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**AN EXAMINATION OF U.S. TAX POLICY
AND ITS EFFECT ON THE INTERNATIONAL
COMPETITIVENESS OF U.S.-OWNED
FOREIGN OPERATIONS**

HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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JULY 15, 2003
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ERATIONS**

TUESDAY, JULY 15, 2003

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

The hearing was convened, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Nickles, Kyl, Thomas, Bunning, Baucus, Breaux, Conrad, and Bingaman.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. This is our second hearing on the international competitiveness and U.S. tax policy. Normally, I do not start until Senator Baucus is here, but he is necessarily delayed and he told me to go ahead. So, we are going to start our hearing.

Last week, we focused on the international competitiveness of U.S.-based businesses. Today, we focus on international competitiveness of U.S.-owned foreign operations.

During this hearing, we will examine what we mean by the term “international competitiveness.” Understanding this term, and particularly how this term is measured, is very important in light of last week’s testimony.

As many of you know, it has been suggested that we repeal FSC/ETI and use the proceeds to reform our international tax rules. Advocates of this approach claim that this is the best way to shore up our U.S. economy and create U.S. jobs.

But during last week’s hearing, our witnesses said that this approach would be a \$50 billion tax increase on U.S. manufacturing and U.S. job space. Witnesses said that a tax increase of this size could force them to move their operations out of the United States to remain, in their words, internationally competitive.

One witness with both foreign and U.S. operations candidly stated, “You can reduce my foreign taxes if you want to, but I will just move my U.S. operations there.”

If we are forced to trade off a domestic tax increase against international tax reform, then we need to understand how international competitiveness will replace any job loss from the tax increase, what kind of jobs it will create, and how it benefits the everyday

working American. Personally, I think this trade-off is an unfortunate choice. Some refer to it as a false choice.

International tax reform is long overdue. Our current system is based on a framework enacted during President Kennedy's administration. In an era of expanding global markets, falling trade barriers, and technological innovations that melt away traditional notions of national borders, it is critical that our international tax laws keep pace with the new business realities.

Today we will hear that our international tax laws have not kept pace. Today, we will hear some fresh and creative thinking on what we should do to reform our international provisions, and yet remain globally competitive.

We are fortunate to have several Senators on this committee who are deeply committed to reforming our international tax laws. Senator Hatch and Senator Baucus have led the charge on this issue for many years.

In addition, during last July's hearing 1 year ago, Senator Graham of Florida expressed grave concerns about the problems of our international tax laws. As a result, he and Senator Hatch formed an international tax reform working group within this committee to evaluate various international reforms and simplification measures.

I said last year in my floor remarks, when Senator Baucus and I introduced an anti-inversion bill, that I recognized that the rising tide of corporate expatriations demonstrate that our international tax laws are deeply flawed.

In many cases, those flaws seriously undermine an American company's ability to compete in the global marketplace. We need to bring our international tax system in line with our open market trade policies. Reform of our international tax laws is necessary for our U.S. businesses to remain competitive in their global marketplace.

More importantly, those U.S. companies that reject doing a corporate inversion are left to struggle with the complexities of competitive impediments of our international tax law rules.*

This is an unjust result for companies that choose to remain in the United States of America, and I think we all need to be committed, as I have said I am, to remedy the inequity.

Let me ask if Senator Bingaman, who is here, would like time to speak for the other side of the aisle.

Senator BINGAMAN. Mr. Chairman, I would like just a few minutes, if I could.

The CHAIRMAN. Yes.

**OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S.
SENATOR FROM NEW MEXICO**

Senator BINGAMAN. Mr. Chairman, first, thank you for having this second hearing on international tax issues. I think it is very important that the committee focus on this subject and that we try to make some progress.

*For more information, *see also*, "The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad," Joint Committee on Taxation staff report, July 14, 2003 (JCX-68-03).

I hope that out of these hearings will come a consensus that a major, probably the major, result and goal that we ought to be aiming for in any changes in this area is to incentivize job creation in this country.

Clearly, we have seen a dramatic reduction in the number of manufacturing jobs in this country. There is a chart behind me that shows both unemployment rates and the unemployment rate in the manufacturing sector.

You can see that the unemployment rate in the manufacturing sector, which is the red line, is moving up much more quickly than the unemployment rate generally. They are both moving up, which is not good.

But the unemployment rate in manufacturing is going up much more quickly than the unemployment rate generally. We need to find ways, in our consideration of these tax provisions, where we can help reduce that trend and change that trend.

The other chart I just wanted to show very briefly relates to the trade deficit. It just makes the point, which I think we are all aware of to some extent, that according to the Commerce Department, the trade deficit for May was \$41.84 billion. Now, that is growing, and has been growing.

In spite of reports that some of our exporters are doing reasonably well, it is clear that much of what we are buying a larger and larger portion of what we are buying, is produced abroad.

That translates into a loss of jobs here, a loss of jobs in the manufacturing sector, a loss of jobs in the service sector. I hope that the Department of Treasury can give us some suggestions for ways that they think this can be reversed.

If there are biases built into our Tax Code that incentivize companies to manufacture overseas or do service jobs overseas, then we need to correct that. I hope that will be what comes out of this set of hearings.

Again, I thank you for having today's hearing. I hope that, in the question and answer period, we can get into some of these issues in more detail. Thank you.

The CHAIRMAN. We are joined by three of our outstanding colleagues to discuss the legislation on international tax that they are concerned about.

We, first, have Senator John Ensign of Nevada, and Senator Barbara Boxer of California regarding the Homeland Investment Act, and when he comes, Senator George Allen of Virginia, to express his views on repealing the FSC/ETI regime.

Who would like to go first?

Senator BOXER. You can go first.

The CHAIRMAN. All right. Then Senator Ensign?

STATEMENT OF HON. JOHN ENSIGN, A U.S. SENATOR FROM NEVADA

Senator ENSIGN. Thank you, Mr. Chairman.

Mr. Chairman, I ask consent that my full statement be made part of the record. That way I will save you some time.

The CHAIRMAN. Yes. And the same for Senator Boxer.

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

Senator ENSIGN. I would just summarize my remarks.

The bill that we are here to talk about today was passed on the Senate floor 75 to 25, with a broad bipartisan support.

Just to summarize what it does, currently U.S. companies that have invested abroad, when they pay tax on those earnings, if they want to bring that cash back into the United States, the differential between the tax that they paid and the U.S. corporate tax of 35 percent, they will pay that again.

Consequently, what they do, is most of the companies leave a huge amount of cash overseas. As we have all seen, the U.S. economy, while it looks like it is showing signs of recovery, it is certainly not what any of us would like to see. It is certainly not a robust recovery, by any stretch of the imagination.

In listening to people, there is a huge amount of cash sitting overseas that companies would like to bring back into this country, but because of the effective tax rates, those companies, frankly, just will not bring back that money.

You can argue whether it is the right tax policy, whatever you want to argue. The bottom line is, they will leave the money overseas if we do not enact this piece of legislation that Senator Boxer, myself, Senator Allen, and others have sponsored.

What the bill will do is set an effective tax rate of about 3.5 percent, when it is all said and done, on the money that they will bring back in. J.P. Morgan has done a study and said that about \$300 billion will come back into this country in that 12-month period.

Now, \$300 billion is a lot of money, even to the size of the U.S. economy. When we are looking for an economic stimulus, this truly would be an economic stimulus.

Just anecdotally, I have talked to many companies, even since we had the bill on the floor. What is interesting, is that several of these were companies who were not part of the coalition pushing the bill.

As you know, the entire package that you have before you is fairly controversial on some of the provisions. Some are going to be winners, some are going to be losers when we are trying to fix some of the FSC provisions.

Because of that, a lot of the companies do not want to look like they are getting something with the Invest in the USA Act, because they may be a winner or loser depending on which side on the Foreign Sales Corporation side of it they come down on.

But, anecdotally, just three companies that I talk to, \$28 billion would come back into the United States. For three companies that are not part of the coalition, \$28 billion. Just three companies. The numbers are so staggering on what will come back in, it truly is amazing.

And, Mr. Chairman and members of the committee, when I was talking to the Treasury Department, because they have raised some concerns over this bill, they said there is no guarantee because money is fungible.

What will happen to the money? It is pretty obvious what will happen to the money, because everybody agrees money is fungible, but some companies will pay down debt. Well, the last time I

checked, that is actually good and healthy for companies to pay down debt.

Some amount is going to be invested. There is no question that some amount will be invested. Some, by the way, will be given in dividends. I mean, we just passed a dividends tax cut because we know that that will help stimulate the stock market. This is one of the ways that we can get money turning in the stock market, providing capital for other companies.

So I think that there are great benefits to the Invest in the USA Act. It is the reason that I sponsored the bill. I think it is one of the most important economic stimulus tools that we have before us today.

And, Mr. Chairman and members of the committee, I am hoping that it does not get bogged down in the controversy over the legislation before us.

I know that there are a lot of good people on both sides of the other pieces of legislation that are before you, but I am hoping that this thing will actually be able to make it into law.

Because if we want to see those jobs that are being lost right now actually start being created, this is the type of legislation that we need to enact to create jobs in the United States to say, you know what? We do not like the fact, necessarily, that the money was invested overseas, but let us at least bring that money back into the United States and put it to work here so that we can create jobs in the United States.

I thank you for this opportunity to testify.

The CHAIRMAN. Thank you.

Senator Boxer.

STATEMENT OF HON. BARBARA BOXER, A U.S. SENATOR FROM CALIFORNIA

Senator BOXER. Thank you so much. I will be very brief here, because my colleague has covered a lot of ground.

We call this the Invest in the USA Act of 2003, and that is exactly its purpose. Its purpose is not to give executive pay raises. As a matter of fact, Senator Ensign and I would like to see our bill strengthened a little bit on that point. The idea is for these funds to be used to create jobs and create product.

I was really rather stunned when the House decided they did not want this because, after all, when do we see something pass 75/25 in the U.S. Senate, something that is probably the best stimulus we could have right now?

I want to show you a chart, Mr. Chairman, to explain what we are talking about here. Mr. Chairman, can you see this or is this too small for you? Can you read that chart?

The CHAIRMAN. Yes, I can.

Senator BOXER. Oh, good.

The CHAIRMAN. Yes.

Senator BOXER. Because you see, right now, we tax profits when they are earned abroad at 35 percent. We are suggesting 5.25 percent for just 1 year, that is all.

Now, Senator Ensign has said the economic stimulus effect is \$300 billion, and he is quoting the private sector. Is it Morgan Stanley that came up with that?

Senator ENSIGN. J.P. Morgan.

Senator BOXER. J.P. Morgan.

Our own Joint Committee on Taxation puts it at \$140 billion. So if you figure somewhere in the middle, it is one of the best, I think, economic stimuluses we could have here.

The beneficial effect on revenue the first year is \$3.9 billion because these monies will be brought back in, so it is actually, for the first year, a revenue raiser. After that, the 10-year cost is only \$3.8 billion when all is said and done.

The bottom line is, if you are concerned—and I know you are—as we all are, that we have seen three million jobs lost, and an economic recovery, which if it is happening at all has not hit my State quite yet—and my State, as the largest State in the union, is pretty important to what happens. We are talking about 6.6 percent employment in California. This is a way that we could really do something to help move things along.

So that is really my message to you. I think that sometimes we do some very interesting things, some obtuse things to stimulate growth. This is something that is pretty direct.

Funds are sitting out there away from this country. We want to bring them back. The legislation is very clear that the purpose is to be used for putting people to work, producing products, hiring, training the rest, and it will be stimulative to this economy and I believe this economy needs that stimulus.

So, I thank you very much for the opportunity to appear before you today.

The CHAIRMAN. Thank you, Senator Boxer.

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

The CHAIRMAN. Now, Senator Allen, welcome to the committee. I have already announced that you were going to speak about the repeal of FSC/ETI. I hope I am right.

STATEMENT OF HON. GEORGE ALLEN, A U.S. SENATOR FROM VIRGINIA

Thank you for allowing me to appear before this committee.

I know this is a very important issue. I want to comment on this ongoing debate on how to effectively comply with WTO obligations relative to the Extraterritorial Income Tax Exclusion Act of 2000 without adversely affecting U.S. jobs and business.

ETI and its predecessor, the Foreign Sales Corporation and the Domestic Sales Corporation Acts, were originally enacted to ensure U.S. exporters were competing on a level playing field internationally.

At the time, high U.S. taxes were forcing United States companies to make difficult choices on how and where to establish manufacturing and production facilities.

Congress wisely crafted the program to encourage production in the United States. Today, the threat of American companies and jobs going overseas remains; not necessarily just on tax policies, but for a variety of competitive factors that threat still continues.

While ETI provides tax benefits of our \$4 billion a year on exported goods for eligible companies, it has been asserted that ETI also supports over 3.5 million American jobs directly and indirectly.

If ETI is simply repealed without enactment of sound legislation in its place, these benefits will be lost to U.S. companies and to U.S. workers at a time when they are most needed. You know of the statistics. You have seen them over these most recent months and over the years.

In fact, over the last 2 years, 2.6 million manufacturing jobs have been lost in this country. More jobs have been lost in the manufacturing sector than in any other economic sector combined.

Mr. Chairman, repealing ETI without an alternative will unfortunately encourage U.S.-based exporters with significant sales abroad to move their operations, and also their jobs, outside of the United States.

Legislation repealing ETI must include tax treatment that accords some alternative provisions for U.S. exporters with primarily domestic production. In my State, the Commonwealth of Virginia, we rank 16th in exports amongst all States, so Virginians are especially concerned with the impact of the ETI repeal.

With the simple repeal of ETI, Virginia would stand to lose up to 82,600 export-related jobs. This is not unique to Virginia. You will find this in a variety of ways across the whole country. This will harm good, hardworking Virginians and Americans across the country in the manufacturing sector and deliver a serious blow to related industries.

The changes, as you well know, in the manufacturing sector, reverberate throughout our economy. ETI's repeal, without anything to take its place, will amount to a tax increase of over \$50 billion over the next 10 years on U.S. manufacturing jobs.

So the bottom line principle, Mr. Chairman, is that tax reform ought to be promoting the creation and retention of jobs in America, and this tax reform should enhance the competitiveness of U.S.-based companies, not penalize them.

I know you, Mr. Chairman, and members of this committee, agree with these principles and will be working in that light.

I would also like to briefly comment on the other topic of discussion, the Homeland Investment Act. This legislation, in my view, Mr. Chairman and members of the committee, would really be a complement to the job growth and tax relief package we just recently passed in Congress.

Temporarily reducing the tax burden associated with bringing back or repatriating accumulated foreign earnings of U.S. companies will provide an incentive of bringing back at least \$140 billion into the United States.

The net result of this temporary change in tax policy would be greater investment in capital and personnel, and, most importantly, it is going to create more U.S. jobs.

Mr. Chairman, the Senate has already acted on this. Unfortunately, the House has not been able to act on it. But as you are looking at foreign investment and U.S. companies that invest abroad, we want them to be investing in this country with American jobs, competing on a level playing field. Let us take back any impediments that harm U.S. companies from reinvesting back in this country.

Mr. Chairman, thank you for the opportunity to appear before this very important committee. I look forward to working with you

and your members in the months to come to get this economy moving stronger for American jobs. I thank you.

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

The CHAIRMAN. All right. I have no questions of this panel.

Do any of my colleagues, rather than call off names? If you have a question, just jump in.

[No response.]

The CHAIRMAN. All right. Thank you very much.

Our next witness is Ms. Pam Olson, Assistant Secretary for Tax Policy, Department of Treasury. Welcome, Secretary Olson.

Ms. OLSON. Thank you, Mr. Chairman.

The CHAIRMAN. Your entire statement as well will be put in the record. We appreciate your summary, and appreciate your being here. Thank you.

**STATEMENT OF HON. PAMELA OLSON, ASSISTANT
SECRETARY, TAX POLICY, DEPARTMENT OF TREASURY**

Ms. OLSON. Thank you. Mr. Chairman, distinguished members of the committee, I appreciate the opportunity to appear here this morning. I applaud the committee for examining the effect of U.S. tax policy on the international competitiveness of U.S.-owned foreign operations.

The importance of our international tax rules to the competitiveness of U.S. businesses and workers is well known to this committee, as evidenced by the fact that the committee has previously approved legislation addressing many issues in the international area.

Unfortunately, this committee's good work on those issues in previous sessions has not resulted in enacted legislation. Nevertheless, the need for changes, such as the changes previously approved by this committee, continues. Indeed, with the growing importance of international competitiveness of the U.S. economy, the need is even more immediate.

Many areas of our tax law are in need of reform to ensure that our tax system does not impede the efficient, effective, and successful operation of U.S. companies and the American workers they employ in today's global marketplace.

I have enumerated a few of them in my written statement, but in keeping with the focus of today's hearing, will address my remarks this morning to the tax policy issues specific to U.S.-based companies competing in markets around the world.

The concern this committee faces today is that our tax code has not kept pace with the changes in the worldwide economy. From the vantage point of the increasingly global marketplace in which U.S. companies compete, our tax rules are outmoded at best, and punitive of U.S. economic interests at worst.

Most other developed countries of the world are concerned with setting a competitiveness policy that permits their workers to benefit from globalization. As former Deputy Secretary Dam observed last year, we, by contrast, appear to have based our international tax policy on the principle that we should tax our competitive advantages.

We made significant changes to the international areas of the tax code in 1962, and again in 1986. Those rules, particularly the subpart F changes in 1962, have not advanced with advances in the economy. Many of the 1986 changes had dubious economic underpinnings in 1986. That has not changed as the years have passed.

The significance of the internationalization of the U.S. economy since the enactment of subpart F is apparent from the statistics on international trade and investment.

In 1960, trade in goods to and from the U.S. represented just over 6 percent of GDP. Today, trade in goods to and from the U.S. represents over 20 percent of GDP, a three-fold increase, while trade in goods and services represents more than 25 percent of GDP today.

Cross-border investment, both in-flows and out-flows, also has grown dramatically in the last 40 years. In 1960, cross-border investment represented just over 1 percent of GDP. In 2001, it was more than 11 percent of GDP, representing annual cross-border flows of more than \$1.1 trillion.

U.S. multinational corporations are now responsible for more than one-quarter of U.S. output and about 15 percent of U.S. employment. Those same multinational corporations produced between one-half and three-quarters of U.S. exports annually.

As a general rule, the ideal tax system should seek to minimize distortions to trade or investment relative to what would occur in a world without taxes. It is impossible, and indeed it would be undesirable, for the U.S. to try to level all playing fields. But we can ensure that our own rules minimize the barriers to the free flows of capital that globalization necessitates. Unfortunately, we have often done the opposite by erecting costly barriers to the free flows of capital that would maximize our international competitiveness, sometimes in the name of leveling the playing field.

As the committee considers reforms to our international tax rules, I would urge you to consider three things. First, changes to subpart F. The target of the subpart F rules is intended to be passive investment type income earned through a foreign subsidiary. However, our subpart F rules extend to some forms of active income from foreign business operations, an extension no other country has undertaken. In other words, in seeking to capture as much passive foreign income as possible, subpart F captures a large share of active income as well, putting the U.S. companies that earn this active income at a distinct competitive disadvantage to companies organized elsewhere.

For example, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income of that foreign distribution subsidiary. The effect of this rule is the imposition of current U.S. tax on income from active marketing operations abroad. Consequently, U.S. companies seeking more efficient foreign distribution facilities face a tax penalty that is not imposed on their foreign competitors.

Another example is that the subpart F rules impose current U.S. taxation on income from certain services transactions performed

abroad. Given the importance of the service sector to our economy today, this rule is particularly in need of reconsideration.

While the purpose of these rules is to differentiate passive or mobile income from active business income, they operate to tax currently some classes of active income arising from business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations.

Second, changes to the foreign tax credit limitation. The foreign tax credit may be used to offset U.S. tax on foreign-source income, but not to offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed, complex, and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad.

The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories, or "baskets," of income. Foreign taxes paid with respect to income in a particular basket may be used only to offset the U.S. tax and income from that same basket. Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately from each of these separate foreign tax credit baskets, further adding to the complexity of the system.

Interest expense is allocated pursuant to an arbitrary formula that results in an over-allocation to foreign income. A restriction tied to an overall foreign loss gives rise to the potential for double taxation when the U.S. company's business cycle for its U.S. operations does not match the business cycle for its foreign operations.

Finally, changes to reduced complexity. We have given the complexity of the rules wholly inadequate consideration. When the international rules were first developed, they affected relatively few taxpayers and relatively few transactions. Today, there is hardly a U.S.-based company that is not faced with applying the U.S. international tax rules to some aspect of its business.

It has been observed that it is difficult to predict the future of an economy in which it takes more brains to figure out the tax on our income than it does to earn it. That is the situation we face. Our tax laws are extraordinarily complex, and that complexity is nowhere more evident than in our international tax rules.

The challenge for businesses trying to comply with the law, or the U.S. government trying to administer and enforce it, is enormous. As we move forward, simplifying our international tax rules should be a paramount goal.

Thank you, Mr. Chairman. I would be pleased to answer any questions.

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

The CHAIRMAN. Thank you very much. I have four questions. If we cannot get through them, since we only have time for one round of questions, I will submit the others for answer in writing.

This is asking you maybe to plow ground twice, but I think, even though it is an elementary question, it is very important to our consideration of this. I would ask you for some sort of explanation, particularly from your position, of the international competitiveness and the increase in U.S. jobs, what kind of jobs it creates, and benefits to the average American, and not just necessarily to the worker?

Ms. OLSON. Well, there is considerable economic evidence that any kind of international growth actually adds to our domestic economy. There is one study that indicates that, for every job we produce abroad, we produce two jobs at home.

