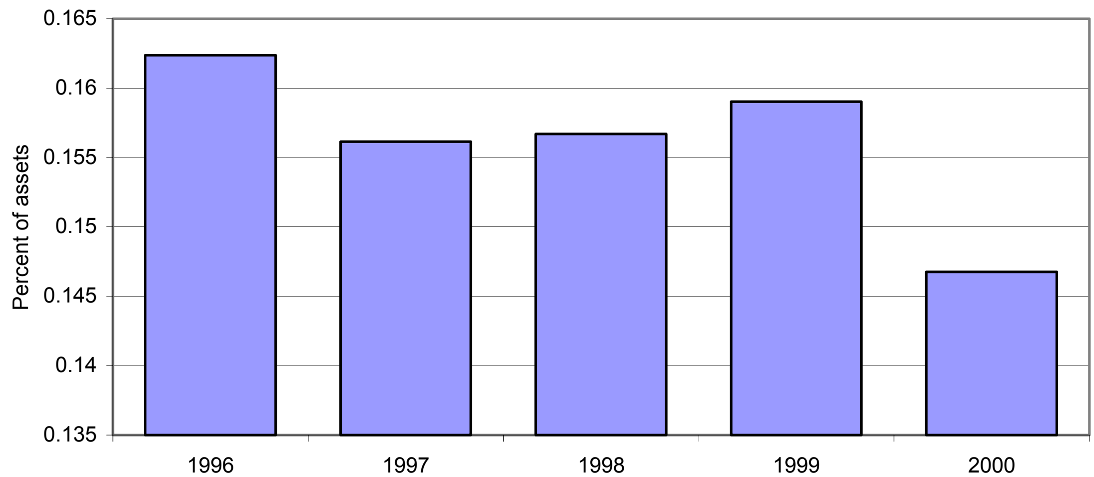
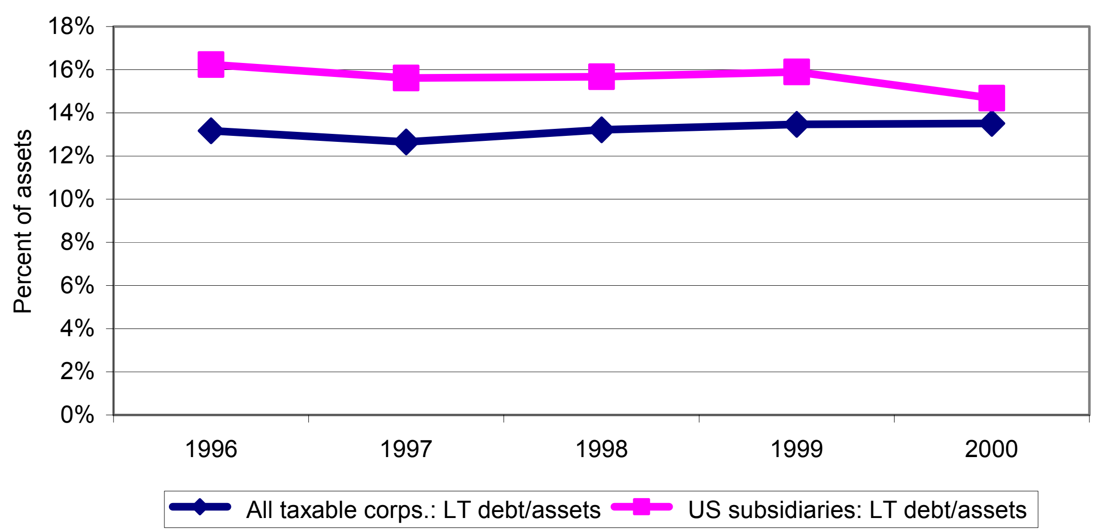


