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Before the U.S. Committee on Finance
An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Based Operations
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Mr. Chairman and Members of the Committee, thank you for the opportunity to voice the views of the Electrolux Group on U.S. tax policy and its impact on domestic and international competitiveness. I am Mark Russell, Vice President for Taxes for Electrolux North America.

Overview of Electrolux

Electrolux is the world's largest producer of appliances and equipment for indoor and outdoor use. Electrolux is incorporated in Sweden, where the company was founded and continues to maintain its headquarters, as well as several thousand employees. In the United States, Electrolux is often identified with vacuum cleaners. Our product line goes well beyond vacuum cleaners. Electrolux is known for its innovative products and strong brands. Electrolux is our biggest and most important brand, but the Electrolux Group includes many other famous brands for indoor and outdoor appliances for both consumers and professional users. These brands include Eureka, Frigidaire, Tappan, Kelvinator, Poulan, Husqvarna, Weed Eater, McCulloch, Partner and Dimas.

Electrolux had annual sales in 2002 of approximately $14 billion while sales in the United States were in excess of $5.5 billion in 2002. Twelve percent of products manufactured in the U.S. by Electrolux are exported. Worldwide, the group has manufacturing operations at 111 locations in 26 countries. The four largest manufacturing operations are located in the United States and account for 23% of the total value of Electrolux's production. Forty percent of the company's operations are in North America, where it employs 20,000 workers in dozens of states.

The larger operations in the United States are in Greenville, Michigan; Webster City, Iowa; Nashville, Arkansas; Springfield, Tennessee; Orangeburg, South Carolina; and St. Cloud, Minnesota. In the past five years, Electrolux has invested in excess of $700 million in plant and equipment in the U.S. In Webster City and Jefferson, Iowa we have three plants with more than 2,100 employees that make clothes washers and dryers and built in vacuum systems. In Arkansas, we manufacture chain saws, grass trimmers and blowers and employ over 2,200. In Springfield, Tennessee, we assemble household ranges and ovens with 2000 employees. The group purchases raw materials such as steel and plastics and other finished components from domestic suppliers in the amount of 1.5 billion to 1.75 billion dollars per year.

The company's worldwide effective tax rate for 2002, 2001 and 2000 was 32.6, 28.3 and 32.5 percent, respectively (30.9, 32 and 32.4 percent excluding one-time items). The Group Treasury organization of Electrolux has the global responsibility for financing and liquidity, and for the management of financial exposures. Group Treasury has four regional centers: Sweden,

Singapore, Brazil and the U.S. The regional centers are responsible for local cash management, financing, and support to the subsidiaries. Electrolux has a high level of liquidity due to recent divestures. Net liquidity is defined as liquid funds less short-term borrowing. For 2002, liquid funds were 11.8 percent of net sales due to divestments.

Worldwide net borrowings were lower for 2002, mainly because of cash flow generation, as well as higher net proceeds from divested and acquired operations. Electrolux had a net debt-equity ratio of 0.05 for 2002, 0.37 for 2001, and 0.63 for 2000.

International Competitiveness

A country's tax system has a major impact on its international competitive position. Current U.S. tax law promotes various policy objectives such as incentives for expanding export sales and increasing research and development expenditures. The current tax code also has various disincentives, a major one being the limitation on interest deductibility (earnings stripping). In addition, the United States taxes corporations on their worldwide income and has higher corporate tax rates than many European Union countries. This worldwide tax system impacts companies like Electrolux and is a factor in decisions to invest in the United States. As the Senate Finance Committee reviews the rule governing U.S. taxation, it should keep in mind two criteria. First, any changes to the U.S. laws governing international tax should not impede the creation of U. S. jobs and the investment of debt and equity capital into the United States by foreign companies which have a capital structure which has evolved for legitimate purposes and is consistent with the internationally recognized arm's length standard. Second, legislation should not target or discriminate against companies which were founded abroad and have deep historical ties to their country of incorporation, and continue to conduct significant business in their home country, particularly when such country has a fully developed tax system with effective tax rates comparable to the U.S.