Moreover, those jobs tend to be higher paying jobs. They are jobs in things like research and development, engineering, and so forth that can be put to extra-productive employment, to the extent that the benefits of those undertakings can be applied abroad as well as domestically.

The CHAIRMAN. We have heard the repealing of the foreign-based company sales and service rules will put great pressure on transfer pricing regulations and the IRS's ability to enforce them. I need your reaction to that.

Ms. OLSON. Certainly, part of the reason for the foreign base company sales and service rules was to backstop our transfer pricing rules. In the last couple of decades, we have made significant advances in the transfer pricing rules. We have requirements for immediate documentation. We have increased penalties for failure to comply.

We have a much greater level of cooperation among our foreign trading partners and ourselves in determining what the proper pricing should be, so it is not as great a concern as it was when the rules were first enacted.

The CHAIRMAN. Your testimony has many references to the R&D credit, depreciation proposals, corporate AMT, and net operating loss carry-backs. I am curious why you included these items in a hearing, as this one is, concentrating on international tax reform.

With the exception of R&D, you did not include these items in the administration's fiscal year 2004 revenue proposals. Are you laying down a marker on what you would want to do with the proceeds of the FSC/ETI repeal, which is about \$50 billion?

Ms. OLSON. Actually, some of those other changes are in the budget as well. For example, the AMT NOL limitation. There are a number of things that we could do that would improve the competitiveness of U.S. companies operating here in the U.S., as well as U.S. companies operating abroad.

Anything we can do to improve the competitiveness of U.S. companies is going to inure to the benefit of the U.S. economy and U.S. workers.

The CHAIRMAN. I think you were here when we had Senator Ensign and Senator Boxer discuss the Homeland Investment bill. I need the administration's and/or your view on the Homeland Investment bill.

Ms. OLSON. Let me give you mine, since I am not sure that the administration's position is entirely ironed out on that.

We think that the bill addresses one of the oddities of our tax rules, which is that we have a worldwide tax system with a foreign tax credit system with a lot of limitations, which means that a lot of income is subject to double taxation. The provision would reduce the tax rate on those untaxed foreign earnings on a one-year basis.

We do not think that a tax holiday like that is the best way to address the issues in our international tax rules. We think it would be far better to do something on a long-term, permanent basis that would improve the competitiveness of U.S. businesses.

The CHAIRMAN. Are you refuting the fact that, even though it is as you describe it, and are you saying that it would not be the immediate shot in the arm to the economy that the sponsors of it say it will be?

Ms. OLSON. We have some doubts about whether or not it would have the stimulative effect that has been suggested.

The CHAIRMAN. I have voted for it, and I have expressed my approval of it. I promised Senator Ensign we would have it on the agenda shortly. So, you need to be prepared for that, if the administration does not like it.

We have more international tax reform proposals than we can pay for, so I need some prioritization on your part. As part of my last question, if you were prioritizing international reforms, what would you address first?

Ms. OLSON. I think that we definitely need to address the limitations on the foreign tax credit. The one that always comes to mind first is the interest allocation rules, which did not make any sense in 1986 and do not make any sense today.

I think we ought to take a serious look at the foreign base company sales and service rules as well, given the development of the service sector in our economy.

The CHAIRMAN. All right. Thank you very much.

Now I am calling on Senator Baucus, and then in this order: Kyl, Bingaman, Bunning, Conrad, Thomas, Breaux, Hatch, and Nickles. Go ahead.

[The questions appear in the appendix.]

Senator BAUCUS. Thank you, Mr. Chairman.

Madam Secretary, clearly this body wants to help American competitiveness, and clearly there are a lot of factors that apply here. The provisions of the Code certainly are some, but I also believe that the rising U.S. deficits and national debt is another, for a lot of reasons.

I understand the administration says that the deficit this year will be \$450 billion. That is a record. That is, by far, a big record. I would like to know why, in your judgment. Is it because of reduction in revenues? If so, what revenues? Is it income, personal, individual, corporate, estate tax? What is it?

Clearly, with rising deficits, we are going to have competitiveness problems worldwide, for a lot of reasons. One, we will not always have current low interest rates. We will not always have current low rates of inflation.

It is my very strongly held view that the more these deficits increase and the debt rises, the more likely it is that sooner, rather than later, we are going to be facing high-interest expenses in the U.S., who for lots of reasons want to attract foreign capital, that in the meantime will start to leave because other foreign investors will start to have less confidence in America's ability to manage its own affairs. I hear that in spades from businessmen in the U.S. and around the world. It may be partly why the dollar is low.

How can we pass a tax simplification measure which costs revenue, which adds further to the deficit? It seems to me that it all should be revenue neutral.

Now, some respond and say, as a percent of GDP, these deficits are not so bad. Well, that is not right. That is not accurate. This

is 4.2 percent of GDP. The average deficit during the Reagan administration was 4.2 percent, the average. So here we are now facing the average during the Reagan presidency.

So, I would just like to know what the administration is doing, what the Treasury is doing, to get these deficits down, other than just glibly, blithely, rhetorically saying we will grow the economy. That is words, not deed. What are the deeds? What is the administration going to do to make us more competitive by addressing these budget deficits?

Ms. OLSON. Well, I do not want to sound either glib or blithe, but the administration does believe that an important way to address the deficits is to grow the economy.

Obviously, some of the increase in the deficit that we are seeing is attributable to the tax cut package that just passed the House and the Senate, because it did concentrate the tax relief in the first 2 years; over \$200 billion of the \$350 billion that was part of the tax relief package is going to go out in 2003 and 2004.

We are also still seeing the effects of the passage of the stimulus bill in March of 2002. The stimulus bill in March of 2002, among other things, allowed companies to carry back for 5 years net operating losses, and that has sent a considerable additional sum of money out into the economy for companies.

Senator BAUCUS. But collections are dropping.

Ms. OLSON. Collections are certainly dropping, yes, because people's incomes are down.

Senator BAUCUS. Well, is it corporate or individual?

Ms. OLSON. They are on both sides.

Senator BAUCUS. Well, then that is counter to what you just said. I mean, you mentioned that the changes in the Code enabled companies to save, and you have got collections that are dropping.

Ms. OLSON. Well, we expect that the deficit would have been worse, the problems would have been worse in the economy but for the tax cuts that left more money in people's pockets to save, invest, and keep workers on the payrolls.

Senator BAUCUS. Do you think large deficits matter?

Ms. OLSON. I definitely think large deficits matter.

Senator BAUCUS. Are these large deficits?

Ms. OLSON. Well, relative to my personal pocketbook, yes, they are very large.

Senator BAUCUS. Are they large in the context of what we are talking about? That is, they matter?

Ms. OLSON. Deficits matter. This is at a size that we need to focus attention on bringing it down. Obviously, there are two sides to the equation, both the spending side and the tax side. We need to look at the spending side of the equation as well.

Senator BAUCUS. Military spending?

Ms. OLSON. I think, given the current world situation, we would be well advised to focus our spending towards the military.

Senator BAUCUS. Should additional tax cuts be revenue neutral?

Ms. OLSON. We look forward to working with Congress in making decisions about what to do on future tax cuts. We do not have plans in the budget, or in the mid-session review which will be coming out later today, for additional tax cuts beyond what we have already rolled out in the budget this year.

Senator BAUCUS. I appreciate your response. I just frankly believe that the administration and the Congress have to do a better job of working together to get these deficits down, because they are going to come back and haunt us.

I am reminded of a Japanese poem, which I read many, many years ago. It is to the effect of, I always knew that 1 day I would travel down this road, only I did not know it would be so soon. My guess is, they are going to be here sooner rather than later, those high interest rates, unless we do something about it now.

Thank you.

The CHAIRMAN. Senator Baucus, thank you.

Now, Senator Kyl.

Senator KYL. Thank you, Mr. Chairman.

I want to get back on the road here and off the detour to the question before us. Let me ask the first question regarding foreign tax credits. You have identified complexity as one of the primary problems with this, the need to simplify it.

I am curious what your recommendations would be for legislatively making this more simple and making it work, and second, your opinion as to whether Treasury has the necessary regulatory authority to deal with this, short of legislation. Is there a possible mix of the two that we could combine here? I am talking primarily about the interest allocation problems.

Ms. OLSON. Yes. That is an issue that has been raised with us on several previous occasions, and we have looked at it on those previous occasions. We have not found ways for us to deal with it without a statutory change, so I do think we need some statutory help there.

In terms of simplifying the foreign tax credit, the biggest problem stems probably from the number of baskets into which companies must separate their income and their foreign tax credits.

The computational work that goes along with that is a nightmare. So if we could reduce the number of baskets, we could significantly simplify those calculations.

Senator KYL. Will the administration be suggesting some specific reforms to the committee or will you be responding? Do you have an idea on that yet?

Ms. OLSON. We included some items in the budget this year that are possibilities. We did not pick and choose among them because it, in some measure, will depend on the amount of revenues that are available for enacting international reforms. But the ones that I have just enumerated were both included in that.

Senator KYL. Let me turn to the subpart F reforms. The idea is to defer the tax liability, but in practice, at least we are advised, these foreign-based company rules can actually operate to deny deferral and thus subject profits to immediate tax in the United States, even when the money is still being used in an active business overseas.

How does this actually happen and what is the best way for us to deal with that phenomenon, if it is true?

Ms. OLSON. It is true. Because of the operation of the rules, a company that is earning foreign base company sales and service income will be taxed on that income in the country in which it is operating and will be taxed again currently here in the U.S.

In calculating foreign tax credits and comparing them to the U.S. tax, you have got different things in play. You have got the base that is subject to tax in the U.S. and in the foreign country, you have got the timing of the income and deductions which may differ in the U.S. and the foreign country, and then you have got the rate.

So to the extent that those things all line up and the tax rate in the foreign country is equal to the tax rate in the U.S., and we do not have anything else kicking in, like for example the interest allocation rules, that would alter the foreign-source income, the foreign tax credit would cover it.

But in many situations, because of combinations of differences, the foreign tax credit will not be able to cover it, will not be able to be used, and the result will be that a company will pay double tax, both in the foreign country in which it is operating, and then here in the U.S.

That puts the company at a disadvantage relative to companies that are headquartered in other countries where they either have a territorial system or have a worldwide system like ours, but without either subpart F rules as broad as ours, or without the foreign tax credit limitations that we have. So, we subject our companies to a tax burden that their competitors in other countries may not be bearing.

Senator KYL. Do you believe that we can exempt the passive income, the rents and royalties and so on, and leave some version of that in subpart F and comply with the trade rulings that have been issued?

Ms. OLSON. Yes, we think we can do that.

Senator KYL. So you distinguish between the active and passive income, and you would be urging us to make that distinction in the reforms that we adopt?

Ms. OLSON. Yes.

Senator KYL. One other question about the whole nature of the global economy. I see the time is about up, so I will make it very quick. Regarding subpart F, how is it that this changing nature of the global economy has made the subpart F and foreign-based company rules outdated? Is there anything beyond just the United States' complexity in our Code that has actually moved to make the concept of this rule outdated?

Ms. OLSON. Well, part of it is the complexity of the rules, but part of it is just the way that the economy has shifted in terms of the fact that it is much more global than it was 40 years ago when the rules were enacted, the fact that we have a large service sector, and large service companies are often subject to these rules on the services that they provide in foreign countries.

The object, back in 1962, was to catch income that was mobile. But if you are providing service income, you have got to be in the country where your customer is. So it is not that you have moved business there for purposes of reducing your taxes or for some other reason, but because that is where you need to be in order to earn the income. So those are the kinds of things that we need to think about as we update the rules.

Senator KYL. Thank you very much.

The CHAIRMAN. Thank you, Senator Kyl.

The next person is Senator Bingaman.

Senator BINGAMAN. Thank you very much.

Ms. Olson, let me ask if you agree with my view that the primary goal we should be trying to achieve through these international tax laws is retention and creation of jobs in this country.

Ms. OLSON. I think it is very important that we retain and continue to create jobs in this country.

Senator BINGAMAN. Is there any other objective that you believe is more important?

Ms. OLSON. That is probably paramount.

Senator BINGAMAN. That is fair, you say, as the most important?

Ms. OLSON. I think that is paramount.

Senator BINGAMAN. All right.

I am a little concerned that we are not able to get from the general down to real specific legislative proposals that we could take action on here.

You have indicated that you think we should make changes in subpart F, we should make changes in the foreign tax credit limitation, we should reduce the complexity.

Are there specific recommendations that Treasury has provided to us as to how to eliminate the complexity and do these other things that we could bring up and vote out of this committee and through the Senate?

Ms. OLSON. We have enumerated some of them that could be considered in the budget this year, but we have not gone into a specific detailing of the ones that are most important. But we would be delighted to work with the committee on that.

Senator BINGAMAN. Do you think that is the right way to have us get to specific recommendations is to have Treasury come up with those, or do you think we should have an outside group of experts come up with recommendations? How do we really get beyond the wailing and gnashing of teeth stage and to a stage where we can take some action?

Ms. OLSON. Well, this committee has previously considered and approved legislation in the international tax area that would have done much to improve the operation of the international rules. I believe that the committee staff, working with the Treasury and the Joint Committee on Taxation, should be able to develop a good package for the committee to consider.

Senator BINGAMAN. Do you believe these changes that you are recommending, changes to subpart F, changes to the foreign tax credit limitation, and reducing complexity, that those, if enacted, would be adequate to eliminate any bias against domestic job retention and job creation that may exist in our Tax Code today or do you think something more comprehensive should be looked at?

Ms. OLSON. If revenues were not a consideration, we might do something larger than the items that we have enumerated. Another thing that I think would do a lot for the U.S. economy is to make the R&E credit permanent. We might also take a look at whether those rules should be updated. They, right now, turn off a base period that goes back to the mid-1980's, and that has the effect of denying to an awful lot of large U.S. companies much of a credit for R&E expenses.

Senator BINGAMAN. Last week when we had our hearing on this related set of issues, we had representatives here from Nestle and—

Senator BAUCUS. Emerson.

Senator BINGAMAN. No, we had another one on the second panel. Electrolux. That is right. Both Nestle and Electrolux's representatives, of course of international companies that have substantial employment in this country, were complaining that they thought these earning-stripping proposals that have come out of the Treasury Department would make it more difficult for them to maintain their employment in this country, and that, rather than creating jobs, those proposals would discourage job creation.

Is this something that Treasury is looking at for modifying these proposals? How are we to take these criticisms that were leveled against the administration proposals last week?

Ms. OLSON. Well, we rolled out a set of proposals a year ago. In response to criticism of them, much of which we found to be warranted, we modified those proposals in what we put into the budget this year.

Our hope was that, with the modifications that we had proposed in the budget this year, we would have addressed many of the concerns of the foreign companies. I know that a number of companies that we have spoken with are, in fact, satisfied with the modifications that we have made.

Our objective was to tailor the rules so that they pick up foreign-owned companies who are stripping the U.S. tax base. One of the things that we think is important for the competitiveness of U.S. companies and the competitiveness of U.S. workers is that foreign-owned companies not have an advantage over U.S.-owned companies in the domestic marketplace, and that is what these rules are intended to achieve.

Senator BINGAMAN. Let me just ask one final follow-up. Would you be willing to meet with the representatives of these companies that were testifying last week and see if additional changes in what you are recommending is justified?

Ms. OLSON. I believe we have met with both of the companies, although I am not sure that we have met with them this year. But, certainly, we are always eager to understand completely the impact of our proposals.

Senator BINGAMAN. Thank you very much.

The CHAIRMAN. Thank you, Senator Bingaman.

Now it is Senator Bunning's turn.

Senator BUNNING. Thank you, Mr. Chairman.

I want to revisit something that Senator Kyl said was off the beaten path. It seems to me, when Ronald Reagan proposed his tax reductions, he proposed \$1 of tax reduction for \$3 of every spending cuts in the early 1980's.

Unfortunately, or fortunately, depending on which way you look at it, we did do the tax reduction. Unfortunately, we did not do the spending reduction. Therefore, the 4.2 or 4.3 percentage of national debt that occurred at that time was because of the inability of Congress to reduce the spending. So much for that. Let us get to the point at hand.

Ms. Olson, along with a number of my colleagues on both the Senate Finance Committee and Banking Committees, I contacted Secretary Snowe earlier this year to express my opposition to the proposed IRS regulation requiring U.S. banks to report the interest income on accounts held by non-resident aliens.

My concern is that this proposal does not appear to be needed to enforce any U.S. tax laws. I do not believe the IRS should prioritize activities that will serve only to allow European nations to tax their residents who invest in the United States.

At a higher level, I am still much opposed to the rule and would like to know if the Treasury plans on officially withdrawing it, if so, when, and if not, why not?

Ms. OLSON. Thank you, Senator. We are continuing to consider what to do with the proposed rulemaking that you referenced. As you may know, this was our second effort in that regard to propose a rule that would cover the issue.

The first set of rules was put out in January of 2001. It would have required domestic banks to gather information on all non-resident aliens. The Treasury and IRS received significant comments on those regulations from people who were justifiably concerned that there were some countries for which we were gathering information where we would not be sharing the information, and that the effect on depositors from those countries could be adverse.

So, we revised those regulations to take those comments into account, but we have continued to get comments and continue to consider those comments.

The regulations, although they are focused on gathering information on non-resident aliens that would not pay tax on that income in the U.S., are for purposes of putting the IRS in a position to exchange that information with other countries who are gathering the same kind of information on U.S. residents who have money in banks in those countries.

So the purpose of the regulations is not for us to help foreign countries enforce their laws, but rather to put us in a position so that we can better enforce our own.

Senator BUNNING. Well, we have a disagreement then. We will strongly object to the rulemaking and will, if necessary, take legislative action to change it.

One of the principles of the U.S. tax system has always been to avoid double taxation of income earned by U.S. citizens abroad. This is largely accomplished through the availability of credits against U.S. tax and for taxes paid abroad.

Obviously, a number of aspects of subpart F which have been discussed, particularly the existence of numerous baskets of income, limit the effectiveness of these foreign tax credits.

To accomplish this goal of eliminating the double taxation of income, could you please comment on which aspects of the Tax Code do an especially good job of achieving this principle and which are particularly troublesome?

Ms. OLSON. Well, the foreign tax credit itself, certainly, is intended to eliminate the double taxation of income. To the extent that it functions with as few limitations as possible, it can readily do that.

We have tried over the years to attain, I think, sort of a theoretical perfection in the limitations on the foreign tax credit, but that theoretical perfection does not match real life.

There are too many differences between our tax rules and the tax rules of other countries for us to be able to load it up with a lot of limitations, such as the multiple baskets that you mentioned, and the interest allocation rules that we have discussed earlier.

So, the consequence is that it does not do what it was intended to do in many situations. So, liberalizing the limitations would go a long ways towards ensuring that it does, in fact, eliminate double taxation.

Senator BUNNING. The last question I have, is how does the Treasury feel about the security industry proposal to make the financial service income basket their base case basket to allow them to better use foreign tax credits?

Ms. OLSON. We think that is a proposal that is worth consideration by the committee.

Senator BUNNING. By our committee?

Ms. OLSON. Yes.

Senator BUNNING. And the Treasury would favor that?

Ms. OLSON. Yes. Yes, we would.

Senator BUNNING. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bunning, thank you.

Now I go to Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Ms. Olson, would the proposals contained in your suggestions increase revenue, would they be revenue neutral, or would they reduce revenue?

Ms. OLSON. They would be scored by the Joint Committee on Taxation in all likelihood as reducing revenue.

Senator CONRAD. And can you tell us by how much they would reduce revenue?

Ms. OLSON. No, I am sorry, Senator. I do not know.

Senator CONRAD. Can you give us some range of estimate of how much they would reduce revenue?

Ms. OLSON. I am sorry, Senator, but I do not have the numbers.

Senator CONRAD. I would just say to you, I think to come before a committee at this point and make recommendations, and not know what the revenue effect is, is really off the mark.

The President's administration today is going to announce the largest deficit in our history by a very large margin, \$450 billion. The previous largest deficit in our history is \$290 billion. As a share of Gross Domestic Product, this deficit is going to be the second highest in 57 years if Social Security is left out of the calculation, as it should be. The revenue this year is headed for the lowest since 1959.

The President's long-term outlook suggests, in his own budget document, that we are never going to get out of deficit under his plan, and that, in fact, although we are at record deficit now, the deficits will explode as the baby boomers retire and the cost to the Federal Government goes up, and the cost of the tax cuts that he has proposed go up as well.

So I think at this juncture, for anybody to come in with a plan and not know what the revenue effect is, is just not responsible.

Ms. OLSON. Senator, we think it is appropriate for us to work with the committee to come up with a good set of changes that would enhance the competitiveness of U.S. businesses, and we would be delighted to work with the committee to do that on a revenue neutral basis, or whatever other basis you would like to have it done.

Senator CONRAD. Well, I appreciate that. I think that is the appropriate way to proceed.

But I would say this to you. I think that if you make proposals, which is what you have done today, you have come in and said these are things we should do, you have got an obligation to know what the effect is on the revenue of the country. I mean, we are awash in red ink here. Part of the equation is revenue. That is half of the equation.

The other half is spending. Spending has gone up. Spending has gone up. Ninety-four percent of the increase is because of defense and homeland security, which virtually all of us supported. I tell you, at this juncture I think all of us are going to have to go back to the drawing board.

One place I think we are going to have to go back to the drawing board, is considering our whole revenue system, my own sense is our revenue system—and you may agree with this—is becoming more and more out of synch with how the rest of the world is operating.

One of the things I am concerned about, is I see our attempt to keep the playing field roughly level for our manufacturers and our producers by FSC and by ETI, and we keep getting ruled GATT-illegal. So, now we have got to find some different way to move.