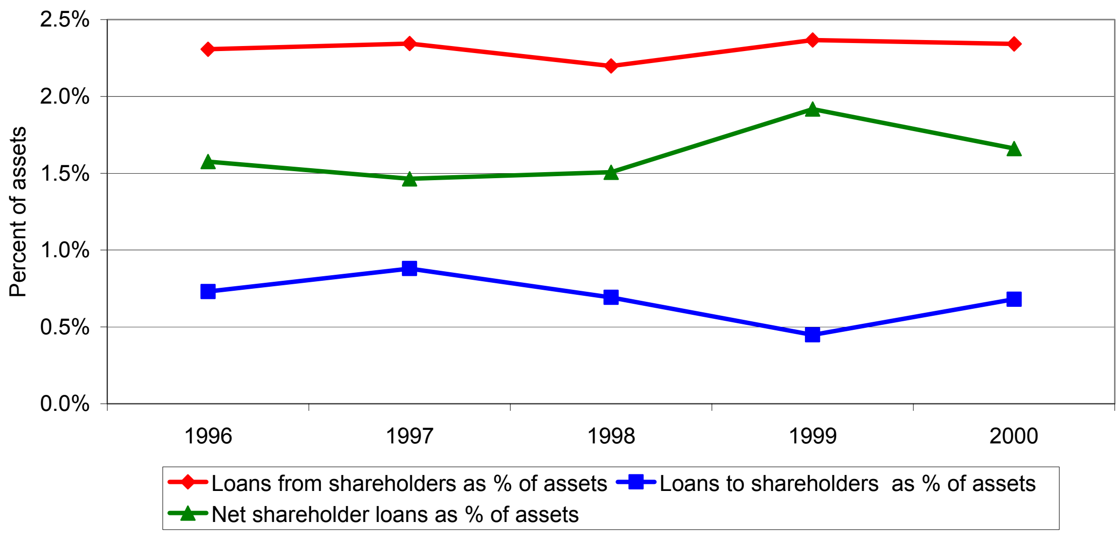
FIGURE 4: LONG-TERM DEBT AS A PERCENTAGE OF ASSETS



U.S. subsidiaries' loans from shareholders are a small and stable fraction of company financing

U.S. subsidiaries' loans from shareholders were only 2.3 percent of assets in 2000 (see Figure 5). U.S. subsidiaries also lend money to shareholders and these loans equal 0.5 percent of total assets. On net, loans from shareholders are a very small share of total assets, just 1.7 percent.[9] Over the past five years, these relationships have been stable and do not indicate any significant increase in net shareholder borrowings.

FIGURE 5: US SUBSIDIARY BORROWING & LENDING WITH PARENT AS A PERCENT OF ASSETS



Three-quarters of U.S. subsidiary related party interest paid to OECD residents

Over 75 percent of related party interest was paid to recipients taxable in OECD countries. In addition to the United Kingdom, the top 10 recipient countries of related party interest were: the

[9] Amounts reported on the Form 1120 corporate tax return do not capture all related party debt and miss some loans with affiliates that are not direct shareholders. Data on loans between affiliates are captured on Form 5472, but this information is not reported with the same timeliness, frequency, and completeness as most corporate tax return data. The most recent data are from 1998 and show net related party debt of 5.1 percent of assets. This figure, however, is based on the 610 largest returns, which account for about 1 percent of all U.S. subsidiary returns with about three-quarters of U.S. subsidiary assets. These data can be further separated into broad industry categories. For example, Form 5472 data show that 76 affiliates in the finance, insurance, and real estate sector account for 38 percent of reported assets, and 25 percent of the borrowing from, and 47 percent of lending to affiliates. This sector has gross borrowing from affiliates equal to 4.6 percent of assets. The remaining 534 affiliates have net related party borrowing equal to 7.0 percent of assets and gross borrowing of 8.6 percent. Overall, net related party borrowing was a smaller share of assets than in 1996 – the data previously published by IRS.

Netherlands, France, Canada, Switzerland, Japan, Germany, South Korea, Sweden, and Belgium. As a general matter, these countries have comprehensive income tax systems that include foreign source interest income.[10] Surprisingly, U.S. withholding tax applies to non-portfolio interest paid to residents of four of these countries (Belgium, Canada, Japan, and Korea).

D. Conclusions

Recent IRS data on U.S. subsidiaries' tax payments, effective tax rates, debt levels, interest income and expense, and loans to and from shareholders show they are very similar to those of all U.S. taxable corporations.

[10] While a few of these countries have (or had) preferential finance company regimes, OECD countries must remove such regimes pursuant to the recommendations on harmful tax practices adopted by the Committee on Fiscal Affairs. EU member countries also are subject to the restrictions on preferential tax regimes imposed by the European Code of Conduct..