Extraterritorial Income Regime

We recognize the repeal of the extraterritorial income regime is the likely response to the World Trade Organization (WTO) decision that extraterritorial income regime (ETI) is prohibited export incentive. Legislation which repeals the ETI should be designed to help sectors of the U.S. economy that currently benefit from the ETI and this should include foreign owned companies which manufacture products in the United States. The ETI regime has been a factor in our decision to maintain and expand our production in the United States. Other countries offer subsidies and incentives to entice companies to locate operations there or have lower tax rates. For example, Mexico and Canada have recently reduced their marginal tax rates to 32 percent and 33.4 percent (combined federal and provincial), respectively compared to marginal rates of 39 percent in the U.S. Without some alternative to the ETI regime, it will be difficult for a foreign owned company to justify further expansion in the United States. Several of our competitors have transferred manufacturing operations to Mexico, Canada, and other countries because of perceived cost advantages. The lower corporate rate in Mexico and Canada are a major factor in the decision. Lower tax rates will increase profit margins which will result in our competitors having a competitive advantage over us. Generally, price is a key factor for consumers when determining which brand appliance to purchase. And net after tax profitability

is, of course, a very important factor in the markets for debt and equity capital, where we must also be competitive.

Electrolux has a history with the United States and wants to maintain and strengthen its operations in the U.S. and at the same time remain competitive in the global marketplace. Representatives Crane (R-IL) and Rangel (D-NY) have introduced H.R.1769, the "Job Protection Act of 2003," which would repeal the current law ETI benefit for transactions after the date of enactment. Senator Hollings (D-SC) has introduced companion legislation (S. 970). This legislation recognizes the need to assist those companies that currently benefit from the ETI by providing transition relief until 2008. In addition, H.R. 1769 would provide a permanent new deduction which reduces the effective corporate tax rate for U.S. manufacturers. This new deduction would be based on U.S. production activities and the product does not need to be exported to be eligible for the deduction. Companies such as Electrolux would receive a sliding-scale effective rate reduction based on the value of their U.S. production of eligible products compared to the value of their worldwide production.

The Jobs Protection Act of 2003 recognizes the fact that if production is to be maintained in the United States, ETI transition relief is needed and companies manufacturing products in the United States which benefited from the ETI regime should receive some type of tax relief that is compatible with the rules of the WTO. As the Senate Finance Committee continues its deliberations on the repeal of the ETI regime, it should not rule out transition relief and corporate rate deduction for those companies making products in the United States.

Policy Considerations Relating to Earnings Stripping Proposals

Electrolux believes that, beyond the context of inversions, the policy considerations relating to earnings stripping are not clear. In particular, Electrolux believes that reforms to section 163(j) should target abusive transactions, and not penalize legitimate business transactions.

Present law provides rules to limit the ability of U.S. corporations to reduce the tax on their U.S. source income through earnings stripping transactions. Code section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its adjusted taxable income, that is, taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion. Disallowed interest amounts can be carried forward indefinitely, and any excess of the 50 percent limit can be carried forward three years.

Electrolux would not be affected by the earnings stripping proposal in the "Reversing the Expatriation of Profits Offshore Act" as passed by the this Committee as stand alone legislation in the 107th Congress and as passed by this Committee and the Senate as a provision in the S. 1149, the "Energy Tax Incentives Act of 2003" and S. 1054, the "Jobs and Growth Reconciliation Tax Act of 2003" because it has not entered into any transactions which can be defined as an inversion transaction. Electrolux commends the Committee for addressing earnings stripping in a narrow context. More specifically, the Senate has addressed earnings

stripping in a manner which impacts only those companies that have done transactions which are solely tax driven. Under this legislation, current law earnings stripping rules would be modified only for those companies which averted U.S. taxes by reincorporating in a tax haven. However, both the Treasury earnings stripping proposal and H.R. 5095, as it was introduced in the 107th Congress, raise serious policy concerns. Both of these proposals unfairly target for adverse federal tax treatment foreign-owned enterprises that engage in legitimate arm's length transactions of the sort that U.S. owned businesses commonly undertake both in the U.S. and abroad. In so doing, both proposals would serve to penalize those very companies that are importing jobs into the United States that could otherwise be located elsewhere.

H.R. 5095. H.R. 5095 would change section 163(j) in several ways.

1. The debt-equity threshold test in current law would be eliminated.

2. Interest paid to certain related parties would not be deductible if the payor's net interest expense exceeds 35 percent of its adjusted taxable income, rather than the 50 percent threshold under current law.

3. Carryovers of interest disallowed would be limited to five years.

4. The carryover of excess limitations would be eliminated.

5. A new interest disallowance rule would be added to section 163(j), which would disallow related-party interest deductions to the extent that the U.S. subsidiaries of a foreign parent are more highly leveraged than the overall worldwide corporate group. Interest amounts disallowed under this new rule would not be eligible for carryover, nor would any excess limitation. The modified present-law disallowance rule and the new disallowance rule would be coordinated by providing that the rule yielding the greater amount of interest disallowed would determine the overall disallowance.