We see the Europeans. They have got a tax system that allows them to rebate at the border. If we do not find a way to level the playing field here, it confers an 18 percent advantage on their manufacturers. That is clearly not something that is sustainable for our manufacturers.

As Senator Bingaman has pointed out, it is going to put us in an increasingly difficult circumstance with respect to job base in an income and economic base for this country.

But I do not think any of us can make proposals any more that do not look at the effect on the revenue base of the country, because what we have got here is a calamity. I do not know when we are going to face up to it, but I would repeat, we are going to have the largest deficit as a share of the national income, the second largest in 57 years. That is serious.

I thank the Chairman.

The CHAIRMAN. Now it is Senator Thomas.

Senator THOMAS. Thank you, Mr. Chairman.

This is sort of a new issue for me. I am not an expert at all. I am interested in what is being said here. I hope that as we proceed, we will pay as much attention to spending as my friends have talked about here. That is where we are.

But I would like to just have you share with us a little bit in terms of a vision of where we are going, what our goal is here in terms of globalization. You have mentioned that several times.

What impact does this have, for instance, on our trade deficit, and so on? Are we encouraging people to go overseas to do their business? Tell me a little bit about what you see happening over time in terms of our position in globalization in terms of trade and our deficit.

Ms. OLSON. Well, that is a question that oftentimes comes up and a concern that is oftentimes expressed. The economics literature suggests that the more we do to increase our international competitiveness, the better we do here at home, that we create jobs here at home by creating jobs abroad.

The more that we make our companies able to compete internationally in the global marketplace, the more opportunities we have for people back here in the U.S. There are a couple of different things that go on here.

One is that as we allow companies to be more competitive abroad, U.S. companies create supply chains back to the U.S. so we increase opportunities for other U.S. companies, U.S. businesses, U.S. workers by virtue of the activities of the U.S. companies abroad.

That is a very significant one that is oftentimes overlooked, but it is really critical that we do focus on the fact that creating opportunities abroad does mean opportunities at home.

The other thing is the opportunities that those things done abroad create here at home tend to be high-income kinds of opportunities. So, for example, as we allow companies to be more competitive abroad, we give them more opportunities to use profitably the research and experimentation, the engineering activities, and so forth that they are undertaking here in selling more products and more services abroad, so we end up encouraging the kinds of activities that are most important to increasing the standard of living here in the U.S.

Senator THOMAS. That is interesting. That, so far, has not been the case. Our trade deficit has continued to grow. So when you talk about opportunities overseas, are you talking about the opportunity to create a business overseas rather than take a product from here?

Ms. OLSON. What we see most often in terms of U.S. companies' participation in markets abroad is not, for example, that they are manufacturing products or undertaking services abroad that then come back to the U.S. Rather, what they are doing is breaking into markets that they would otherwise not be able to break into by virtue of establishing operations abroad.

Senator THOMAS. They are providing the services for that market overseas, not here.

Ms. OLSON. Providing services or they may be manufacturing products. But because of either domestic content limitations, or tariffs, or transportation costs, were they not manufacturing those products where they are manufacturing them, they would not have those sales at all, and if they did not have those sales at all, that would ultimately mean less for the U.S. economy.

Senator THOMAS. So the product that we basically get is the profit being sent back, or encouraging the profit to be sent back from overseas into this economy.

Ms. OLSON. And the additional use of the U.S.-created intangibles, the research and experimentation, the engineering, the addi-

tional use and the additional profit margin that comes from the use of those activities.

Senator THOMAS. Are those benefits figured into the trade deficit?

Ms. OLSON. To the extent that the money comes back in some fashion. It may form part of our service surplus, but it does not show up in the manufactured goods line.

Senator THOMAS. I guess it is a little difficult to get an image in your mind of where you want to be in 20 years, or 10 years. So what we are doing, is we seem to be totally obsessed with what is going on next week, where we really need to be looking at where we want to be over time. As we look at trade, we seem to be increasing the deficit, of course, all the time, and I just wondered.

Again, I am not an expert in this, but it seems like the more we can encourage activities here with products being sold overseas, that that would be what we would really prefer to do.

Thank you for being here.

Ms. OLSON. Thank you.

Senator HATCH. Senator Breaux?

Senator BREAUX. Thank you, Mr. New Chairman.

Senator HATCH. What is the world coming to?

Senator BREAUX. Secretary Olson, thank you very much. Unfortunately, you have the duty of coming to the Senate Finance Committee today to talk about foreign tax policy, on the day that the announcement that the Federal deficit is at an all-time record.

The numbers are so shocking, it really should be like a slap in the face to all of us with a wet towel because of the significance of how big it is. We can argue about, well, the deficit is as large as it is because we do not tax enough, or it is as large as it is because we spend too much money. There is a little bit of truth on both sides.

I was looking at the charts in the President's budget this year on the non-defense discretionary spending, and it is \$386.6 billion. If we eliminated all the non-defense discretionary spending, it still does not come close to getting rid of the deficit if we did not spend a nickel. So, it is not just spending. I mean, obviously we could eliminate all of that and still not come close to getting rid of the deficit for this year.

So it is a huge problem. If you look at your own estimates, I think, of about \$26 trillion that we are going to need in additional revenues just to cover the baby boomers' entitlement obligations, it is truly a frightening situation. It is like we are a gigantic California, almost. So, there are enough challenges for everybody.

Ms. OLSON. It is a good thing Senator Boxer left.

Senator BREAUX. Yes. I mean, I did not like hers, either. I mean, 22 of us thought her proposal was kind of off the wall, too.

One of the things that was supposed to be used for the offset in the recent tax bill was the Section 911, as you know, the foreign tax exclusion on foreign workers

Can you give me a little bit of the administration's policy on that aspect? Is this going to come back as a pay-for somewhere? What is the administration's position on that particular aspect?

Ms. OLSON. Well, Senator, we appreciate the concerns that drove the committee to consider it in the legislation that was considered

by the committee a couple of months ago, in particular, that we are treating U.S. foreign workers differently than domestic U.S. workers.

But the fact of the matter is foreign U.S. workers are in a different environment, and we think that the tax code treatment that they currently get is probably warranted.

Foreign workers, U.S. workers who are located abroad, serve an important interest of the U.S. economy, and that is that, like U.S. international operations in general, they serve as part of the supply network that encourages the purchase of additional goods and services from U.S. companies. So, they have a very important effect on the U.S. economy.

For the most part, U.S. rules are different than the rules that expatriates from different countries operate under, because those other countries tend not to tax them.

Senator BREAUX. They are not taxed at all, basically.

Ms. OLSON. At all. That is correct. So as companies are considering whether to hire and an expatriate from a European country or a U.S. expatriate, there is a built-in tax preference for the European expatriate over the U.S. expatriate. The Section 911 exclusion goes some distance to minimize that difference, and we think it is probably a pretty important difference for the U.S. economy.

Senator BREAUX. So the administration basically supports the concept of Section 911?

Ms. OLSON. That is correct, Senator.

Senator BREAUX. Now, on the proposal to allow for the money to be brought back to the United States at a 5 percent rate for 1 year, I take it it is pretty clear the administration does not support that. Am I correct?

Ms. OLSON. I am speaking for myself rather than for the administration because the administration's position is not firm yet.

Senator BREAUX. Not developed.

And my concern was that it was 1 year, no consistency. I did not think there were any real requirements on what would have to be done with it. I mean, it certainly did not demand that it be spent on new projects that would not have already been done despite that relief. I mean, they could have brought it back and used it for dividend declarations, if they wanted to.

What are your concerns from your standpoint as tax counsel?

Ms. OLSON. Well, we do not believe that a 1-year tax holiday is the right thing to do for sound tax policy. We think we ought to make changes to the tax code that are sensible, long-term changes to the tax code.

This will have the effect of penalizing some companies that have repatriated earnings as they have gone along and paid the tax relative to those that have not. Because it is just a 1-year provision, it opens lot of opportunities for planning that certainly some companies will take advantage of in ways that the committee might not find appropriate.

Based on our discussions with a number of different companies that are interested in the proposal, it seems likely that it will mean some additional investment in the U.S., but it also seems likely that it will mean some dividend payout, some debt reduction, and perhaps some pension funding. The debt reduction is the one that

is probably cited most frequently, and is probably not going to have a particularly stimulative effect on the economy.

Senator BREAUX. Thank you very much.

Senator HATCH. Thank you, Senator Breaux.

Ms. Olson, you just have two more to go, unless somebody else shows up, myself and Senator Nickles.

But I think most of the members of this committee agree that we need to repeal the FSC/ETI provisions in order to honor our WTO obligations. However, many of us are concerned that we find a way to help the companies that are currently benefitting from these provisions so that they do not face a huge tax increase as they are repealed.

Unfortunately, it is impossible to replicate these benefits without violating WTO rules. Therefore, it seems to me that we ought to focus our efforts on passing tax provisions to help U.S. corporations or companies become more productive and help them to compete globally.

Now, to me, this means a mix of incentives, such as making the research credit permanent and allowing faster depreciation on productive equipment, combined with fixing the international tax laws or tax rules.

Now, does the Treasury Department agree that legislation that helps only domestic companies or that focuses only on multinational firms is not a complete solution?

Ms. OLSON. It definitely would not be a complete solution to the repeal of FSC/ETI. We do need to ensure that the companies that are currently benefitting get a soft landing and transition from the current rules.

Senator HATCH. All right. All of the corporate inversions over the last few years demonstrate that it can be an advantage to a company to sidestep the U.S. international tax laws. Now, if a company starts up here and wants to expand overseas, it soon finds that the Tax Code is a barrier.

Does the Treasury believe that it is better to address the inversion issue by punishing companies that move their headquarters offshore or by making our international tax rules friendlier to global expansion?

Ms. OLSON. We would prefer to have a set of tax rules that are conducive to international operations and not rules that penalize certain companies. I think our biggest concern with the proposals that would just penalize certain companies is that we believe that people would quickly find a way around them, that we would then be embarked on an ongoing effort to plug those holes.

Moreover, and this is perhaps the most important part, we would not have a level playing field for U.S. companies vis-a-vis foreign companies, so we would give foreign companies an advantage over U.S. companies. That concerns us.

Senator HATCH. When companies expand overseas, they likely hire more people at their U.S. headquarters. At least, that is my view. It is my understanding that every time Wal-Mart opens up stores in a new country, that means more jobs in Arkansas in order to keep overseas operations running smoothly.

I am sure that is true for lots of companies, the R&D jobs, the marketing jobs, the management and support jobs. We can have

those jobs here supporting U.S. companies' worldwide operations. I think we ought to make it easier to grow those kinds of good-paying headquarter jobs right here at home.

Now, let me just ask you this one final question, Secretary Olson. Is it the Treasury's view that our international tax rules make it harder to get and keep those kinds of good-paying jobs in our domestic corporate headquarters?

Ms. OLSON. Yes, it definitely impedes the ability of U.S. companies to expand and compete abroad.

Senator HATCH. Thank you.

We will turn to Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much. Secretary Olson, thank you as well.

I am interested in trying to come up with a solution. I am assuming the administration says, to be WTO compliant FSC will be repealed, and now how do we fix it?

Ms. OLSON. Correct.

Senator NICKLES. Is that correct?

Ms. OLSON. That is correct.

Senator NICKLES. And for the most part, I think I have heard you say, well, we need to change our international taxation laws to be not only compliant, but competitive.

Ms. OLSON. Yes, that is correct.

Senator NICKLES. And I am trying to figure out how to do that. I have gleaned some suggestions from your statement. But some parts of your statement, as it pertains to repatriation—and I can understand your statement saying we want something long term, not just a one-term shot. This is interesting. That was probably my initial thought, too.

Some people have told me, though, if you do not do repatriation, you are never going to get that money back. Do you agree with some of the estimates that there might be as much as \$200, 300, 350 billion that might be repatriated if we did have a one-term or 1-year shot of, say, a tax at 5.25 percent?

Ms. OLSON. We have not tried to run numbers ourselves on the amount of money that might come back. But the estimates that have been made by the Joint Committee and by the private sector groups that have looked at it seem reasonable in terms of the amount that might be repatriated.

Senator NICKLES. So it might be as much as \$200 or 300 billion.

Ms. OLSON. That is correct.

Senator NICKLES. Some individuals, some companies, some CEOs, have told me that they definitely would bring back billions of dollars, so that maybe would whet my appetite a little bit more to give it a more serious consideration.

You mentioned your personal position was not in favor of it, but the department and the administration have not taken a final position. Is that correct?

Ms. OLSON. That is correct.

Senator NICKLES. All right.

Also, looking at your statement, there are just two or three things in your segment talking about U.S. taxation on income earned abroad.

You mentioned, "The practical effect of the worldwide system is a tax on U.S. companies, repatriating their earnings to the extent that foreign tax credits are unavailable to offset U.S. taxes." Skip a couple of lines. "This creates an incentive for U.S. companies to keep their income abroad, which can increase the cost of investment in the United States. This results in a disadvantage to U.S. workers."

You go on to say, "This is because the U.S.'s worldwide tax system, unlike other worldwide systems, can tax active forms of business income earned abroad before it has been repatriated, and it often imposes stricter limits on the use of foreign tax credits that prevent double taxation on income earned abroad. I am just looking at this, and it almost seems we ought to repatriate."

Ms. OLSON. I have given speeches on this a number of times, Senator Nickles, and every time I have to pause and say that that does not mean that I am supporting the repatriation proposal.

Senator NICKLES. I can imagine, because I can see the proponents. I am surprised that some of the proponents of the package did not quote your statement.

Ms. OLSON. And they may at their later testimony. We do think that it would be worthwhile our taking a long-term look at the structure of the Tax Code to see whether or not our worldwide system continues to make sense or whether we would be better off with a territorial system. That is not an effort that we have had time to undertake. What we do not think would be good policy would be to just do it on a 1-year basis.

We do think that if the committee considers and moves forward with modifications of the subpart F rules and modifications of some of the foreign tax credit rules, you will go some distance to addressing these issues.

Senator NICKLES. Well, I appreciate those two suggestions. I think we need to be looking at those. Concerning Senator Conrad's comments as to how much of this is paid for, assuming that we repealed FSC, am I correct that there is about \$50 billion over the next 10 years?

Ms. OLSON. I believe that is the most recent estimate, Senator.

Senator NICKLES. I keep hearing that. I am assuming that what you are suggesting is within that category.

Ms. OLSON. You could certainly use some of the revenues to do some international reform, yes.

Senator NICKLES. You could probably use a lot of it to do international reform, could you not?

Ms. OLSON. My guess is that there is probably more than \$50 billion in international reform that would be worth considering.

Now, there may be other things that we could do that would ameliorate that effect, but one of the concerns that I have had over the last couple of years in looking at our formulation of tax policy, is that we seem to make our decisions purely on the basis of revenues as opposed to sound tax policy. And I think when we let the revenues drive our policy decisions, we are probably making some mistakes in terms of the effect on the economy.

Senator NICKLES. I might agree with a lot of that, but I would think that there are two or three things. One, I think we need to have that menu of options on how we can fix the dilemma.

This is a heck of a dilemma, to have a Tax Code that is so complicated that very few people understand it, and basically has an ultimate impact of discouraging U.S. investment, and putting us at a competitive disadvantage. We need to fix that.

It is appalling to think of people saying, well, I am debating making an investment. Do I want to make it in the United States, or make it in Europe, or make it in China? And to say, well, the Tax Code is pushing me overseas. Or, if we are going to have a conglomeration of companies, it is advantageous to be headquartered someplace else other than the United States.

I find that offensive. I think we need to change it. We need to improve it. I also think if repatriation does mean bringing in \$200, 300 billion back to the United States, there is a lot of merit there.

You mentioned that while payment of debt would not be that stimulative, and maybe the money would be used for pension losses that occurred because the markets have declined, and so on, I think those are all pluses, from a person that used to run a corporation.

If you have had a significant downturn, those could be very big pluses that might enable pension payments to be made. It might enable you to survive another period of time in a difficult environment.

So I hope that the administration will keep an open mind on repatriation, and let us consider the pluses as we consider some of the other options to make us more competitive internationally. Thank you very much.

Ms. OLSON. Thank you.

Senator NICKLES. Thank you, Mr. Chairman.

Senator HATCH. Well, I just want to add that I think repatriation might be find if it is done permanently, which is pretty hard to do. But to do it in just a 1-year shot is, I think, pretty poor tax policy. I just wanted to add that to these comments.

Ms. Olson, we want to tell you that we appreciate you for the calm, measured, deliberative style that you have shown here today in answering all of these questions. We appreciate having you here and appreciate your wisdom and advice. Thanks so much.

Ms. OLSON. Thank you.

Senator HATCH. Our third panel includes representatives from the technology, manufacturing, and financial services sectors. They will explain how our international tax laws hamper their global competitiveness.

In addition, we have two former international tax counsels from the Department of Treasury who will provide their views on international reform, and a leading economist on international taxation.

Mr. Dan Kostenbauder, vice president of Taxes for Hewlett-Packard, will discuss the effects of tax policy on the technology sector.

Mr. Charles Hahn, director of Taxes for Dow Chemical, will discuss the concerns of multinational manufacturers.

Mr. Michael Gaffney, first vice president at Merrill Lynch, will talk about the competitiveness of the financial services industry.

We will also hear from Mr. David Rosenbloom of Caplin & Drysdale, who is a former international tax counsel with the Department of Treasury and is presently the director of the Inter-

national Tax Law Program at the New York University School of Law.

Mr. Stephen Shay, a tax partner with the Boston firm of Ropes & Gray, will provide his views. Mr. Shay is a former international tax counsel during the Reagan administration.

Mr. Shay, I understand that you were willing to accept our invitation at a very late date, and we appreciate your efforts to be with us here today.

Finally, we have one of the Nation's leading economic experts on international taxation, Dr. James Hines. Dr. Hines is a professor of Economics, Public Policy, and Business Economics at the University of Michigan. He has written extensively on today's topic.

So we will begin with Dr. Hines, then we will go to Mr. Kostenbauder, then Mr. Hahn, Mr. Gaffney, Mr. Rosenbloom, and finally, Mr. Shay.

Dr. Hines.

STATEMENT OF PROFESSOR JAMES R. HINES, JR., UNIVERSITY OF MICHIGAN BUSINESS SCHOOL, OFFICE OF TAX POLICY RESEARCH, ANN ARBOR, MI

Dr. HINES. Mr. Chairman and members of this distinguished committee, my name is James Hines. I am honored to have the opportunity to participate in these hearings.

The contribution of the U.S. tax system to the competitiveness of American multinational firms and the performance of the U.S. economy has been the subject of extensive analysis and rethinking in recent years.

What we have learned can be summarized in two points. The first, is that the ownership and activities of multinational corporations are highly sensitive to taxation, much more so than what was previously believed to be the case.

The second, is that the competitiveness of the world economy has the potential to change everything we think, about the features that characteristic tax systems that promote economic efficiency.

Together, these two findings carry dramatic implications for the kind of tax policies that advance the competitiveness of U.S.-owned firms, the well-being of Americans, and the productivity of the world economy.

Much of the current structure of U.S. taxation of foreign income dates to the early 1960's when the world economy looked very different than it does today. The United States taxes the worldwide incomes of American companies, granting foreign tax credits for foreign income taxes paid.

At the time it was enacted, this structure was thought to promote global economic efficiency. Most observers are considerably less confident now that this kind of tax system, imbedded as it is in a world economy in which many other countries exempt foreign income from taxation, is efficient.

The most recent research suggests just the opposite, that the U.S. effort to subject foreign income to taxation at the same total rate as domestic income is likely to reduce the productivity of the world economy and the well-being of Americans.

These are difficult concepts, particularly since the tax policy stance that the United States has maintained over the last 40

years, increasingly to our detriment and to the detriment of the world economy, nonetheless has considerable intuitive appeal.

It is useful in this context to consider what other countries do and what it implies for the design of U.S. policies. Business income earned abroad by American firms is subject to taxation by the United States, whereas business income earned abroad by firms based in other countries is often not subject to taxation by their home governments.

Furthermore, even those countries that tax foreign income do not impose the kind of strict foreign tax regime that the United States does. These differences influence the competitiveness of American firms in certain foreign markets.

Firms from countries that exempt foreign income from taxation have the most to gain from locating their foreign investments in low-tax countries, leaving investors from countries such as the United States that tax foreign income more heavily concentrated in high-tax countries.

As if this were not problematic enough, the U.S. tax system has many other features that distinguish it from the systems even of other countries that tax foreign income. The American subpart F system, our unwillingness to grant tax-sparing credits for investments in developing countries, and the unfortunate proliferation of baskets used to calculate foreign tax credit limits, are just three examples of features that our major competitors are unwilling to adopt because they impose such evident burdens on American taxpayers and the U.S. economy.

The welfare principles that underlie the U.S. taxation of foreign income rely on the premise that direct investment abroad by American firms reduces the level of investment in the United States, since foreign competitors are assumed not to react to new investments by Americans.

It follows from this premise that national welfare is maximized by taxing the foreign incomes of American companies, whereas global welfare is maximized by providing foreign tax credits.

If, instead, direct investment abroad by American companies triggers additional investment in the United States by foreign companies, which is likely in a globally competitive market, then entirely different prescriptions follow.

National welfare is then maximized by exempting foreign income from taxation and global welfare is maximized by conformity in the systems of taxing foreign income among capital-exporting countries.

All of these considerations suggest that the longstanding U.S. policy goal of subjecting foreign income to strict taxation by the United States is detrimental to the functioning of the world economy and contrary to U.S. interests.

Senator HATCH. Thank you, Dr. Hines.

[The prepared statement of Dr. Hines appears in the appendix.]

Senator HATCH. We will next go to Mr. Kostenbauder.

**STATEMENT OF DAN KOSTENBAUDER, VICE PRESIDENT-
TRANSACTION TAXES, HEWLETT-PACKARD COMPANY, PALO
ALTO, CA**

Mr. KOSTENBAUDER. Mr. Chairman, members of the committee, thank you for the opportunity to appear today. My name is Dan Kostenbauder. I am vice president of Transaction Taxes at Hewlett-Packard.

HP has about 65,000 U.S. employees, following our merger with Compaq last year. We have revenues of about \$72 billion. We conduct about \$4 billion of research and development annually, and about 80 percent of that is conducted in the United States.

It is clear to me, as someone who has been with Hewlett-Packard and interested in our international activities and international tax for over 20 years, that the ability of HP to compete outside of the United States is very helpful and very powerful for HP's ability to have jobs and employment in the United States.

The graph on page 3 of my testimony is interesting. I will refer you to it. It shows the percentage of HP revenue derived from activities outside of the United States over the last 20-plus years. And from a low in 1983 of a little over 40 percent, now almost 60 percent of our revenue is derived from sales to customers outside of the United States.

On page 4 is a graph that shows that HP's experience tracks the impact of the relatively more rapid growth of other country economies than the U.S. economy since World War II. So, again, to be successful in this global economy, we need to be successful in the U.S., but we also need to be successful outside of the U.S.

In particular, from an HP perspective as an information technology company, why does this occur? One reason is that we have global customers. A lot of our customers like to have one IT vendor, or a limited number.

So if we are going to provide services and products to either U.S.-based multinationals or foreign-based multinationals, we have got to have a global capability. That implies that we have a lot of activity outside of the U.S.

Another reason that we need to be successful outside the U.S. is that research and development is very important to us. To the extent that we develop a new product, we have spent the R&D dollars.

If we can amortize that benefit over the broadest possible market, it reduces the average R&D expense per dollar of revenue. That has got to be helpful. To the extent we have a more constricted market, our R&D as a percentage of revenue goes up and we will be less able to compete against our foreign competitors.

And, finally, there is a need for us to manufacture close to our markets. Some of our products are relatively heavy compared to their value. To the extent we manufacture them locally, that is helpful. Also, a number of our products fall pretty rapidly in value. The closer we are to customers, the more able we are to compete.

I want to talk about a couple of specific international tax provisions. First, the foreign-based company sales and services income provision. The base company rules—again, I will refer you to my testimony on page 7—apply to cases where there is a transaction between related parties, and there is also some activity outside of

the country in which a company is incorporated, often when, they are buying or selling to or from one of those related parties. It is a complex concept and somewhat hard to describe.

But if I can just point you to the first chart there, what I am really trying to demonstrate is that if you have a whole number of factories in different countries selling to a whole number of markets in other countries, to the extent that you have those transactions, there is no subpart F income implicit in the manufacturing or selling activity.

When you move to the more simplified example showing the trading company, typically the activities and the revenue earned by that trading company are what would be called base company income and would be subject to current U.S. tax.

So in the first example, any earnings receive the benefit of deferral of U.S. tax until dividends of those earnings are paid to the U.S., whereas, in the second example, any earnings of that trading company would automatically be taxed in the U.S., even though it reflects just part of the income from what might otherwise be completely foreign-related activities.

Why do companies use trading companies? The trading company helps to simplify a great number of business processes that are necessary: foreign exchange currency exposure management, VAT registrations, invoicing, accounting, Customs declarations. All of that is facilitated by having a trading company. If you look at that second picture, each of the factories has one customer, and each of the selling companies has one vendor.

I want to also discuss the Invest in USA Act, or Homeland Investment provisions. We think that they would be very helpful for the U.S. economy. It has been described as a temporary provision, yet I think it is a temporary provision with permanent consequences. It will permanently allow the movement of between \$150 and \$300 billion worth of cash that now is outside of the U.S. economy into the U.S. economy for investment and use here.

We believe that the many uses that would occur, a variety of them discussed already, would be extremely helpful and valuable for the U.S. economy. Companies would not move that cash if they did not think there was some benefit to having it here, and a lot of us that are interested in that provision do.

I also think that more risk taking would be encouraged by having that much cash. It is just that much of a fall-back for companies willing to assume additional risk.

One final point. Other countries that have territorial systems essentially tax that same type of income at a zero rate rather than 5.25 percent. So, even at 5.25 percent, we are paying a much higher rate than our foreign competitors pay to move cash back to their home countries.

Thank you.

Senator HATCH. Thank you.

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

Senator HATCH. Mr. Hahn?

STATEMENT OF CHARLES J. HAHN, DIRECTOR OF TAXES, TAX DEPARTMENT, THE DOW CHEMICAL COMPANY, MIDLAND, MI

Mr. HAHN. Thank you, Mr. Chairman and members of the committee. My name is Charles Hahn, and I am tax director of The Dow Chemical Company.

Dow is a diversified chemical, plastics, and agricultural company. We have sales in more than 170 countries totaling \$28 billion annually; 41 percent of that is domestic and 59 percent is international.

We have 191 manufacturing sites in 38 countries around the world; 62 of those sites are located in the United States. They represent 57 percent of our long-lived assets. Most of our employees are in the U.S., and we are a major exporter.

The chemical markets that we face are global and fiercely competitive. Dow is the largest U.S. chemical company, but only third largest in the world. Of the top 10, only three chemical companies are from the U.S.

So for those reasons, the topics of this hearing, ETI repeal and international competitiveness, are critical to us. For companies like mine to continue playing the vital role in increasing U.S. exports and creating American jobs, repeal of those provisions must be coupled with much-needed reforms of our outmoded international tax laws.

U.S. manufacturing is not isolated. In fact, it is integrated with, and highly dependent upon, global operations. Making those global operations more competitive through international tax reform will directly help U.S. manufacturing and other U.S. jobs, and help to counteract the effect of the ETI repeal.

The impact of the ETI repeal is very substantial in U.S. multinational companies. For example, Dow's 2002 ETI benefit was \$38 million. Collectively, U.S. multinational companies currently provide 56 percent of all U.S. exports. They also provide 23 million American jobs, 21 percent of U.S. GDP, and \$131 billion in annual U.S. R&D spending.

Enhancing the competitiveness of this group through international tax reform would contribute directly to the U.S. economy by both increasing exports in U.S. manufacturing jobs and other jobs supporting those global operations.

Foreign direct investment by Dow and others creates new markets for American products. In the chemical industry, transportation costs are high and times for delivery are long, so locating near customers or raw materials is critical.

Customers also want a local presence as a way to solve problems and to provide supplies quickly. Local plants not only serve as customers for our U.S. exports, but they also provide distribution for full product lines, even though only a small portion of those products may be manufactured locally.

In 2002, Dow exported \$3.76 billion and 80 percent of those went to related companies, in recent studies by OACD, and the Commerce Department confirmed that relationship.

In addition, many non-manufacturing jobs support and depend on the overseas operations of U.S. firms. Dow is typical. We are headquartered in Midland, Michigan, and naturally many of our global processes occur there. For example, 87 percent of Dow's over

\$1 billion in R&D took place in the United States, a majority in Midland.

Additionally, small businesses support and depend on Dow's global operations. Unfortunately, over the last few years we have been increasingly harmed by the basic structure of the international tax regime.

Dow typically operates in countries that have tax rates that are very similar to that of the U.S. But because we can only carry forward taxes, for example, for 5 years, we are currently faced with the expiration of foreign tax credits, caused primarily by domestic losses, which are not then recaptured when domestic profits return.

The problem is made worse by the high interest allocation and other expenses to foreign-source income. This and other flaws serve to go ahead and be a double tax on our income, and a tax that our competitors do not, in fact, face. Because of this, it erodes the competitiveness of our company, and all U.S. companies that face this system.

Finally, the system is simply too complex and results in a huge compliance burden. But, more importantly, in my opinion, it distracts our non-U.S. business and causes them to slow down in what they are doing because they have to take all of these effects into account, and in the end changes how we do that. That may be the biggest penalty of all.

In conclusion, the WTO-mandated changes to the U.S. tax law should include reforms to our international tax rules. These changes will help ensure that Dow and other U.S. companies can continue to compete globally against foreign-based companies operating under more advantageous tax regimes. We stand ready to help the committee in doing that.

Thank you.

Senator HATCH. Thank you, Mr. Hahn.

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

Senator HATCH. Mr. Gaffney, we will take your testimony.

**STATEMENT OF MIKE GAFFNEY, CO-HEAD OF GLOBAL TAX,
FIRST VICE PRESIDENT, MERRILL LYNCH, NEW YORK, NY**

Mr. GAFFNEY. Mr. Chairman, Senator Hatch, Senator Bingaman, Senator Breaux, thanks for allowing me to come down and testify.

My name is Mike Gaffney. I am a first vice president and the co-head of the Global Tax group at Merrill Lynch. I am appearing on behalf of the Securities Industry Association today.

The SIA welcomes the opportunity to come down and summarize our perspective on how U.S. tax policy affects the international competitiveness of our industry. We realize that this is a challenging time for international tax policy, and the choices that are made by Congress in revising the international tax rules will be vitally important to the future health of the U.S. economy, as well as the SIA member firms.

I think traditionally when policymakers have debated the effects of U.S. tax policy on international competitiveness, the focus has been primarily on the consequences to industrial firms.

To be clear, the SIA does support the objective of a vibrant domestic industrial sector, as most of those client and companies will ultimately be clients, hopefully, of Merrill Lynch and will lead to

future capital generations which Merrill Lynch can be a part of, as well as other member firms.

We also recognize the power of the argument that a significant portion of the revenues generated from the repeal of the FSC/ETI regime should be reinvested in the domestic manufacturing base. Nonetheless, the financial services sector also makes significant contributions to domestic jobs and revenue and is profoundly affected by the international tax environment in which we do business.

I speak today to advocate international tax rules that will promote a fair and competitive environment for securities firms, banks, and similar financial service entities, and thus strengthen our domestic economy.

Merrill Lynch does do business in all 50 States and the District, and we also operate in 35 countries overseas. Our current employee roster is about 40,000 here in the States, and about 51,000 around the world. Of the 11,000 around the world, about half are situated in London, about another 1,500 in Tokyo. So, we tend to congregate in the large financial service centers around the world.

Those figures of 40,000 in the U.S. and 51,000 around the world are down pretty significantly over the last 3 years, as we have hit a difficult working environment both domestically and overseas. At the end of 2000, our employee roster was about 72,000, of which 50,000 were in the U.S. and the other 21,000 or so were overseas.

So, we have had to retrench a bit, specifically overseas. There has been about a 45 percent reduction in the employee base as we have had to rationalize businesses going forward.

We have a pretty straightforward perspective on the goals of U.S. tax policy with respect to domestic international competitiveness. We believe our country's tax rules should not distort the outcome of commercial competition among global firms or across industries.

As a result, we believe that U.S.-based financial service firms that are operating globally should be able to compete in London, Frankfurt, Tokyo, and the other major financial centers around the world under a tax regime that is comparable to the way which those who are non-U.S.-based global competitors operate.

We support fair rules for U.S.-based global financial services firms doing business in the U.S. Those firms are members of the securities industry and are vibrant competitors to Merrill Lynch and the other U.S.-based firms.

We believe the international tax policies of the U.S. should be even-handed across different sectors of the economy. We believe that the report prepared last week in preparation for these hearings by the Joint Committee illustrates the importance and significance of the financial services sector to the U.S. and to the global economy.

I think my paper references some of the statistics that shows foreign direct investment by U.S. firms abroad in financing, insurance, and real estate represented about 43 percent of total direct foreign investment, while investment by U.S. manufacturers overseas was about 28 percent.

The one basic question that is sometimes lost is, why have U.S. securities firms and other financial institutions made such large in-

vestments overseas? I think it is not that different than my colleagues here have mentioned: that is where our customers are.

We are providing a service. We are in a service business. In order to actively compete overseas, like any other service industry, we have to go out, get customers, and attempt to keep customers that we have by providing them services that they require.

I think the statistics on Merrill's overseas expansion going up and down the last several years is indicative that we are there trying to compete overseas, sometimes with success, sometimes with not great success.

But the underlying concept is, some of the proposals that we would like to see, the committee has already wrestled with and approved. The basic tenet is the active financing exception to subpart F.

Some of the other things that the SIA would like to see are corollaries to that, having to do with taking that concept, that what a financial service entity earns, interest and dividend income, is in fact the life blood, or the equivalent of the inventory and sales to a non-financial institution.

Some of what we are supporting is to have provisions that are there already, made permanent, and certain other smaller changes made in other areas of the Code that are corollary to that.

With that, that is my testimony.

Senator HATCH. Thank you, Mr. Gaffney.

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

Senator HATCH. Mr. Rosenbloom.

**STATEMENT OF H. DAVID ROSENBLOOM, CAPLIN &
DRYSDALE, CHARTERED, WASHINGTON, DC**

Mr. ROSENBLOOM. Thank you, Mr. Chairman and members of the committee. I am grateful for this opportunity to express my views on the subject of this important hearing.

My name is David Rosenbloom. I am a lawyer, specialized for over 30 years in international taxation, and a practitioner and professor in that field.

I am not representing anyone here today, or any institution. I am speaking merely as a reasonably knowledgeable citizen.

No reasonable person would oppose the goal of maintaining competitiveness of U.S.-owed foreign corporations. The hard question, however, is what that implies for the rules of tax policy.

If it implies rules that guarantee the ability of U.S.-owed foreign companies to stand toe-to-toe with foreign firms engaged in similar active businesses, that is one thing.

If it implies adopting in U.S. law the most taxpayer favorable rules from every other industrialized country, that is something entirely different.

Like any rules, the present international tax rules of the United States can certainly be improved. If it were left to me, I would revamp them completely in the name of simplicity, administrability, competitiveness, and fairness, fairness to all taxpayers in the United States.

This would lead to far more sweeping changes than are presently contemplated. I would favor a targeted exemption for active busi-

ness income in real countries, countries with real tax systems. I would favor tightening of rules with respect to income not attributable to active business and income earned in tax havens.

I would favor the intelligent use of international tax treaties to tailor these basic rules to fit particular circumstances, and I would favor authorization of the Revenue Service to develop rules to ensure that the new regime does not allow tax sheltering activity.

The United States has always been a leader in international taxation, not a follower. When we adopted legislation with respect to CFCs in 1962, we stood alone in the world. Since that time—a point that has not been made here today—a large and growing number of other countries have adopted similar legislation.

In 1986, there were six countries with CFC legislation. Today, there are approximately 25. The CFC rules in these countries are all modeled, to some extent, on the U.S. rules from 1962, though of course there are important differences.

Many of the countries that have adopted CFC legislation have employed either a black list or a white list to differentiate among foreign countries; they would tax income in black list countries; they would allow deferral for income in white list countries.

Alternatively, some countries use a high tax/low tax approach. I think these approaches are something the United States should consider.

The implicit judgment in our law that all foreign jurisdictions stand on the same footing is incorrect and it leads to many problems in the application of our laws.

It is crystal clear that the rest of the world has been tightening, not loosening, home country taxation of foreign operations and foreign income, particularly in tax havens.

In these circumstances especially, the committee should take time to consider carefully where the all-important lines between current taxation and deferral should be drawn.

I urge you not to rush, in the name of competitiveness, to surrender segments of the U.S. tax base without considering offsetting measures with respect to income that is not active business income and income benefitting from tax haven regimes.

CFC legislation is not the province of only the Fortune 500. In the year 1998, there were approximately 46,000 CFCs that reported, owned by nearly 2,000 U.S. domestic companies.

Many of these CFCs are not engaged in active business. Many are located in tax havens. Many cannot make any reasonable claim to a competitiveness concern. There is unquestionably a tax shelter component to some CFC planning and implementation.

In addition, our CFC rules serve to protect our domestic tax base by deterring U.S. persons from deflecting their income to foreign corporations.

I am very concerned that the competitive interests of some companies may carry on their coattails unjustified benefits for persons whose foreign operations are unworthy of protection and would be deemed unworthy of protection by just about everyone.

Our foreign tax credit rules are, in my view, even more problematic than the CFC rules. These rules are so complicated, as has been said today, that only specialists can now understand them.

It is for that reason, as well as my understanding that very little tax revenue derives from foreign active business income, that I would favor exemption of such income when earned in jurisdictions that have real tax systems comparable to our own, which is where most of our investment is located.

On the other hand, I would be much more wary of other types of income. If the committee opts for lesser measures, I recommend it proceed cautiously, considering tightening along with loosening, and that it strive to do no harm to the existing and functioning U.S. international tax system, which truly is not so bad.

In fact, although that system can be improved, it is wrong to emphasize its dysfunctionality. The present rules have served the country well for more than 40 years, and in that time I have not noticed any terrible deterioration of U.S. economic interests.

As a general matter, I think it is important to recognize there is no other tax system in the world that works better than, or even as well as, the present U.S. system. Each year, it touches the lives of more than 150 million people with virtually no corruption, surprisingly little error, and remarkable efficiency. This is rare in the world.

Both the system as a whole, and the agency that administers it, are the envy of just about every other country that has devoted serious thought to these subjects.

In my judgment, these sentiments apply to the international aspects of the system no less than to the rest of it. Such are the principles I think should inform, a fresh view of the important subjects of today's hearing.

The moment appears to offer a rare opportunity for Congress to take such a fresh view and to consider genuine, and not piecemeal, international tax reform. I hope it will do so. I would be pleased to respond to any questions that members may have.

Senator HATCH. Thank you, Mr. Rosenbloom.

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

Senator HATCH. Mr. Shay, you are our final witness here.

I have to step out for a minute. I will be right back. Then we will start questions after Mr. Shay.

STATEMENT OF STEPHEN E. SHAY, ESQ., PARTNER, ROPES & GRAY, LLP, BOSTON, MA

Mr. SHAY. Thank you, Mr. Chairman and members of the committee.

As may become clear in a moment, I am expressing my own personal views and not the views of either my clients or my law firm.

I want to follow up on what David was just saying from a slightly different tack. The thrust of my remarks, is really that there is much that needs to be improved about our rules, but they are not nearly as bad as some claim, viewed from an overall perspective.

My first comment goes to the question of competitiveness. Clearly, this committee wants to look at that issue from the context of, what will improve the living standards of Americans? So any proposal needs to be not tested.

Not just will it improve the after-tax incomes of our multinationals, which is not insignificant as an issue. But the question

is, how will that translate and how will the rules translate into a benefit for the Americans that live, reside, and work in this country?

In that connection, I have long been very skeptical about the claims made for the ETI. One of the things that concerns me, is it is very hard to have one of our own proposals found an illegal export subsidy, and then to have to change it, apparently under pressure.

But I have questioned whether we have re-examined the ETI appropriately since its inception in 1971. In 1971, we did not have floating exchange rates. We put in place an export subsidy and we have not really looked closely at whether it was cost effective since then, in my judgment.

Once exchange rates began to float in the 1970's, there is a question as to whether export subsidy was in the overall interest of this country. Yes, it helps the firms that were benefitting from it. It helps their employment.

But the fact is, the cost of that subsidy probably exceeded the net export increases. While I am not an economist, that is a proposition to be tested. I am not sure it has been tested. I think we need to take all the claims that are being made to support a proposal and look at them objectively.

The main point I wanted to make in my testimony was that, looked at as a whole, there is a real question as to whether U.S. companies are disadvantaged in the international marketplace by the U.S. tax system.

Why do I say that? I do not mean to minimize that there are some provisions that are, in fact, harmful and can very adversely affect a particular company, such as the unevenness of our loss or capture rules that Mr. Hahn referred to.

But taken as a whole, we do not, as was suggested earlier, tax the worldwide income of our U.S. multinationals, at least to the extent the income is earned through a foreign corporation. That income is not taxed by the United States until it is repatriated as a dividend.

There has been a lot of discussion today of foreign-based company sales rules. That is correct. When those rules apply, they do, indeed, cause current taxation. While it is onerous and they probably should be revised, the fact is, if one looks at the data, I suspect that you will not find much foreign-based company sales income because they are relatively easily avoidable.

So in terms of looking at where the data is, it is not clear to me that we have a crisis on the deferral side. In fact, our system of deferring taxation of foreign income earned from a foreign corporation, I think, at a very general level, puts us in roughly the equivalent position of countries that exempt foreign income.

That would raise a question of, well, would an exception not be simpler or easier? In some respects, yes, in other respects, no. It is interesting to me that we are not proposing an exemption. I have seen no major proposal proposing an exemption. I think the reason for that is, the current system is better for our taxpayers in terms of being able to have a lower level of tax.

Why is that? When you are in a high-tax country as opposed to a low-tax country, you have to pay those taxes. Our system, our

foreign tax credit system, has a number of rules that are disadvantageous in crediting those taxes. They have all been discussed.

Let us discuss some of the rules that are advantageous. There are, in fact, some major parts of the American tax rules that permit a foreign tax to offset what any other country would call U.S. income.

Two examples. Foreign royalty income, or royalty income that is earned from abroad. Most exemption countries do not allow exemption for foreign royalty income. They treat it as their home country income. They say, well, you have got a deduction in the other country, and so we should tax it here. The other example is the sale source rule, which I am not going to go into in detail.

So my plea to the committee is, step back, take a deep breath. Look carefully at the claims that are made as to the effect of the overall structure. It needs to be changed. I think we have time to change it. It is not at all clear to me that we should be earmarking ETI revenue for international tax reform.

I think that is an open question that should be judged. That revenue should be weighed against what is the absolute best result for the overall American public from use of that revenue.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shay appears in the appendix.]
Senator HATCH. Thank you very much.

Mr. Hahn, you mentioned in your testimony that Dow believes that the repeal of FSC/ETI must be accompanied by the reform of the international tax rules.