Administration Budget Proposal. The Administration's budget for fiscal year 2004 proposes to make the following changes to section 163(j):

1. Repeal the current law 1.5 to 1 debt to equity safe harbor and replace it with a safe harbor that would be determined based on a series of debt-to-asset ratios identified for certain asset classes.

2. Impose a worldwide limitation that would deny a deduction for disqualified interest paid by U.S. members of a corporate group that are more highly leveraged than the overall group. The amount of interest that would be disallowed under the worldwide test would be limited by the safe harbor based on asset classes. A carry forward of interest amounts that exceed the worldwide limitation would not be permitted.

3. Reduce the threshold for the limitation based on adjusted taxable income from 50 percent to 35 percent of the adjusted taxable income.

4. Limit the indefinite carryforward for disallowed interest under the adjusted taxable income limitation of current law to five years.

5. Eliminate the 3-year carryforward of excess limitation.

Electrolux believes both of these proposals raise numerous policy issues which should be considered before any action is taken on legislation to modify Code section 163(j) in a manner which goes beyond those changes that have previously been approved by the Senate and that target clearly abusive transactions.

- Both proposals are discriminatory, violate the arm's length standard, and would be in direct conflict with U.S. treaty obligations. U.S. subsidiaries of foreign parent companies should be taxed under the same rules as are U.S. companies that are owned by U.S. parents, and interest paid to treaty country affiliates should be deductible on the same terms as interest that is paid to U.S. affiliates, which, of course, is subject to the arm's length standard. If enacted as proposed in the 107th Congress, section 201 of H.R. 5095 would clearly violate the anti-discrimination article of the U.S.-Sweden Income Tax Treaty, as well as the similar anti-discrimination article of the U.S. Model Income Tax Convention and many other bilateral tax treaties to which the U.S. is a party. This is because section 201 would impose restrictions on the deductibility of interest payments that go beyond the arm's length standard applicable to interest paid to U.S. affiliates.

- Because it is very common for U.S. multi-national corporations to capitalize their foreign subsidiaries in significant part with debt, as well as equity, these proposals create a substantial risk of retaliation by our treaty partners. Subject to satisfying the arm's length standard, interest payments on such debt are typically deductible for purposes of the host country's corporate income tax. These proposals create a substantial risk that our major treaty partners will respond to this U.S. discrimination by similarly restricting the ability of the foreign subsidiaries of U.S. multi-national corporations to deduct interest payments on their intercorporate debt. The result would be a general and highly undesirable increase in the tax burden of such foreign subsidiaries of U.S. corporations and, overall, an added tax burden imposed on multi-national businesses and thus on international trade.

- The proposed changes to section 163(j) are arbitrary. The purpose of the current law safe harbor is designed to limit interest deductibility to U.S. subsidiaries that are thinly capitalized. Repeal of the debt-equity safe harbor would result in the disallowance of interest payments by corporations that are not thinly capitalized.

- The one-size-fits-all approach of the worldwide test does not take into account that some businesses by nature involve more debt than others, and this includes businesses that are cyclical in nature. It also disregards the long-recognized U.S. and international tax principle that a corporation is entitled to be treated for tax purposes as a separate taxable entity from any of its related corporations as long as it satisfies the arm's length standard in its business dealings with those corporations. The arm's length standard is inconsistent

with any requirement, such as the worldwide test would impose, that each related corporation must be capitalized according to the same debt-equity ratio.

- Current law carryforwards were designed to prevent a permanent loss of deductions if interest expense appeared high due to year-to-year fluctuations in profits. This reflects the reality that cash flow arising over a period of years can be used to service debt in any particular year. Focusing on a single year's debt provides an unrepresentative view of the company's capital structure and is not a good measure of the company's long-term ability to service debt. Carryforwards are consistent with the broader tax policy of addressing consequences of annual accounting periods.

- Clearly, there are business cycles in most industries and adjusted taxable income does not increase each year in a straight-line consistent manner.

- Focus on a single year's debt provides an unrealistic view that is inconsistent with an arm's length view of a company's ability to service debt.