As you know, some repeal proposals would allocate all of the revenues raised by the repeal of FSC/ETI provisions to tax changes benefitting only domestic manufacturers.

We have been told that, absent such legislation, U.S. jobs would be lost. Now, do you believe that U.S. jobs will be lost if we fail to also address the much-needed changes in our international tax rules?

Mr. HAHN. Yes, I absolutely do. As I said, it is becoming quite a burden for us. It affects our ability to compete. Again, our extension into international markets has greatly increased our exports by our sales to our related subsidiaries, and more importantly, the distribution of product lines.

It also, as has been mentioned several times, supports what I would call our headquarters jobs, the R&D type of jobs, the functions that we have relating globally.

So, if we do not have a competitive international tax system and U.S. companies are not out there in that international market, we are going to lose U.S. manufacturing jobs. That is one of the key things we ought to be looking at.

Senator HATCH. Mr. Kostenbauder, you spoke avidly about allowing companies the opportunity to repatriate their overseas profits at a greatly reduced dividend rate. Now, I agree, this is an intriguing concept, one that I supported both in the Finance Committee and on the floor of the Senate.

Can you tell us why this reduced dividend should not just be made a permanent part of the Tax Code? Why should we not simply allow the earnings to be repatriated without imposing any tax?

Mr. KOSTENBAUDER. Well, with respect to the rate, I think the 5.25 percent rate was chosen as sort of a balance between a rate that was low enough to really encourage companies to move cash back to the United States (and thereby generate some positive revenue for the proposal), versus being too high and consequently discouraging the significant movement of cash to the United States.

In terms of permanence, you might actually design a regime where we could have zero tax, or a very low rate, on a permanent basis, which would be a significant step toward what would be described as a territorial system of taxation.

The U.S. system, since its inception, has been a worldwide system. I think the change from the worldwide approach that we have adopted, with its many modifications and imperfections, to a territorial or substantially territorial system is really a very big decision.

I do not think that the deliberations necessary to make that decision have really been thought through and processed. We have not reached a general consensus reached that that is where we should be.

However, the U.S. economy has been suffering, particularly the tech economy, very serious job losses and serious competitive challenges for 3 years. I think the stimulative effect right now of allowing that cash to move to the U.S. would be very beneficial to the U.S. economy, and that would help all of us.

I think it is also consistent with the direction of many of the reforms currently under consideration to allow companies to reposition their global cash. And, as I indicated in my testimony, I think it allows, depending on the estimates, \$150 billion to maybe \$300 billion of cash that now sits outside the United States to be moved back to the United States permanently. So, I think it is permanent in that respect.

Senator HATCH. In your statement, I noticed the two charts where you were emphasizing the importance of a trading company. You talked about how our outdated foreign-based company rules encouraged companies to put marketing and trading operations in each and every country in which they do business.

Now, that seems like that has to automatically arise the costs of selling U.S.-made and U.S.-designed products overseas. How do you think those rules affect smaller American companies that are trying to start selling their products overseas?

Mr. KOSTENBAUDER. I think they create a lot of complexity that would be eliminated. Certainly, Hewlett-Packard is a major corporation. We have a lot of resources. It is a challenge for us, with the resources we have available, to keep track of and deal with all of the complex international tax rules.

Certainly for the smallest U.S. companies, it is a real challenge. I think the base company rules provide a tremendous amount of complexity without really a concomitant increase in U.S. revenue.

I might also point out that the proposal, although it is a part of subpart F, is certainly distinct from all of the passive income rules, and we are not proposing or advocating any changes in the passive rules at this point.

Senator HATCH. Well, thank you. I will turn this back to the real chairman of this committee, and thank you all personally for your

testimony and the time you have spent in coming here and helping us.

Now I would like to submit questions for answer in writing.

The CHAIRMAN. Yes.

[The questions appear in the appendix.]

The CHAIRMAN. I was necessarily called away for a news conference on another subject, so I did not get a chance to introduce all of you, or any of you. So, I appreciate the opportunity to have you here as expert witnesses.

I am going to call on, I think, Senator Bingaman, then Senator Breaux. I may have some questions when they are done, but I want to let them go first.

Senator BINGAMAN. Thank you very much, Mr. Chairman. Thank you all for being here and testifying.

I wanted to ask, first, Professor Hines, one of the issues I have been trying to understand is, does the current set of international tax laws that we have in place encourage job creation and retention in this country, or discourage it, or is it basically irrelevant to the issue? I mean, do you have any thought on that?

Dr. HINES. Yes. If there are inefficiencies in the tax system, and I think all the speakers have agreed that there are, ultimately what that does is reduce the well-being of Americans. The way that happens, is by depressing job creation, or if there are jobs, lowering the wages that people earn in those jobs.

If the economy becomes less productive, then wages fall and the rate of profit falls. That is what happens when we permit the tax system to be inefficient.

Senator BINGAMAN. So you are saying the inefficiencies in the system that we now have depress job creation, and presumably also depress job retention.

Dr. HINES. And wages. Yes.

Senator BINGAMAN. And wages as well.

In order to deal with the problem I am a little confused about how major a reform is called for. The Department of Treasury and Ms. Olson testified that, in the administration's view, we need to reduce complexity, we need to change subpart F, and we need to make changes in the foreign tax credit limitation rules.

That seems to me to be a fairly modest set of proposals if, in fact, we have got depression of job creation that you described going on. Do you think something more fundamental, more widespread, more basic is required in order to deal with the problem?

Dr. HINES. Senator Bingaman, there are two ways to think about this problem. Yes, I do think that something broader would be helpful to the U.S. economy and would stimulate job creation and wage growth.

But I also think that modest reforms have the prospect of doing some of that. It is hard to see sometimes the beneficial effects of reform because it has modest effects on wages. But we have more than 100 million workers, so when you add it all up, it adds up to a lot of money for the U.S. economy.

So, yes, subpart F reform, reforming the baskets, the expense allocation rules, and the other things that Assistant Secretary Olson talked about would be beneficial and would feed back to the well being of American workers. Broader reforms would do even more.

Senator BINGAMAN. Mr. Rosenbloom, you make reference to this. You say that my personal preference in regard to outbound taxation would be to revamp the rules completely in the name of simplicity, administrative fairness, and competitiveness. This would be far more sweeping changes than are presently being contemplated.

Is it your thought that it is worth the effort to do something comprehensive here? Toward the end of your testimony you seemed to be saying the system is working pretty well and it is better than anyone else's system, so do not get too concerned.

What is your view on that?

Mr. ROSENBLOOM. Yes. I think that the present system and the people who administer it deserve a lot of respect. Your predecessors have considered these rules many times, and the rules are the product of a lot of thought that has gone before this. A lot of the discussion has been in terms that are very similar to the terms that have been discussed in this chamber today.

I realize that this is a political process. But if one could move to a perfect system, an ideal system for the United States, in my view, we would not tax active foreign business income.

I think the literature suggests that our current rate of taxation on active foreign business income is actually negative. That may be one of the reasons that, as Mr. Shay suggested, you are not encountering any proposals to actually achieve exemption, because people do better under the current system than with exemption, which is a fairly amazing fact, but I think it is probably true.

I would recommend moving in the direction of identifying and exempting active business income—and I would distinguish from that passive income, and probably tax haven income. I repeat that many, many countries in the world today, including almost all European countries and lots of our competitors, Japan, Germany, the UK, France, Italy, all of them go after tax haven income today.

So I think, when you cut through the discussion that has been held today, that is really the nub of it. What are we going to do about tax haven income under these rules? Because I think I do not have any problem with the active income in the Germanys, the Frances, the UKs, the Switzerlands. No problem with that at all. I do not think most people do.

Senator BINGAMAN. So is it fair to assume that you could make the changes you just described with regard to active foreign income and with regard to going after tax haven income and all and come out somewhat revenue neutral?

Mr. ROSENBLOOM. I think you might actually raise revenue.

Senator BINGAMAN. That is an encouraging suggestion.

Thank you very much.

Senator BREAUX. Let me just ask a couple of questions on the whole system that we have in place now. Maybe Hewlett-Packard, Mr. Kostenbauder. Why would HP not be advantaged by just taking your foreign tax credit? You are not located in countries that have no taxes and tax havens in particular, are you? Or have the tax credits just expired? I mean, what is it, 5 years? Why can you not just take your credits under the current system and do very well?

Mr. KOSTENBAUDER. Well, as a global company we operate in lots of different jurisdictions, certainly throughout Europe and Asia. I

mean, the entire world is covered. We have a current practice of regular dividend flows. We take foreign tax credits where appropriate on those.

We also have, as many companies do, certain activities in low-tax jurisdictions—very active factory and real business activity. That activity helps us, from the point of view of the benefits of deferral, have a more competitive global enterprise. Some of those low-tax earnings are prohibitively expensive to bring back to the U.S. because they would, in fact, be taxed pretty much at a full 35% U.S. corporate tax rate.

Senator BREAUX. Well, it seems to me that is one of the reasons it is structured like that, so that U.S. companies just do not go pick out all the non-tax countries in the world and move everything over there, and then have absolutely no tax on any of your earnings.

Mr. KOSTENBAUDER. Well, Senator, certainly we have not moved all of our activities to other countries.

Senator BREAUX. I am talking, theoretically. We could just have every company in America doing business in every country that does not charge any taxes whatsoever. I mean, all of a company's income would be produced in no-tax or tax haven countries.

Mr. KOSTENBAUDER. One way to think about that, is that we have a portfolio of foreign jurisdictions in which we do business. So we have the biggest part of our international activity in Europe, which has tax rates that are certainly comparable to the U.S. tax rates. We also operate in Puerto Rico, which generally has a lower rate on most of our manufacturing activity. We do that in Ireland as well, where we manufacture for the European market.

That is part of a portfolio. Our international competitors are located in those places. Those locations have advantages not only from the point of view of low taxes, but they may have low labor rates. They are certainly close to local markets. So, there are a lot of reasons for conducting business in such locations.

But, again, 100 percent of Hewlett-Packard's international activity has not, over time, migrated to those countries. It is a small part of the portfolio. It makes sense for a lot of reasons, and certainly a low tax rate is a positive for locating some activities in those countries. But it certainly does not draw all of our activity. The incentive effect is just one factor that we consider.

Senator BREAUX. Well, I understand it is not all. I am just talking hypothetically. If I was a company and it was structured along those lines, I would just be inclined to put everything in a no-tax country.

Mr. Rosenbloom, do you have any comment on that concept?

Mr. ROSENBLOOM. I would tend to think that a company would be remiss not to do that.

Senator BREAUX. Well, we have had a good discussion. I do not want to belabor it. We have a vote that has just started. But hopefully we will be able to make some improvements and reform, and yet at the same time keep something on balance that makes sense.

I thank the panel very much.

The CHAIRMAN. Yes. Thank you, Senator BreauX.

Since there is a vote starting, and since I think it would be rude to keep you sitting around here for 15 minutes while I recess the

committee, I have got three or four questions that I am going to submit for answer in writing.

Normally, we would like to have those back in about 2 weeks, if you could. I would appreciate it very much.

Thank you all very much for your contribution.

[The questions appear in the appendix.]

[Whereupon, at 12:20 p.m., the hearing was concluded.]

APPENDIX

PREPARED STATEMENT OF HON. GEORGE ALLEN

Thank you Mr. Chairman. I appreciate the opportunity to come before the Committee today and comment on the ongoing debate over how to effectively repeal the Extraterritorial Income Exclusion Act of 2000 without adversely impacting U.S. jobs and business.

ETI and its predecessors, the Foreign Sales Corporation, and Domestic International Sales Corporation acts, were originally enacted to ensure U.S. exporters were competing on a level playing field internationally. At the time, high U.S. income taxes were forcing U.S. firms to make difficult choices on how and where to establish manufacturing and production facilities. Congress crafted the program to encourage production in the U.S.

Today, the threat of American companies and jobs going overseas remains. While ETI provides tax benefits of over \$4 billion a year on exported goods for eligible companies, ETI also helps support over 3.5 million jobs, directly and indirectly, in the U.S. If ETI is simply repealed without enactment of sound legislation in its place, these benefits will be lost to U.S. companies and to U.S. workers when they are most needed. Indeed, last month alone, the U.S. lost more than 56,000 manufacturing jobs, following a steady decline over several years. Over 2.6 million manufacturing jobs have been lost over the past two years. More jobs have been lost in the manufacturing sector than in all sectors of the U.S. economy combined. Mr. Chairman, repealing ETI without an alternative will encourage U.S.-based exporters with significant sales abroad to move their operations and jobs out of the U.S.

Legislation repealing ETI must include provisions that provide some alternative relief to U.S. exporters with primarily domestic production. Virginia ranks sixteenth in exports among all States, so Virginians are especially concerned about the impact of ETI repeal. With a simple repeal of ETI, Virginia stands to lose up to 82,600 export-related jobs. This will harm good hardworking people in Virginia's manufacturing sector, and deliver a serious blow to related industries. And, changes in the manufacturing sector echo throughout the economy.

ETI's repeal, without anything to take its place, will amount to a tax increase of over \$50 billion over the next ten years on the U.S. manufacturing jobs base which is now covered by ETI. Tax reform should promote creation and retention of jobs for Americans and the competitiveness of U.S.-based companies, not penalize them.

International tax reforms to maintain our international competitiveness would be a positive change, but such reforms should not be paid for by increasing taxes on the domestic manufacturing and production base, which would increase the cost of doing business in this country, but more importantly would severely jeopardize the livelihood of millions of Americans.

If I may, I would also like to briefly comment on the other topic of discussion for this hearing, the Homeland Investment Act. This legislation would be an effective compliment to the recent tax relief package the Congress recently passed.

By temporarily reducing the tax burden associated with repatriating the accumulated foreign earnings of U.S. companies, we can provide an incentive for businesses to bring approximately \$140 billion back to the U.S.

The net result of this temporary change in tax policy would be greater investment in new capital and personnel, but most importantly, new U.S. jobs.

The Senate has already overwhelmingly supported this initiative once, I respectfully urge the Finance Committee to bring it before the full Senate once again for consideration.

Thank you Mr. Chairman for the opportunity to testify before you today. I look forward to working with you and the Committee on these important tax issues in the coming months.

PREPARED STATEMENT OF HON. MAX BAUCUS

Today's hearing take us one step closer to streamlining our sprawling international tax laws. More than a year ago, Senators Graham, Hatch, Grassley, and I formed an International Tax Working Group. The Working Group was put together to review our international tax laws and make recommendations for improvement.

We focused on simplification of these laws, so that U.S.-based multinationals could compete in the global economy. Achieving this goal will encourage American companies to remain in this country, while creating jobs and promoting economic growth. Our international tax laws have not kept up with the increased globalization of the economy. The Working Group has made great strides toward pinpointing areas for reform. And I am pleased that these efforts reinforce the objectives Senator Hatch and I have made in the past.

And I am also pleased that today's hearing turns an eye towards simplification. Today we will address such complex tax laws as—anti-deferral regimes, the foreign tax credit and sourcing and allocation rules. Reform in these areas would have a significant effect on U.S. companies competing in the global marketplace. At last week's hearing, we heard testimony about the decline of the manufacturing sector and ways to help industry. Providing incentives to reverse this decline and keep manufacturing jobs in the U.S. is not inconsistent with reforming our international tax rules and making corporations more competitive.

Mr. Chairman, it is critically important to have laws that benefit, rather than penalize, U.S. corporations competing globally with foreign counterparts. International tax reform is about keeping jobs in America. And we need to ensure that the United States provides an environment that U.S. corporations want to conduct business in—not an environment American businesses choose to flee. Common sense would indicate that the more corporations headquartered—and incorporated—in the U.S., the more jobs we have here at home.

Department of Commerce data shows that in 1999 U.S. multinationals employed over 21 million people in the United States—out of a workforce of 130 million. In 2000, foreign affiliates of U.S. companies purchased \$203 billion of goods from U.S. sources, while domestic operations of U.S. multinationals exported \$236 billion to other foreign customers. Thus, U.S. multinationals accounted for \$439 billion of merchandise exports in 2000, or about two-thirds of overall U.S. merchandise exports.

But we don't want to enact laws that will encourage companies to move operations offshore to avoid taxes. Rather, we want to take advantage of this opportunity to review the U.S. system of international taxation, make modifications where appropriate, eliminate overlap and simplify where possible. Mr. Chairman, I want to thank you for holding this hearing today. And, I want to thank Senators Graham and Hatch for their continuing efforts in the area of international tax reform. I look forward to hearing from our witnesses on this important and timely issue.

PREPARED STATEMENT OF HON. JIM BUNNING

Thank you, Mr. Chairman.

I am grateful to the chairman for holding this hearing today. As my colleagues are all aware, the issue of the effect that our tax system has on the international competitiveness of American-based companies is one that is fundamental to our economic future.

Hardly anyone will disagree that the U.S. tax system is fundamentally outdated in many areas of international taxation. The bulk of our international tax rules were written over 40 years ago. The intervening decades have seen significant changes both in the business models of multinational corporations and in the world economy. Many of the rules that are currently in place do not meet the basic goal of the avoidance of double taxation. This has to change if American-based companies are to be competitive. The recent focus on corporate inversions is disturbing evidence of this fact.

This committee will be making a number of important decisions in the coming months that could have wide-reaching impact on the place of America and American

businesses in the future world economy. I am indebted to our witnesses today for taking the time to share their expertise and experience with us as we grapple with the issues before us.

I look forward to an informative and enlightening exchange of ideas.
Thank you.

PREPARED STATEMENT OF HON. JOHN ENSIGN

The United States has maintained a tax system for decades that makes it prohibitively expensive for our U.S.-based companies to bring foreign earnings back for investment in the United States and thus encourages reinvestment of those earnings offshore.

Under international tax principles, primary jurisdiction to tax income is the country where the business operates rather than the country where the business is based.

Many countries (but not the U.S.) exclude foreign dividends from domestic taxation, which encourages the reinvestment of surplus foreign earnings back home into these countries.

In the U.S., by contrast, companies are required to pay tax on foreign subsidiary earnings when the earnings are brought back to the U.S. at a 35-percent U.S. tax rate.

As a result, foreign earnings of U.S.-based companies have accumulated abroad because companies are reluctant to repatriate these funds at this high tax rate.

In the simplest and worst case, a company that is faced with a 35% U.S. tax on a \$100 profit can invest \$65 dollars in the United States or \$100 in a foreign country. Obviously, the foreign investment is the better choice.

This aspect of U.S. tax law is a significant incentive to leave foreign earnings offshore. As a result, less desirable foreign investments are frequently more profitable for U.S. companies despite better investment opportunities in the United States.

Based on an examination of the financial statements of the S&P 500, JP Morgan conservatively estimates that the pool of foreign earnings that has accumulated over the years and is eligible to be brought to the United States is about \$300 billion.

Much of this accumulated foreign investment is designated for financial reporting purposes as permanently invested overseas and thus there is no expectation of any U.S. tax being paid in the future.

Invest in the U.S.A. proposal included in S. 1056

The Senate-passed Jobs and Economic Growth tax bill included a provision originally introduced as S. 596 by myself, and Senators Boxer, Smith, Bayh, Allen and Enzi. It was adopted by voice vote after a 75–25 vote adopting a procedural motion on the floor to consider it.

All the Republicans and half the Democrats voted in favor. Similar bipartisan proposals have been introduced in the House.

Proposed Change

For a one-year period, the 35% tax rate on transfers to the U.S. of foreign corporate earnings would be replaced with a 5.25% toll charge on transfers in excess of the company's historical average.

No foreign tax credit would be allowed for 85% of the foreign taxes associated with dividends and other transfers qualifying for the 5.25% toll charge. The 5.25% toll charge could not be reduced by net operating losses.

This amounts to about a 3.75 percent U.S. tax after foreign tax credits—about the same as what companies have show that they are willing to pay on average.

PricewaterhouseCoopers examination of the most recent IRS tax data shows that, on average, companies repatriate earnings when the additional U.S. tax burden is about 3.7 percent. If the rate were increased it would encourage less investment in the United States. Reducing the rate could result in less U.S. revenue.

To encourage immediate economic stimulus, the reduced rate of tax would be effective for the first taxable year ending 120 days or more after the date of enactment. Thus, for example, if the bill was enacted on May 25, 2003 and the electing taxpayer is on a calendar year, the bill will apply to the taxpayer's taxable year ending December 31, 2003.

Obviously, since the bill was not enacted as part of the growth package, I will encourage this Committee to select an effective date that maximizes the economic benefit in the next twelve months—to encourage the maximum amount of U.S. reinvestment as quickly as possible.

Estimated additional U.S. investment from accumulated foreign earnings

JP Morgan performed an independent study of S&P 500 financial data for its investors and conservatively estimates that it would bring in about \$300 billion and advises that the proposal will result in a significant amount of economic stimulus including:

- A 2–3% cumulative increase in domestic investment during 2003–04,
- A 1 % cumulative increase in GDP growth (.5 % in 2003 and .5% in 2004) and
- A 3% reduction in nonfinancial corporate debt that strengthens corporate balance sheets and lowers corporate bond rates.

To provide a sense of the significance of this one-percent of additional GDP, we can compare it to the stimulus in the just passed growth bill.

Standard & Poor and Morgan Stanley Company estimated that the portion of the President's tax proposals that were enacted this year would increase GDP by about one-percent in 2003. Bank of American estimated the impact as about .5 percent in 2004.

Prudential Financial published a Research Report in June on the proposal, stating:

“We believe that a fund transfer of this magnitude would have significant macroeconomic implications, spurring growth, driving employment, stimulating domestic U.S. capital expenditures, easing the burden of under-funded pension programs, and in particular, helping hard-pressed U.S. manufacturing corporations to pay down debt and de-lever their balance sheets to better cope with deflationary pressures.”

A PricewaterhouseCoopers survey of just 14 companies showed that the proposed change would result in an additional \$47 billion reinvestment in the United States from just those 14 companies.

This would increase domestic investment in plant, equipment, R&D, and pension plans depleted by decline in the stock market; reduce domestic debt loads; increase dividends that could be productively redeployed; and raise equity market valuations by increasing funds available for share repurchases.

The extent to which this is beneficial to the U.S. economy is determined by the use of the funds when they are reinvested. Although the PricewaterhouseCoopers survey on use of the funds focuses on 14 relatively large companies, the change will improve the financial condition of all U.S.-based companies regardless of size.

I ask unanimous consent that the results of this survey be entered into the record:

Uses of Additional Dollars Brought to the U.S. as a Result of S. 596 PricewaterhouseCoopers Survey of 14 Companies (4/11/03)	
Percent of foreign subsidiaries' accumulated untaxed earnings at end of 2002 that would be distributed to the U.S. as a result of S. 596	54%
Additional distributions to U.S. in the survey (note that this is just the amount in excess of the base amount of normal distributions)	\$47,045,799,109
Use of additional distributions shown above –	
1. Additional investment in U.S. plant, equipment, inventory, land or working capital	32%
2. Additional U.S. debt reduction ¹	32%
3. Additional repurchase of company stock	12%
4. Additional portfolio investment in the U.S.	9%
5. Additional/accelerated contributions to U.S. pension plans	4%
6. Additional dividends to shareholders	1%
7. Additional compensation to corporate officers	0%
8. Additional compensation to other than corporate officers	0%
9. Other investments in the U.S. (identified by respondents as additional expenditures on R&D, business start-ups, and business & technology acquisitions)	<u>10%</u>
Total	100%

¹ The additional debt reduction is reported by some as a first step prior to a determination as to how best to use resources that were previously invested abroad. For others, the U.S. debt reduction is the intended improvement in the U.S. operations (to stabilize or improve debt ratings).

Revenue estimate

The *Joint Committee on Taxation's* preliminary revenue estimates is that S. 596 will increase tax receipts by about \$3.8 billion in the first year, and reduce net revenue by \$3.8 over the 10-year budget period. I believe that the JCT estimating work is ongoing.

PricewaterhouseCoopers, JP Morgan and a statement by House Ways and Means Committee Chairman Thomas at a hearing disagree with the JCT estimate. PwC and JP Morgan both estimate that the proposal increases federal receipts over the 10-year period.

The Invest in the U.S.A. Act is a bipartisan, sensible, fiscally responsible way to encourage companies to invest these earnings here at home and provide immediate investment and growth in the American economy.

Lowering the tax burden on foreign subsidiary income for a limited time will open the floodgates for privately held foreign funds to be brought back into the American economy to provide immediate economic stimulus.

Thank you for allowing me to testify here before you today.

PREPARED STATEMENT OF MICHAEL GAFFNEY

I. INTRODUCTION.

Mr. Chairman and Members of the Committee, I am a First Vice President and the CoHead for Global Tax at Merrill Lynch & Co., and I am appearing today on behalf of the Securities Industry Association (the "SIA").¹ The SIA thanks you for this opportunity to summarize our perspective on how U.S. tax policy affects the international competitiveness of U.S. firms. This is a challenging time for international tax policy. The choices that Congress makes in revising our international tax rules will be vitally important to the future health of the U.S. economy.

Traditionally, when policymakers debate the effects of U.S. tax policy on international competitiveness, they focus primarily on the consequences of various policy choices to industrial firms. The SIA fully supports the objective of a vibrant domestic industrial sector, and we also recognize the power of the argument that a significant portion of the revenues generated from repeal of the ETI regime should be reinvested in domestic manufacturing. Nonetheless, the financial services sector also makes significant contributions to domestic jobs and revenue and is profoundly affected by the international tax environment in which we do business. I speak before you today to advocate international tax rules that will promote a fair competitive environment for securities firms, banks and similar financial services firms and, as a result, strengthen our domestic economy.

We have a straightforward perspective on the goals of U.S. tax policies with respect to domestic and international competitiveness: our country's tax rules should not distort the outcomes of commercial competition among global firms, or across industries. As a result, we believe that U.S.-based global securities firms, banks and similar financial services firms should compete in London, Frankfurt, Tokyo and other major financial centers under a tax regime that is comparable to those under which our non-U.S. based global competitors operate in those same centers.

Similarly, we support fair rules for non-U.S. based global financial services firms doing business in the United States; we have no truck with tax protectionism. Finally, we believe that the international tax policies of the United States must be evenhanded across the different sectors of the U.S. economy, and not distort capital allocations within the U.S. economy by preferring one sector over another.

The report prepared by the Staff of the Joint Committee on Taxation for these hearings illustrates the importance of the financial services industries to our country's global competitiveness. That report concludes that, on an historical cost basis at year-end 2000, U.S. direct investment abroad in "finance, insurance and real estate," in addition to direct investment in foreign banks, was \$534.5 billion (or 42.9 percent of the total investment), while US direct investment in foreign manufacturers amounted to \$344 billion (or 27.6 percent of the total investment).²

Why have U.S. securities firms, banks and similar financial institutions made such large direct investments in overseas markets? The answer is simple, but often overlooked: although our businesses require substantial capital, at their heart our firms are engaged in *services* businesses. Like any other services industry, we have to go to our customers to provide the services they require. In this respect, there is a fundamental difference between all services firms, on the one hand, and manufacturers, on the other: we have no uniform "product" that can be manufactured in one location and sold in many others.

To see the magnitude of the investments that U.S. financial services firms have made in providing services to their local customers around the world, one only needs to look at the 2002 Annual Report of any major U.S.-based multinational financial services firm. As of the end of calendar year 2002, for example, my own firm of Merrill Lynch employed over 10,000 of our 50,900 worldwide employees outside the United States, of which nearly 5,500 were in London alone.³

¹The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 700,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$214 billion in U.S. revenue and \$285 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

²See Joint Committee on Taxation, THE U.S. INTERNATIONAL TAX RULES: BACKGROUND, DATA, AND SELECTED ISSUES RELATING TO THE COMPETITIVENESS OF U.S.-BASED BUSINESS OPERATIONS, JCX-67-03, at 46 (July 3, 2003).

³See Merrill Lynch & Co., 2002 ANNUAL REPORT, at 15, 24-6 (2003).

For the same reasons that U.S.-based financial services firms have expanded abroad, they compete here in U.S. domestic markets with foreign-based financial services firms that have invested billions of dollars to tap into U.S. markets and to reach U.S. customers.

It is critical to note that the expansion of our international business has not come at the expense of U.S. jobs, because our employees outside the United States service *local* customers, not U.S. customers. To the contrary, our growth internationally has created *more* jobs in the United States to support and manage our global customer base.

Because securities firms and similar financial services businesses are engaged primarily in the delivery of sophisticated services to customers in major financial centers, we have relatively little flexibility on where we locate our international operations. Financial services firms generally are subject to local regulation, and in order to deal with customers we are required to establish a substantial presence in each such jurisdiction. More generally, because our business model is based on providing *services to customers*—whether in an advisory role or by applying capital to provide services, financial services firms effectively are required to establish a substantial local presence in order to reach any local customer base, regardless of the regulatory environment. This comparative immobility in where we site our operations means that we are particularly sensitive to the international tax rules of the United States, as well as the local tax rules in the world’s principal financial centers: we cannot, for example, simply choose to move from London to the Cayman Islands and to export our “product” back to our U.K. customer base.

To be fair, it is more difficult to design appropriate tax rules for financial services firms than it is for some other services businesses, because so much of our business involves the application of capital to provide customer services. Interest income, for example, is passive investment income when earned by an individual investor, or even by a mutual fund—but, in the hands of a securities firm or bank, interest income arising from a loan to a customer, or from a bond held in inventory for sale to customers, is active business income attributable to our core customer services of market making and financial and credit intermediation. As a result, income from capital has different economic and tax consequences depending on the context in which it is earned.

This Committee, and its counterpart in the House, worked very hard to implement this basic principle, for example, in the “active financing income” rules of subpart F. We very much appreciate the commitment of the Committee and its staff in developing workable tests under subpart F to distinguish between passive interest income, on the one hand, and active financing income, on the other.

I will now turn to specific international tax issues of particular importance to the members of the SIA. There are many provisions of general application that affect financial services firms, but the following remarks focus solely on issues that are uniquely relevant to our industry.

II. SUBPART F OF THE CODE—ACTIVE FINANCIAL SERVICES PROVISION.

Congress enacted crucial but temporary reforms of the international tax rules for financial services firms in the Taxpayer Relief Act of 1997. As a result of these reforms, “active financing income” earned by foreign subsidiaries of U.S.-based financial services firms now is taxed in the same general manner as the active business income earned by foreign subsidiaries of U.S.-based industrial firms. Since 1997, Congress has renewed the active financial services provision three times. Most recently, the provision was extended for five years in the Job Creation and Worker Assistance Act of 2002 and is scheduled to expire at the end of 2006.

As Congress recognized in 1997, 1998, 1999 and again in 2002, a U.S.-based financial services firm should not be liable for U.S. tax on the active business income earned by its foreign subsidiaries until those earnings are returned to the U.S. parent. Foreign-based competitors have always enjoyed either delayed taxation of such income or total home country exemption from tax. Similarly, U.S.-based industrial firms have never been subject to the immediate tax regime of subpart F in respect of the overseas business income of their foreign subsidiaries. In order to allow financial services firms to formulate long-range business plans in a stable and appropriate business environment, we urge that the active financing income rules be made permanent as soon as possible. *This issue is the single most important international tax legislative priority of the SIA.*

III. FOREIGN TAX CREDIT PROVISIONS.

1. *Interest Allocation.*

To prevent double taxation, U.S. taxpayers may use foreign income taxes that they incur in their international operations as credits against their U.S. tax liabilities. This credit is, however, subject to an important ceiling, which is that a U.S. company's foreign tax credit cannot exceed what the U.S. tax would have been on the company's "foreign-source income." Unlike other countries, the U.S. today calculates foreign-source income by allocating some U.S.-only expenses—in particular, interest expense—against foreign-source income, based on simplified apportionment formulas. These mandatory apportionment formulas are intended to do "rough justice." Current law's "water's edge" apportionment formula for *interest* expense, in addition, ignores any debt and interest expense of a U.S. company's foreign subsidiaries. As a result, for many taxpayers (particularly industrial firms), current law allocates too much U.S. interest expense to reduce foreign source income for U.S. tax purposes, leaving the taxpayer unable to credit some of its foreign tax payments against its U.S. tax liability.

As an alternative to the "water's-edge" formula, some policymakers have proposed that taxpayers be required to allocate their interest expense using a "worldwide fungibility" approach. This approach in effect views each asset of a global company as debt-financed to the same extent and at the same financing rate as every other asset of the company, including for this purpose all the assets and borrowings of all domestic and foreign subsidiaries.

The worldwide apportionment formula effectively assumes that a multinational group's domestic and international businesses are similar in their capital needs, and that money is perfectly fungible across all of the group's worldwide operations. In reality, of course, these assumptions are never perfectly correct, either with respect to the leverage of different domestic and foreign operations, or the different financing rates available in the U.S. and foreign markets. Because securities firms, banks and other similar financial institutions are very highly leveraged compared to industrial firms, any differences between commercial reality and the theoretical construct of worldwide fungibility are greatly magnified in the financial services industry.

U.S.-based securities firms have adapted their operations as best as they can to the current tax regime. Some dealers, like most industrial firms, find the current rules to be unfair, because their domestic and foreign business profiles are similar, and the premise of the worldwide fungibility of money therefore reasonably describes their operations. Other firms, however, have found that worldwide fungibility would only make matters worse, because of significant differences between the kinds of businesses they conduct domestically and internationally (and therefore the leverage or financing rates applicable to each).

We frankly have not been able to construct a single interest allocation model that accurately reflects the business realities of different highly-leveraged financial institutions with different business mixes, given that money in fact is not perfectly fungible across global businesses. Accordingly, we propose that financial services groups be permitted to elect to allocate their interest expense under the current law provisions, or alternatively to apply the "worldwide fungibility" approach, depending, in effect, on which regime more closely describes their business model. We suggest that the election be made once every five years. This would prohibit attempts to game the system, but would permit taxpayers to revise their elections as their long-term business strategies (and hence mix of business) evolve. The election should apply only to taxpayers that are *bona fide* financial services groups, which meet the qualitative and quantitative income requirements for the group as a whole to qualify as a financial services entity for foreign tax credit purposes.⁴

In addition, consideration could be given to reducing the cost of such an election, and simplifying its administration, by providing that current law's financial institution subgroup rule would *not* apply to a financial services group that elects to allocate interest expense under current law.

Finally, if worldwide fungibility is enacted for any group of taxpayers (industrial or financial), the application of those rules to intercompany debt owed by foreign subsidiaries to the U.S. parent must be addressed. It is tempting to suggest that this is the sort of technical matter best left to regulations, but in light of the amount of intercompany debt outstanding among multinational groups today, and the confusion that would result if implementing regulations either were not issued quickly or were not clear, it is imperative that a worldwide fungibility statute be clear on its face, and applied in a manner that is consistent with its purpose.

⁴Treasury Regulation section 1.904-4(e)(3)(ii).

2. *Permanent Difference Items.*

Current law assigns a taxpayer's items of foreign income to nine different income baskets: the first eight baskets address specific categories of income, and all remaining income is assigned to a "residual" or "general limitation" basket. Treasury regulations then allocate the foreign taxes incurred by the taxpayer to the different income baskets to which those relate.

For a manufacturing or typical services firm, the "general limitation" basket effectively is the base case: income from core business activities falls into that basket, and only in specific (and generally exceptional) cases does income fall into other baskets. For a financial services firm, by contrast, the "financial services income" basket is intended to sweep within it all of its core business income, and the general limitation basket in fact holds only income derived from peripheral activities not connected with the firm's core financial services business.

It sometimes is the case that a foreign jurisdiction will impose tax on amounts that are not (and never will be) income in a U.S. sense; these amounts are generally described as "permanent difference items."⁵ Current Treasury regulations (§ 1.904-6(a)(1)(iv)) arbitrarily assign foreign taxes paid on a permanent difference item to the general limitation basket.

The current rule makes sense for U.S. manufacturing firms; because the general limitation basket is the base case income basket for those companies, U.S. manufacturing companies will more likely be able to eventually credit those real foreign tax costs. This same rule penalizes financial services firms, however, because for the financial services industry only income (and taxes) from peripheral activities fall into the general limitation basket. For financial services firms, the financial services basket, not the general limitation basket, is the base case.

This problem arises as a result of many acquisitions and other commonplace transactions; accordingly, the SIA recommends that a statutory provision be adopted to recognize that the financial services income basket is the base case basket for financial services firms, and therefore to put otherwise unclassified foreign taxes on permanent difference items into this base case basket. This solution will provide financial services with the same opportunities that are already provided to industrial firms to recoup their actual foreign tax costs derived from active business activities.

3. *Section 904(g) Reform.*

Section 904(g) is part of the regime for determining the source of income for purposes of section 904's limitations on the utilization of foreign tax credits. Section 904(g) currently provides as a general rule that income derived by a U.S. parent company from its foreign subsidiary will be resourced from foreign-source income to U.S.-source income, to the extent that the foreign subsidiary in turn is treated as having earned that income from U.S. sources.⁶

When applied to foreign securities dealer subsidiaries of U.S. financial services firms, the resourcing rules inequitably limit the ability of U.S. securities firms to utilize U.S. tax credits for foreign taxes paid on income derived from their overseas securities dealing businesses. Foreign securities dealer subsidiaries of U.S. firms often deal in U.S. securities, such as U.S. Treasuries and U.S. issuer-Eurobonds, to serve local customer needs or as hedges of local customer contracts. Since dividends and interest payments generally are sourced for U.S. tax purposes according to the residence of the *payor* thereof, foreign securities dealer subsidiaries of U.S. firms necessarily receive U.S. source dividends and interest in the ordinary course of their securities dealing businesses with *customers*, and *are subject to tax on such income* in the foreign jurisdictions in which they operate.

The policy underlying the sourcing rules of section 904(g) is to prevent the resourcing of passive and mobile income derived from U.S. sources through the use of foreign subsidiaries. This policy concern, however, is not implicated in the case of dividends and interest income received on U.S. securities held by a U.S.-owned foreign securities dealer for purposes of conducting its securities dealing businesses

⁵For example, if a U.S. financial services company acquires a foreign target that holds a portfolio stock investment in a third company and the acquirer makes a section 338 election, the resulting step-up in the subsidiary's tax bases in its assets will mean that the foreign subsidiary may not recognize gain on a subsequent resale of that portfolio stock investment for U.S. tax purposes, while recognizing gain (and incurring a real tax liability) under local law. The result is a permanent reduction in the subsidiary's total income from a U.S. perspective, when compared to foreign law tax accounting norms.

⁶Thus, for example, if a U.S. corporation earns interest income from a U.S. Treasury held as an investment, that interest income is U.S. source. Section 904(g) provides that the result is the same (*i.e.*, U.S. source income) if the U.S. parent company causes a subsidiary to buy that U.S. Treasury as an investment, and then derives interest, dividend or subpart F income from its subsidiary attributable to the earnings on that U.S. Treasury.

with foreign customers. Therefore, the SIA recommends that an amendment be made to section 904(g) to exclude from its scope income derived from a U.S.-owned foreign securities dealer subsidiary that is in turn derived from any security (as defined by section 475(c)(2), which includes physical securities and derivative instruments) held by a person in connection with its activities as a securities dealer.⁷

4. 10/50 Corporations.

The SIA endorses proposals of policymakers which would apply a look-through approach to dividends paid by so-called “10/50 corporations,” regardless of the year in which the relevant earnings and profits were accumulated.

IV. SECTION 956—INVESTMENT IN UNITED STATES PROPERTY.

Section 956 of the Code is an anti-abuse measure that treats an investment by a foreign subsidiary of a U.S. parent company in “United States property,” such as stock or debt of a U.S. affiliate, as a deemed dividend for subpart F purposes, on the theory that such transactions economically are similar to a direct repatriation of the subsidiary’s earnings. In this regard, Congress has recognized in the past that certain exceptions to the definition of “United States property” are warranted to cover ordinary course business transactions entered into by foreign securities dealer affiliates of U.S. securities firms because such transactions do not violate the purpose of section 956.⁸ All of the issues described below relate to continuing technical problems in the mechanical application of current section 956 to U.S. securities firms, banks and similar financial services firms, in contexts that do not implicate section 956’s policy agenda.

1. Sale of U.S. Affiliate’s Securities in the Ordinary Course of Business.

“United States property” generally includes stock or debt of a foreign subsidiary’s U.S. parent (or any other U.S. affiliate). Currently, there is no exception to this general rule to cover the case, which commonly occurs, of a foreign securities dealer subsidiary of a U.S. financial services firm that makes a market in the securities of a U.S. affiliate. The effect of current law is to provide a disincentive for U.S. financial services firms to use their own foreign subsidiaries to make markets in securities that the U.S. group issues to international investors, which is a nonsensical result as a commercial matter.

The solution to this very frustrating problem is to exclude from the definition of United States property any security issued by a U.S. affiliate held by a foreign dealer in securities, provided that (i) such securities are held primarily for sale to customers in the ordinary course of business, and (ii) the dealer in fact disposes of such securities within a period consistent with holding such securities for sale to customers in the ordinary course of business.

2. Investments in Unrelated Non-Corporate Entities and Individuals.

Section 956(c)(2)(F) provides that United States property does not include the stock or obligation of an unrelated domestic corporation.⁹ There is no parallel exception to the definition of United States property for investments made in obligations of unrelated U.S. partnerships, trusts, estates, or individuals.

As a result, section 956 today applies beyond its intended scope. It also hinders the ordinary course overseas business activities of U.S.-based financial services firms and, in addition, gives preferential treatment to offshore investment funds as compared to onshore funds, by placing barriers to domestic partnerships looking to finance purchases of foreign securities. Section 956 should be amended to provide for an exception from the definition of United States property for obligations of *unrelated* U.S. partnerships, trusts, estates and individuals, provided, of course, that those entities in turn hold no securities of a U.S. affiliate.

⁷A similar amendment was proposed by section 203 of the International Tax Simplification for American Competitiveness Bill (introduced in the 105th Congress, 2d session, as H.R. 4173).

⁸The Taxpayer Relief Act of 1997 amended section 956 by adding two exceptions to cover ordinary course transactions entered into by foreign securities dealer affiliates of U.S. securities firms, *e.g.*, securities loans and sale repurchase agreements. Under both types of transactions, collateral *equal in value* to the cash or securities loaned is required to be posted, as is the case in similar transactions with unrelated parties at arm’s length. See section 956(c)(2)(J) and section 956(c)(2)(K).

⁹For example, a domestic corporation that “is neither a U.S. shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate.”

V. EARNINGS STRIPPING.

The earnings stripping rules of section 1630) primarily are relevant to foreign-owned firms, because they limit the ability of foreign-based multinationals to reduce the taxable income of their U.S. subsidiaries through the payment of interest expense to foreign affiliates (or to third parties in respect of debt that is guaranteed by foreign affiliates).

Proposals have been made to significantly tighten the “earnings stripping” rules of section 1630). If enacted, some of these proposals could have dramatic adverse consequences to the U.S. securities dealer affiliates of foreign banking institutions. As discussed previously, interest expense often represents the largest single category of tax deduction to a financial institution, and any distortion in the amount that the Code treats as deductible therefore can have enormous repercussions. As a result, any change to the tax rules in this area must be carefully considered and based on sound tax policy.