- Under U.S. and international tax principles, guaranteed debt does not necessarily indicate that the borrower is thinly capitalized. With respect to domestic corporations, U.S. law has long recognized that guaranteed debt is often used merely as a means of reducing both the documentation and the borrowing costs that would result from unguaranteed debt. The Treasury proposal and H.R. 5095 unfairly penalize U.S. subsidiaries of foreign parents for engaging in this reasonable and common business practice. Particularly when such guaranteed borrowing otherwise satisfies the arm's length standard, the proposals would further discriminate against foreign multi-national corporations in violation of U.S. treaty obligations.

In addition, with specific reference to the Treasury's proposal for a safe harbor determined by a series of debt-to-asset ratios identified for particular asset classes, Electrolux has the following concerns:

- It is inappropriate to apply such a safe harbor principally to cross-border debtor-creditor relationships between related parties. As is reflected in section 385(b)(3) of the Code and numerous judicial decisions, the ratio of corporate debt to equity plays a substantial role in determining the deductibility of interest payments by U.S. corporations to related persons, whether the payment is a cross-border transaction or is a purely domestic transaction. In that light, prescribing a maximum debt-equity ratio that is applicable principally to cross-border related-party interest payments and not to otherwise similar domestic related-party interest payments, as would be the case with respect to Treasury's proposed amendment to section 163(j), is unwarranted and, as previously noted, would violate the nondiscrimination clauses of many of the tax treaties to which the U.S. is a party. For that reason, if Congress were to conclude that such a safe harbor is necessary, either to give effect to the arm's length standard or for other reasons, the safe harbor should be applied even-handedly to all corporate payments of interest to related persons without regard to whether the payments occur in a cross-border context. Such a safe harbor could be applied in a uniform and nondiscriminatory manner in any one of three

ways. First, section 163(j) could be amended so that it applies to all corporations, including both domestic and foreign multinational groups. Second, section 385 could be amended to require such a safe harbor in measuring the adequacy of the debt-equity ratios of all U.S. corporations for purposes of determining the deductibility of interest paid to any related persons. Third, the Treasury could exercise its current authority under section 385 to prescribe regulations that require such a safe harbor in determining the deductibility of interest paid to any related persons by all U.S. corporations.

- Tax basis should not be the standard for determining allowed indebtedness. Stock acquisitions, taxable or tax-free, are frequently accomplished without a step up in the basis of the assets. The same is true for tax-free asset acquisitions, as occur for example by certain statutory mergers. However, fair market value generally is greater than asset basis and that excess should be allowed in calculation of the permitted debt. In reality, financial institutions base financing decisions on fair market value and not tax basis. If the tax law is going to focus only on asset basis, there is no reason to limit such a rule to cross-border affiliates. Rather, such a rule should be applied across the board, including debt-equity determinations in the case of payments to domestic affiliates.

- Another serious flaw is the transitory nature of the asset class percentages. Treasury has not indicated the origin of its study that produced these percentages. Are these percentages based upon objective economic reality and, therefore, likely to remain in place or are they based on short-term fiscal objectives and thus may well change at some future date? As an example of this concern, note that the present 50% adjusted taxable income limitation in section 163(j) is proposed to be reduced to 35%; yet the Treasury has not produced any data to support the need for such a change other than for the limited purpose of dealing with inversions.

Other Issues to Consider

As the Committee works to address repeal of the ETI regime and international tax reform, it should consider other incentives to encourage investment in the United States and also remove the various disincentives. Electrolux commends the Senate Finance Committee for including a provision in S. 1149, the "Energy Tax Incentives Act of 2003" which would provide a tax credit for the manufacture of energy-efficient appliances, including energy-efficient clothes washers and refrigerators. This credit serves two purposes. First, this credit encourages investment in designing and manufacturing appliances which would save energy. Second, the credit encourages companies like Electrolux to continue manufacturing products in the United States. Basically, this credit will encourage inbound investment.

Other disincentives impacting inbound investment include withholding taxes. Although the U.S. has taken a positive step to eliminate withholding taxes in the U.S./U.K. treaty, a broader approach would be preferred. The removal of withholding on dividends would remove an additional barrier to investment.

Conclusion

As Congress continues its consideration of a legislative response to the WTO's ruling of the ETI regime as a prohibited export subsidy, Congress should consider the role foreign owned companies with substantial U. S. operations play in the U.S. economy. Companies like Electrolux are an integral part of the U.S. economy. U.S. tax laws should not impede a foreign owned company from producing products in the U.S., exporting these products, and thus keeping the jobs of the workers who produce those products in the U.S.

Electrolux appreciates this opportunity to present our views. We are willing to assist the Committee in any manner as it continues its deliberations on international tax issues.