The SIA believes that it is vitally important that all securities firms doing business in the United States compete on a level playing field. This issue is important not simply to our member firms that ultimately are foreign-owned. U.S.-based member firms also are interested in a fair resolution to this issue, because, if the United States were to adopt rules that were perceived as a form of tax protectionism, our U.S.-based members see the possibility of foreign retaliatory “mirror” rules as a real possibility.

VI. GLOBAL DEALING OPERATIONS/DIVIDENDS-RECEIVED DEDUCTION.

Some financial services businesses, such as some derivatives or foreign currency dealer operations, typically are organized and conducted in a single globally-coordinated fashion (generally referred to as “global dealing” operations). U.S.-based financial services firms engaged in global dealing operations have faced many tax issues over the years relating to the allocation and sourcing of income and deductions among related taxpayers engaged in such operations, and the possibility of multiple layers of taxation.

Foreign subsidiaries of U.S.-based financial services firms may operate global dealing activities through branches in several countries, including the United States. As a result, these foreign subsidiaries of U.S. firms may derive income that is subject both to U.S. net income and branch taxes and to tax in their home jurisdictions. The net result can be the imposition of up to four layers of taxation (one foreign, and three U.S. layers) on the same item of income, as it is distributed back to the U.S. parent: (1) U.S. net-basis taxation of trading profits attributable to the U.S. branch of the foreign subsidiary, (2) foreign net-based taxation of the global income of the foreign subsidiary, (3) U.S. branch taxes (including the branch level tax on “excess interest” and the tax on the “dividend equivalent amount”) and (4) U.S. taxation of dividend income when the foreign subsidiary pays an actual dividend to its U.S. parent corporation—even when the dividend is attributable to “effectively connected income” (“ECI”) and a U.S. corporate tax has been previously paid—with no credit or other relief for any foreign withholding tax paid to the foreign subsidiary’s home country.

The SIA is optimistic that in due course final Treasury regulations will develop a rational regime to reduce the instances in which the IRS asserts that a global dealing operation gives rise to an inadvertent deemed U.S. branch. In the meantime, however, we urge adoption of the following three legislative actions to prevent a U.S. securities firm engaged in a global dealing operation from suffering unintended triple taxation of income:

- Amend section 245(b) to permit a 100 percent dividends-received deduction (“DRD”) where a dividend is attributable, directly or indirectly, to earnings of a 100 percent owned foreign subsidiary that have been subject to U.S. net income tax;
- Amend the branch tax rules to provide an exception for ECI of a 100 percent owned foreign subsidiary that has been subject to U.S. net income tax; and
- Provide a direct foreign tax credit to the U.S. parent for foreign taxes payable on the portion of dividends received from a foreign subsidiary that are treated as derived from U.S. sources and are paid out of earnings previously subject to U.S. net income tax.

RESPONSES TO QUESTIONS FROM SENATOR GRASSLEY

Question 1. I noticed your testimony on earnings stripping. You are in an industry that is very sensitive to competitive interest rates. Do U.S. companies in your indus-

try believe they are at a competitive disadvantage because of earnings stripping tactics by foreign companies?

Answer. I have never viewed the earnings stripping rules as a provision that puts U.S. based financial services companies at a competitive disadvantage, because the earnings stripping rules only affect the ability of non-U.S. based companies to deduct interest. When I think of provisions that place U.S. based financial service companies at a competitive disadvantage, I think more of the need for a permanent active financing rule to exempt active income earned by our overseas affiliates from the scope of subpart F, as well as the two changes to section 956 which are described in my written testimony.

Question 2. In your testimony regarding “permanent differences” what are your views on simply enacting a de minimis rule that would transfer over trapped foreign credits in a rarely used basket? AT what level or percentage would you set such a rule?

Answer. My views are that instead of creating additional complexity inherent in any new de minimis rule (which would then have to be coordinated with a transfer to another basket rule), the better answer would be to place the creditable foreign tax in the correct basket to begin with. The SIA believes the better answer would be to change the statute to recognize that the financial services income basket is the base case basket for financial services firms, and therefore to put otherwise unclassified foreign taxes on permanent difference items into this base case basket. It should be noted that the IRS considered and rejected this proposal in drafting recent Treasury regulations. In the Preamble to those regulations, the IRS explained its rejection on the grounds that the problem we describe “rarely occurs.” Our response is twofold: First, the problem is not at all rare, but in fact arises as a result of many acquisitions and other commonplace transactions. Second, the relative rarity of an occurrence does not justify a clearly wrong answer.

Question 3. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, then Y re-sells the widgets (without changing them) for 125 to unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States currently tax that 25? Why or why not?

Answer. Since your fact pattern assumes an appropriate transfer price, your question goes to the heart of whether the foreign base company sales and services rules operate effectively, or require change. Frankly, those sections do not impact the financial services industry to a significant degree, and therefore these rules are not one of our industry’s major concerns.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

This is the second of two hearings on international competitiveness and U.S. tax policy. Last week, we focused on the international competitiveness of U.S.-based businesses. Today, we focus on the international competitiveness of U.S.-owned foreign operations. During this hearing, we will examine what we mean by the term “international competitiveness.” Understanding this term, and how it is measured, is very important in light of last week’s testimony. As many of you know, it has been suggested that we repeal FSC-ETI and use the proceeds to reform our international tax rules. Advocates of this approach claim that this is the best way to shore up the U.S. economy and grow U.S. jobs. But during last week’s hearing, our witnesses said this approach would be a \$50 billion tax increase on U.S. manufacturing and the U.S. jobs base. They said a tax increase of this size could force them to move their operations out of the U.S. to remain “internationally competitive.” One witness with both foreign and U.S. operations candidly stated “you can reduce my foreign taxes if you want to, but I’ll just move my U.S. operations there.”

If we are forced to trade off a domestic tax increase against international tax reform, then we need to understand how international competitiveness will replace any jobs lost from the tax increase, what kind of jobs it will create, and how it benefits the everyday American. Personally, I think this trade-off is an unfortunate choice. Some have called it a “false choice.” International tax reform is long overdue. Our current system is based on a framework enacted during President Kennedy’s administration. In an era of expanding global markets, falling trade barriers, and technological innovations that melt away traditional notions of national borders, it is critical that our international tax laws keep pace with new business realities. Today, we will hear how our international tax laws have not kept pace. Today, we

will hear some fresh and creative thinking on what we should do to reform our international provisions and remain globally competitive.

We are fortunate to have several senators on this committee who are deeply committed to reforming our international tax laws. Sen. Hatch and Sen. Baucus have led the charge on this issue for many years. In addition, during last July's hearing, Sen. Graham expressed grave concerns about the problems in our international tax laws. As a result, he and Sen. Hatch formed an International Tax Reform Working Group within this committee to evaluate various international reforms and simplification measures. As I said last year in my floor remarks when Sen. Baucus and I introduced our anti-inversion bill, I recognize that the rising tide of corporate expatriations demonstrates that our international tax rules are deeply flawed. In many cases, those flaws seriously undermine an American company's ability to compete in the global marketplace. We need to bring our international tax system in line with our open market trade policies. Reform of our international tax laws is necessary for our U.S. businesses to remain competitive in the global marketplace. More importantly, those U.S. companies that reject doing a corporate inversion are left to struggle with the complexity and competitive impediments of our international tax rules. This is an unjust result for companies that chose to remain in the United States of America. I am committed to remedying this inequity.

PREPARED STATEMENT OF CHARLES J. HAHN

Mr. Chairman and members of the Committee, I am Charles Hahn, Director of Taxes for The Dow Chemical Company. My company, as a member of the Coalition for Fair International Taxation (C-FIT), believes the international competitiveness of U.S. companies operating in the global marketplace should be the focus of any legislative response to the World Trade Organization (WTO) ruling that invalidated the "Foreign Sales Corporation (FSC) Replacement and Extraterritorial Income Exclusion (ETI) Act."¹

Dow is a diversified, integrated science and technology company that develops and manufactures innovative chemical, plastic and agricultural products and services to many essential consumer markets worldwide. We serve customers in more than 170 countries in a wide range of markets, including food, transportation, health and medicine, personal and home care, and building and construction, among others. Dow's annual sales equal approximately \$28 billion, with 40.8 percent in the U.S. and 59.2 percent international. We have 191 manufacturing sites in 38 countries; 62 of those sites are in the U.S. representing 57 percent of the long-lived assets of the company.

Chemical markets are necessarily worldwide and fiercely competitive. Dow is the largest U.S. chemical company, but only the third largest in the world. Of the ten largest chemical companies, only three are from the U.S. The topics of this hearing, ETI replacement and international competitiveness, are critical to us.

INTRODUCTION

This statement focuses on the importance of enacting FSC/ETI replacement legislation to Dow and other U.S.-based multinational companies in the manufacturing industry. In order to allow companies like mine to continue playing a vital role in increasing U.S. exports and maintaining millions of American jobs, repeal of the ETI provisions must be coupled with much needed reforms of our outmoded international tax laws. In any case, the Congress should strive to maintain the competitiveness of *all* American businesses and their workers, without discriminating against U.S. companies that have substantial, active businesses abroad. To do otherwise would penalize U.S. workers whose jobs depend on their companies' ability to sell products and services throughout the globe.

DISCUSSION

Today's hearing springs from a WTO dispute initiated by the European Community (EC), leading to a WTO ruling that both the FSC and the ETI regime that replaced it are impermissible export subsidies. The WTO has authorized the EC to impose over \$4 billion in annual sanctions against American products, and the EC

¹The January 14, 2002, WTO Appellate Body Report in *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European* upheld the decision of the WTO panel that the FSC Replacement and Extraterritorial Income Exclusion Act confers prohibited export subsidies in violation of the international trade obligations of the United States.

has threatened to impose these sanctions on January 1, 2004, if the Congress has not made “significant progress” in complying with the WTO’s ruling by the fall of this year. In view of the magnitude of the potential sanctions, we understand the inevitability of the ETI regime’s repeal. At the same time, we understand the Congress is expected to fashion replacement legislation that is WTO-compliant but that also addresses the competitiveness of American companies. The core element of any replacement legislation should be reform of antiquated U.S. tax rules that undermine the international competitiveness of U.S.-based multinational corporations and their workers.

I. REPLACEMENT LEGISLATION SHOULD TAKE ACCOUNT OF THE VITAL ROLE OF U.S. MULTINATIONAL CORPORATIONS

The ETI regime in current law is intended to create a level playing field for U.S. companies competing in markets outside the United States. If the goal of replacement legislation is to target former ETI users, then the Congress must take into account the impact of repeal on U.S.-based multinational companies like Dow. Dow is a major exporter with \$3.76 billion of export sales in 2002. Our ETI benefit in 2002 was \$38 million. For all of the U.S. chemical industry, ETI benefits range from \$750 million to \$1 billion annually. Collectively, U.S.-based multinational corporations, which manufacture in whole or in part in the United States but also rely on foreign operations to carry out distribution, marketing, or other export-related activities, currently provide 56 percent of all U.S. exports.

Repeal of the ETI benefits would result in a huge tax increase at a time when the chemical industry is severely depressed. Our industry has suffered its worst two years in two decades and its most prolonged downturn since the 1930’s, in large part due to the overall economic downturn and high energy and feedstock prices.

Additionally, if the focus is on improvements to the U.S. economy, then the Congress must consider that U.S. multinational corporations are responsible for 23 million American jobs; 21 percent of U.S. GDP; \$131 billion in annual U.S. R&D spending; and 49 percent of U.S. corporate income tax payments. Enhancing the competitiveness of this large and important sector would contribute directly to the domestic economy.

A. FOREIGN OPERATIONS OF U.S. MULTINATIONALS INCREASE U.S. EXPORTS

Foreign direct investment by Dow creates new markets for American products. This activity leads to sales in foreign markets that likely would not occur by simply exporting goods. In the chemical industry, particularly for basic chemicals, transportation costs are high and times for production long, so locating near customers or raw materials is critical. Customers want a local presence as a way to solve problems more expeditiously and to provide supplies quickly. Local plants not only serve as customers for raw materials produced in the U.S.; but, in the case of Dow, these overseas facilities also provide distribution for full product lines, even though only a small portion is produced locally.

A recent study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment led to two dollars of additional exports and a \$1.70 increase in the U.S. bilateral trade surplus. The Commerce Department’s “Survey of Current Business” indicates that in 2000 (the most recent year for which data are available), U.S.-based multinationals accounted for nearly two-thirds of overall U.S. merchandise exports. Foreign affiliates of U.S.-based multinationals purchased \$203 billion of goods from U.S. sources, while domestic operations of U.S.-based multinationals exported \$236 billion to other foreign customers. Dow is a good example. As mentioned previously, in 2002, Dow exported \$3.76 billion, with 80 percent of those sales to related subsidiaries.

B. THE INTERNATIONAL OPERATIONS OF U.S. MULTINATIONALS ENHANCE JOBOPPORTUNITIES IN THE UNITED STATES

As noted by the Council of Economic Advisors in 2003, “The U.S. economy is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the U.S. by providing jobs and income.”² Indeed, U.S. multinational corporations are major employers of American workers. The most recent Department of Commerce data indicate that U.S. multinationals employed over 23 million people in the United States in 2000, out of a national workforce of 139.2 million. Many of these U.S. jobs support and depend on the overseas operations of U.S.

² US Council of Economic Advisors, *Economic Report of the President*, 2003, p 208.

firms, particularly jobs related to maintaining and expanding U.S. product development and research initiatives. Dow is typical of many U.S. global companies. We are headquartered in Midland, Michigan, and naturally many of the functions necessary for our global operations are performed at that U.S. location. For example, 87 percent of Dow's over \$1 billion in 2002 global R&D spending was performed in the U.S., the majority in Midland.

Additionally, small businesses support and depend on Dow's global operations. As the Small Business Administration found in a report discussing the role of small businesses in the global economy, "smaller firms can conduct international expansion on their own, or by collaborating with a multinational firm. The intermediated form of international expansion has certain advantages. The small firm benefits from having access to the multinational firm's global market reach."³ Accordingly, reforms that increase the international competitiveness of U.S. multinationals would have a positive "spill-over" effect on those small businesses that contract with Dow.

II. THE FOCUS SHOULD BE ON PRO-COMPETITIVE REFORMS TO OUR INTERNATIONAL TAX RULES

Dow is increasingly harmed by the basic structure of the U.S. international tax regime, which was enacted over 40 years ago, when the U.S. economy dominated the world. At that time, 18 out of the top 20 global companies were headquartered here, and this country accounted for over half of all multinational investment in the world. Today, to remain competitive and fuel U.S. economic growth and jobs, Dow and other domestic companies must compete against foreign-owned firms for clients and customers that are located around the globe.

U.S. tax policy should compliment rather than frustrate U.S. trade policy. The domestic economic benefits of free and open trade are not only challenged by ongoing tariff and non-tariff barriers in many global growth markets but are also being frustrated by an outdated domestic international tax regime written decades ago in a vastly different competitive environment.

Restrictive aspects of the foreign tax credit limitation have the effect of subjecting Dow to double taxation of foreign source income and inefficient operations. Dow typically operates in countries with tax rates similar to that of the U.S. We are currently faced with the expiration of foreign tax credits caused by the erosion of our foreign tax credit limitation by domestic losses, with no offsetting recapture when domestic profits return. The problem is made worse by the high allocation of expenses to foreign source income. The overly broad scope of current law also results in the current taxation of active business income earned abroad. These and other flaws in our U.S. tax rules operate, in a sense, as an extra "tax" on Dow. Because this "tax" is not borne by foreign multinationals, the effect impedes the competitiveness of Dow and all U.S. companies that have substantial active businesses abroad.

Additionally, the current system for taxing international operations is overly complex. We spend an enormous amount of time complying with the worldwide and detailed reach of the U.S. system. This has a large compliance cost (6100 of our 7800 page 2001 tax return dealt with international issues, and this is representative of the relative effort we are required to expend). More importantly, our non-U.S. business operations have to understand and deal with the U.S. tax effects of their transactions, which slows them down, distracts them, and changes how they operate. (Attachment A provides a detailed list of provisions, supported by Dow and other C-FIT member companies, that should be included among the core elements of replacement legislation to maintain the international competitiveness of U.S. businesses.)

III. IN ANY EVENT, REPLACEMENT LEGISLATION SHOULD TAKE ACCOUNT OF THE FULL RANGE OF AMERICAN BUSINESSES THAT UTILIZED FSC/ETI

The ETI regime was created to help U.S.-based companies compete with foreign-based companies that operate under significantly different and more favorable home-country tax rules. Replacement legislation must continue this objective of global competitiveness for U.S. goods and services. A proposal introduced in the House of Representatives,⁴ however, would focus on domestic manufacturing and ac-

³ SBA Office of Advocacy, "The New American Evolution: The Role and Impact of Small Firms" (June, 1998).

⁴ H.R. 1769, a bill introduced on April 11, 2003 by House Ways and Means Committee members, Rep. Crane (R-IL) and Rep. Rangel (D-NY), in order to bring the United States into compliance with the WTO ruling by replacing the current-law ETI benefit with a deduction of up to

tually penalize U.S. companies that seek to compete overseas. We believe this is the wrong approach. Instead, replacement legislation should take into account the interests of *all* American businesses and their workers, and ensure that they are not placed at a disadvantage in relation to their foreign competitors.

CONCLUSION

The challenge for Dow and other U.S. companies to remain competitive on an international basis has never been greater than it is today. When U.S. firms are competitive in the global marketplace, we are better able to enhance the demand for U.S. produced products and create U.S. jobs. In view of this reality, the WTO-mandated changes to U.S. tax law should include much needed reforms to our international tax regime. These changes will help ensure that Dow and other U.S. based companies can continue to compete globally against foreign-based companies operating under more advantageous tax regimes. We stand ready to work with the Finance Committee to achieve this result.

Attachment A

The following provision should be included among the core elements of legislation to maintain the international competitiveness of U.S. businesses:*

Foreign base company sales and services income. Repeal rules that impose current U.S. taxation on income from active foreign business operations involving certain sales and services transactions of a controlled foreign corporation (“CFC”). If repeal of the foreign base company rules is subject to any exception, care must be taken to avoid “creating” subpart F income where no such income would arise under current law, and thus report language should make clear that the “manufacturing” exception of current law would continue to apply.

The following provisions were not included on this list, on the assumption that the Congress will enact both the provision to repeal the foreign base company rules and the provision to add look-through rules to prevent the current taxation of payments between related CFCs (discussed below): study of proper treatment of the European Union under same country exceptions; and expansion of subpart F *de minimis* rule to the lesser of five percent of gross income or \$5 million.

Provide comparable relief for other income. Current law should also be amended to prevent the current taxation of active foreign oil or gas business income, including income derived in connection with the pipeline transportation of oil or gas between foreign countries (without regard to whether the CFC that owns the pipeline also owns an interest in the oil and gas that is transported, or whether the oil or gas was extracted or consumed within the foreign country).

Provide comparable relief for commodities transactions. Amend the exceptions to the definition of subpart F rules that generally provide for the treatment of net gains on commodities transactions as foreign personal holding company income (“FPHCI”), to clarify that the exceptions cover (1) commodity hedges entered into in the normal course of a CFC’s trade or business, primarily to manage the risk of price changes or currency fluctuations with respect to ordinary property or property described in section 1231(b)⁵ that is held or to be held by the CFC; and (2) sales of stock in trade of the CFC or other property that would be included in inventory, property that is depreciable in the hands of the CFC, or supplies of a type regularly used or consumed by the CFC in the ordinary course of business.

Look-through rules to prevent the current taxation of payments between related CFCs. Present law imposes current U.S. tax under the foreign personal holding company rules of subpart F on any dividends, interest, rents and royalties received by a CFC from a related CFC when those two subsidiaries are located in different countries. A “same-country” exception applies when the two related CFCs are organized and operated in the same country. Subpart F should not apply regardless of the location of the related CFCs as long as the income from which the payment is derived is non-subpart F income of the paying company. Permitting look-through treatment for these payments makes sense—as long as the payments reflect active business income that normally would not be subject to current taxation unless paid back to the U.S. parent. Current law appears designed to protect the tax base of other countries or to promote overseas investments in the same jurisdiction where

¹⁰ percent of the income attributable to domestic production. This bill would also discriminate against companies in industries other than manufacturing that currently make use of the ETI regime, including services businesses that either facilitate U.S. exports or provide services relating to those exports in foreign jurisdictions.

⁸ The provisions are not listed in any particular order; all are of equal importance.

⁵ All references to “sections” are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

the paying/distributing subsidiary of the U.S. parent company is located. Neither of these policies appears compatible with a system designed to make American companies competitive with foreign-based companies.

Provide look-through rules for sales of partnership interests. For purposes of determining subpart F income that is FPHCI, a CFC that sells an interest in a partnership in which the CFC owns 25 percent or more of the capital or profits interests should be treated as selling a proportionate share of the partnership's assets attributable to such interest.

10-year foreign tax credit ("FTC") carryforward. Extend the carry-forward period for excess foreign income taxes and excess oil and gas extraction taxes from five years to ten years, effective for existing carry-forwards.

Worldwide interest allocation. Modify the interest allocation rules applicable for purposes of calculating a U.S. taxpayer's FTC limitation, by providing for worldwide allocations, to prevent the over-allocation of interest expense. Consideration should be given to making this rule elective, and to addressing inequities arising under the specific allocation methodologies prescribed by current Treasury regulations.

Re-characterization of overall domestic loss. Conform the treatment of an overall domestic loss to that of an overall foreign loss by re-characterizing subsequent U.S.-source income as foreign.

Consolidation of FTC baskets. Repeal the FTC "baskets," including the special section 907 limitation, and replace them with a three-basket system for passive income and "other passive category income," financial services income, and "general basket" income.

Alternative minimum tax ("AMT") limit on FTCs. Repeal the 90 percent limit on the utilization of the AMT FTC.

Look-through rules for dividends from noncontrolled section 902 (10/50) companies. A 10/50 company is a foreign joint venture in which the U.S. ownership is more than 10 percent but not more than 50 percent. Through 2002, earnings and foreign taxes relating to these companies are segregated into a separate FTC basket that applies for each such joint venture, thus precluding use of these credits in either a company's general FTC basket (the financial services basket in the case of banks) or to average among 10/50 companies. While changes to the law made in 1997 repeal the 10/50 rules for foreign earnings after 2002, the Congress failed to provide adequate relief for significant transition issues.

These transition issues were not solved by the rules articulated in Notice 20035, recently released by the Treasury Department to address the transition to the new 10/50 regime. Specifically, credits derived from dividends paid after 2002 out of pre-2003 earnings and profits will be confined to a single 10/50 basket. Further, 10/50 credits carried forward from pre-2003 years will be confined to a single 10/50 basket. Effectively, in both instances, any such excess credits will expire unused because, under the existing rules, no new income will be generated of the sort needed to absorb these credits. This result appears to have been unintended when the 1997 rules were drafted, and the proposal would correct this flaw in the 1997 legislation. The proposal, as outlined in the Joint Committee on Taxation's staff simplification study published in 2001, would permit full "look-through" treatment for both credits being carried forward as well as new credits produced from pre-2003 earnings, thus permitting taxpayers to determine the allocation of credits based on the nature of the underlying earnings rather than the form of business from which the income was earned.

FTCs claimed indirectly through partnerships. For purposes of determining indirect FTCs, stock owned, directly, or indirectly, by or for a partnership should be treated as owned proportionately by its partners when applying the constructive ownership rules for determining whether applicable ownership thresholds are satisfied.

Include transition rules if FSC/ETI is repealed. Many U.S. financial institutions finance multi-year leases of various U.S. manufactured goods, including aircraft, under the FSC/ETI rules. The Congress is considering repeal of these provisions in response to a World Trade Organization ("WTO") ruling that both the ETI regime and FSC transition rules contained in the ETI statute violate existing WTO agreements. Failure to preserve transition benefits for FSC/ETI leases would create a competitive disadvantage for U.S. financial institutions and have a serious negative impact on U.S. companies that have structured lease agreements in reliance on existing law. Appropriate transition rules should be provided to preserve the total FSC and ETI benefit contemplated by the parties for transactions closed prior to enactment of any FSC and ETI repeal legislation.

Other provisions:

“Working Capital” Exception to Subpart F. Fluctuations in a CFC’s working capital held in the active conduct of a trade or business should not result in FPHCI that is currently taxed under subpart F.

Application of look-through rules to interest, rents or royalties for purposes of the FTC. Extend the look-through treatment applicable to dividends from 10/50 companies to any interest, rent, or royalty received or accrued from a 10/50 company.

Ordering rules for FTC carryovers. FTCs used in a taxable year would be treated as used first from carry-forwards to such year. To provide further relief, consideration should be given to extending the carryback period to three years.

Active financial services income. The rules that permit U.S.-based financial services companies to defer U.S. tax on the active financial services income of a CFC (the active financing exception to the anti-deferral rules of subpart F) were extended in 2002 for five years. These rules, which are permanent fixtures of the Internal Revenue Code for most other non-financial U.S.-based multinationals and are the norm for foreign-based competitors, should be made permanent.

Election not to use average exchange rate for foreign tax paid in a nonfunctional currency. Permit an election to determine the amount of foreign taxes paid at the exchange rate in effect on the date of payment rather than the average exchange rate for the taxable year, if the liability for such taxes is denominated in any currency other than the taxpayer’s functional currency (with regulatory authority to make the election available with respect to a qualified business unit).

Application of uniform capitalization rules to foreign persons. The uniform capitalization rules should apply to foreign taxpayers only for purposes of taxing income effectively connected with the conduct of a U.S. trade or business, if the taxpayer capitalizes costs of produced property or property acquired for resale in accordance with the method used in its financial statements.

Clarification of the financial services basket. The scope of the financial services basket should be clarified to include all income from all activities that relate to the active conduct of a banking, insurance, financing, or similar business. Current law can create anomalies in which financial services income is not necessarily treated as financial services basket income. For example, under Treasury regulation section 1.904-6(a)(1)(iv), differences between the U.S. tax base and that of foreign countries can create non-financial services basket income for financial services companies. This “base difference” rule should be clarified so that income and related FTCs relating to base differences are treated as financial services basket income for financial services companies.

RESPONSES TO QUESTIONS FROM SENATOR GRASSLEY

Questions 1. I was interested in your testimony that FSC–ETI repeal should not discriminate against companies with foreign activities and should be coupled with international tax reform. Would you support a proposal that helps U.S. manufacturing without this discrimination, especially if it was coupled with international reform?

Answer. Yes, we would support such a proposal, BUT ONLY if it were coupled with significant international reform.

Dow strongly supports measures that make U.S. manufacturing and U.S. companies competitive in international markets. In particular we have long supported fast capital cost recovery, the R&D credit, FSC/ETI and international tax reform. Each individual element addresses a different aspect of competitiveness and each is important, but none is sufficient alone. When FSC/ETI is repealed, reform of our outmoded international tax provisions is the most critical item the Congress must address. Our current international tax rules create significant competitive disadvantages for U.S. based multinational companies. When combined with the clear relationship between increases in the foreign operations of such companies and their exports from and jobs in the United States, international tax reform must take priority. Furthermore, focusing solely on manufacturing is misplaced to the extent that it detracts from Congress’ need to consider the full range of U.S. businesses that currently utilize FSC/ETI. Because the ability to compete worldwide is critical to our capacity to retain and grow our job base in the United States, we believe that revenue constraints should be resolved in favor of coupling ETI repeal with reform of our international tax laws.

Question 2. You mention your foreign tax credit problems. How much of this is caused by the interest allocation rules?

Answer. Dow’s current foreign tax credit problem is primarily caused by the effect of domestic losses on our foreign tax credit limitation. Those losses and the lack of

a domestic loss recapture provision have created excess credits and effectively shortened the carryforward period in which we can use such credits.

The use of worldwide interest allocation rather than the current interest allocation rules would have reduced our current excess foreign tax credits by approximately 11%. This understates the effect somewhat because in 2000 and 2001 Dow had a net operating loss and the interest allocation rules had no effect. On a long-term basis we estimate that moving to worldwide interest allocation, not taking into account the repeal of FSC/ETI, would change our normal foreign tax credit position from excess credits of \$30 million per year to excess limitation of \$10 million per year.

Question 3. Repeal of the foreign base company rules will cost around \$37 billion. Is there a more targeted way to fix the problems you are having with these rules?

Answer. The most promising alternative we know of is the provision in the bill recently introduced by Senator Hatch (although we do not know the potential revenue cost). That provision would repeal the foreign base company sales and services rules for income derived from foreign-to-foreign transactions, transactions covered by an Advanced Pricing Agreement with the IRS, or from transactions with countries with whom the U.S. has a comprehensive income tax treaty which includes an exchange of information program (excluding the Barbados treaty in force on July 28, 2003), subject to an exception for “round-tripping.” C-FIT companies are currently focusing on these provisions.

Question 4. Would you explain in more detail your problem with foreign oil & gas pipeline transportation?

Answer. This is not an issue we face, but an oil company member of C-FIT has described an example where subpart F inappropriately triggers current income, involving the pipeline transportation of oil from a landlocked country to a contiguous country with a seaport.

Question 5. On your suggestion regarding payments between related controlled foreign corporations, how can we be certain that repealing these rules will not result in abuses?

Answer. Dow is normally in a “balanced” or slight excess foreign tax credit position. As a result these provisions often have little actual effect on our U.S. tax. However, they do add substantial complexity to how we structure legal entities, and to decisions regarding intercompany transactions between such entities. By triggering U.S. taxation of active business income when subsidiaries make crossborder payments, current law penalizes U.S.-based multinationals for responding to market or investment opportunities by redeploying active foreign earnings among foreign businesses conducted through multiple CFCs.

Providing look-through treatment for payments between related CFCs properly focuses subpart F on the underlying activities that generated the income, rather than the business form used. As revised, the code would continue to tax nonactive, mobile income. Section 367 and the intercompany pricing rules protect the U.S. against attempts to transform U.S. or passive income into active income, such as the artificial transfer from the U.S. of intangible property.

Furthermore, far from creating a potential for abuse of U.S. rules, eliminating the foreign-to-foreign related party rules would encourage U.S. taxpayers to reduce their foreign tax liability, ultimately reducing the amount of foreign tax credits claimed against U.S. tax liability.

Question 6. I read that you want transition for the FSC-ETI rules. What, in your view, is a reasonable transition period?

Answer. Dow believes that a two-year transition period is reasonable, particularly based on testimony provided to the Finance Committee by U.S. Trade Representative General Counsel John Veroneau, on July 8. Current FSC/ETI users like Dow would suffer economic harm if the Congress departs from its general practice of including grandfather provisions to cover taxpayers that utilized the ETI rules to facilitate exports. As a member of C-FIT, we also support grandfather provisions comparable to those when ETI was enacted in 2000, along with equivalent transition relief, including an extension to leasing transactions that qualified under ETI. C-FIT companies believe taxpayers in these ETI transactions fairly priced their leases in reliance on an assessment of Congressional intent—as reflected in the legislative history—that the law in effect when the transactions were closed complied with the WTO obligations of the United States.

Question 7. I see that you receive FSC-ETI benefits of \$38 million a year. How many percentage points does FSC-ETI reduce your tax liability?

Answer. Expressing FSC-ETI benefits as a tax percentage rate can be highly misleading. Similar amounts of FSC-ETI benefits can produce significantly different tax percentages because such percentages depend on the amount of net income earned in a year and where that income was earned. Companies like Dow in cyclical

industries, often find their tax liabilities widely variable from year to year. FSC/ETI benefits are more stable.

On average, for the past five years, the FSC–ETI benefit has reduced Dow’s global tax rate by 3.2%. However, for years of more normal profitability, the FSC–ETI benefit is 1.5% to 2.0%.

Question 8. What percentage of your manufacturing is done outside the U.S. as opposed to within the U.S.?

Answer. Approximately 43% of Dow’s manufacturing is done outside the United States. Non-U.S. sales are 59% of total sales.

Dow is a capital intensive manufacturing company. The best measure of the manufacturing Dow conducts in the United States is the percentage of our long-lived assets located here. In 2002, 57% of our long-lived assets were located in the United States.

Question 9. To what degree are your U.S. operations dependent on your foreign sales?

Answer. Dow’s U.S. exports have historically remained stable at about 15% of Dow’s non-U.S. sales. As Dow’s non-U.S. sales and operations grew, so did our exports. After the acquisition of Union Carbide Corporation, the U.S. exports/non-U.S. sales ratio increased to 20%.

In 2002 Dow had a positive U.S. trade balance of approximately \$2.6 billion.

In addition many functions performed in the United States support foreign as well as United States sales. R&D is a good example. In 2002 Dow had 4500 R&D positions in the United States. R&D for Dow is constant at about 4% of sales. Without the 59% of our sales that are foreign, we could not fund as much R&D and 2250 or about 50% of the U.S. R&D positions would be in jeopardy.

Question 10. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for \$100, and Y re-sells the widgets (without changing them) for \$125 for unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The \$25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States currently tax that \$25? Why or why not?

Answer. The United States should not automatically tax the \$25 before it is repatriated. In this example the functions performed in the trading company constitute an active business, are substantial and justify the profit earned. The location of those activities should not be determinative of whether to impose current tax.

The rule that would trigger income under current law was written in the absence of a well-developed transfer-pricing regime, when it was possible for taxpayers to seek to shift profits to low-taxed foreign sales subsidiaries. The policy concern was not focused on the movement abroad of an income-producing activity, but rather on the inability of the old rules to ensure that U.S. income was not being over-allocated to the foreign jurisdiction. The legislative history of the base company sales rules include no suggestion indicating the mere fact that a sales function might be easily located overseas is in and of itself a basis for imposing U.S. tax on the sales income. Thus, for example, a CFC’s home-country sales income has never been subject to the base company rules.

The development of transfer-pricing regimes in the United States and around the world has greatly reduced the concern that taxpayers will be able to shift more income out of U.S. taxing jurisdiction than is justified by their foreign activities. I would also note that subpart F does not currently apply to most active business operations in low-taxed countries; the real issue is the identification of cases in which the principle of deferral may be subject to abuse. For example, in your fact pattern, it appears that some of the property is “round tripping”—produced and sold in the United States, a fact that may indicate tax avoidance as the predominant motive for the exportation of that property.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Thank you for scheduling this second hearing on the competitiveness implications of our international tax rules, Mr. Chairman. Last week we concentrated on domestic companies and U.S. subsidiaries of foreign corporations. This week we are focusing on the effect of these rules on U.S.-based multinational companies.

This Committee faces a major challenge in connection with the WTO’s ruling that our FSC/ETI tax provisions are illegal trade subsidies. While it is clear that we must repeal FSC/ETI, it is not *as clear* how we can best craft tax provisions that

not only help our companies deal with the loss of these benefits, but also keep U.S. workers and their employers the most productive and most competitive in the world.

As we heard from some of the witnesses at last week's hearing, proposals have already been developed to help domestic manufacturers cope with the repeal of FSC/ETI by providing an exemption that would lower their effective tax rate. One such proposal enjoys the bipartisan support of more than 120 House members.

While I am certainly not opposed to lowering tax rates on U.S. manufacturers, I am convinced that such a solution, by itself, is not adequate. This is because it ignores the very real problems our tax code presents to U.S. businesses that expand overseas. I will not take the time now to go into detail about those problems, but this Committee has examined them before, and we will hear more about them today.

The point I wish to make, Mr. Chairman, is that as we decide how to reallocate the FSC/ETI benefit, which we must do, we should strive to pass tax provisions that would increase the ability of *all* American firms to compete and gain in productivity, both those just at home and those which also operate abroad.

There is a false notion we hear from time to time that if we make it easier for U.S. companies to operate effectively on a worldwide basis, we are making them more likely to move U.S. jobs abroad. I believe just the opposite is true—that making U.S. firms more competitive worldwide increases the quality and quantity of American jobs.

Mr. Chairman, I plan to introduce legislation later this month that would repeal the FSC/ETI provisions and provide significant incentives for increased productivity here at home and greatly improved competitiveness of American firms around the globe, while also simplifying the tax code. This bill will build on legislation I previously introduced with Ranking Democrat Baucus.

The issues before the Committee are very significant for the future of our commercial leadership in the world, as well as the prosperity of our people, for decades to come. I look forward to listening to the witnesses and exploring these issues in further detail.

PREPARED STATEMENT OF JAMES R. HINES, JR.

Mr. Chairman and Members of this distinguished Committee, my name is James R. Hines Jr. I am Professor of Economics, Public Policy, and Business Economics at the University of Michigan, where I am also Research Director of the Office of Tax Policy Research. I am a Research Associate of the National Bureau of Economic Research, and the Research Director of the International Tax Policy Forum. I am honored to have the opportunity to participate in these hearings on the effect of U.S. tax policy and its impact on the competitiveness of U.S.-owned foreign corporations.

The contribution of the U.S. tax system to the competitiveness of American multinational firms and the performance of the U.S. economy has been the subject of extensive analysis and rethinking in recent years. What we have learned can be summarized in two points. The first is that the ownership and activities of multinational corporations are highly sensitive to taxation, much more so than what was previously believed to be the case. The second is that the competitiveness of the world economy has the potential to change everything we think about the features that characterize tax systems that promote economic efficiency. Together, these two findings carry dramatic implications for the kinds of tax policies that advance the competitiveness of U.S.-owned firms, the well-being of Americans, and the productivity of the world economy.

Much of the current structure of U.S. taxation of foreign income dates to the early 1960s, when the world economy looked very different than it does today. The United States taxes the worldwide incomes of American companies, granting foreign tax credits for foreign income taxes paid, and permits taxpayers to defer U.S. taxation of certain kinds of active foreign income. At the time it was enacted, this structure was thought to promote global economic efficiency. Most observers are considerably less confident now that this kind of tax system, embedded, as it is, in a world economy in which many other countries exempt foreign income from taxation, contributes to the efficiency of resource allocation. The most recent research suggests just the opposite—that the U.S. effort to subject foreign income to taxation at the same (total) rate as domestic income is likely to reduce the productivity of the world economy and the well-being of Americans.

These are difficult concepts, particularly since the tax policy stance that the United States has maintained over the last 40 years, increasingly to our detriment and to the detriment of the world economy, nonetheless has considerable intuitive appeal. It is helpful, therefore, to parse this issue first by evaluating the impact of

U.S. taxation on the position of American firms operating abroad, and second by considering the implications for the design of U.S. tax policies.

Taxation and the competitiveness of American firms

Business income earned abroad by American firms is subject to taxation by the United States, whereas business income earned abroad by firms based in other countries is often not subject to taxation by their home governments. Major capital-exporting countries such as Germany, France, Canada, the Netherlands, and Australia effectively exempt most or all of the foreign income earned by their companies. To be sure, some other countries, including Greece, Italy, Japan, Norway, and the United Kingdom, tax the foreign business incomes of their resident companies, but even these countries do not impose the kind of strict foreign tax regime that the United States does.

These differences influence the competitiveness of American firms in certain foreign markets. Firms from countries that exempt foreign income from taxation have the most to gain from locating their foreign investments in low-tax countries, since such investors benefit in full from any foreign tax savings. Firms from countries (such as the United States) that tax foreign profits while providing foreign tax credits may benefit very little (in some cases not at all) from lower foreign tax rates, since foreign tax savings are offset by reduced foreign tax credits and therefore higher homecountry taxation. These relative tax incentives therefore create incentives for investors from countries that exempt foreign income from taxation to concentrate their investments in low-tax countries, leaving investors from countries that tax foreign income while providing foreign tax credits more heavily concentrated in high-tax countries.

There is considerable evidence that the patterns of ownership associated with foreign investment respond to these incentives created by home-country tax regimes. Taxation within the United States offers one such example. Recent research compares the location of investment in the United States by foreign investors whose home governments grant foreign tax credits for federal and state income taxes with the location of investment by those whose home governments do not tax income earned in the United States. Firms that are able to claim credits against their homecountry tax liabilities for state income taxes paid in the United States should be much less likely than others to avoid high-tax states. The evidence bears this out: Japanese and British investment in the United States is concentrated in high-tax states, whereas German, French, Dutch, and Australian investment in the United States is concentrated in low-tax states. The difference is in large part attributable to the ability of Japanese and British firms to claim credits in their home countries for taxes paid to U.S. states.

The lesson of American states is applicable to U.S. investment abroad. Since the United States taxes the foreign incomes of American companies and permits a foreign tax credit for income taxes paid to foreign governments, American firms may receive very little benefit from the low tax rates available in some foreign countries, since income earned in such countries produces sizable U.S. tax liabilities. As a result, German, French, or Dutch firms, that do benefit from low tax rates available in some foreign countries, are at times able to outbid their American competitors for foreign acquisitions or other investments based solely on tax advantages.

More detailed provisions of U.S. and foreign taxation of foreign income can produce dramatic examples of the impact of our tax system on the competitiveness of American firms. One such example is provided by "tax sparing." Most high-income countries other than the United States include "tax sparing" clauses in the treaties that they sign with many developing countries, but the United States has steadfastly declined to do so. "Tax sparing" is the practice by which capital exporting countries amend their taxation of foreign source income to allow firms to retain the advantages of tax reductions provided by host countries. Specifically, "tax sparing" often takes the form of allowing firms to claim foreign tax credits against homecountry tax liabilities for taxes that *would* have been paid to foreign governments in the absence of special abatements. Since foreign tax credits are then based on tax obligations calculated without regard to taxes actually paid, any special tax breaks offered by host country governments enhance the after-tax profitability of foreign investors and are not simply offset by higher homecountry taxes.

Japan permits its firms to claim "tax sparing" credits for investments in certain developing countries, while the United States does not. Recent research compares patterns of Japanese and American foreign investment over the same time period. Holding other considerations constant, it follows that, to the extent that "tax sparing" is effective, Japanese firms should exhibit greater willingness than American firms to invest in developing countries. In addition, Japanese firms should be more

likely than are Americans to receive special tax breaks from countries with whom Japan has “tax sparing” agreements.

The evidence indicates that “tax sparing” is effective in stimulating foreign investment. Japanese firms locate a much higher fraction of their foreign investment in countries with whom Japan has “tax sparing” agreements than do American firms. Furthermore, host governments appear to grant Japanese firms significant tax reductions that are not available to their American counterparts. Holding constant other considerations, “tax sparing” agreements are associated with 140 percent higher foreign investment levels by Japanese firms than by American firms, and 23 percent lower tax rates imposed on Japanese rather than American investors.

The details of the foreign tax credit calculation method offers another insight into the impact of the U.S. tax system on the competitiveness of American firms operating abroad. The foreign tax credit is limited to the amount of U.S. tax that would otherwise be due on foreign income. Taxpayers are permitted to add together different sources of foreign income in calculating their foreign tax credit limits, but only within “baskets” of income types. These “baskets” were introduced with the idea that they would prevent widespread avoidance of U.S. taxes by taxpayers claiming foreign tax credits, but in practice they have contributed greatly to the complexity and inefficiency of the U.S. tax system. Notably, other countries that tax foreign income have not been eager to copy the U.S. “basket” system.

The Tax Reform Act of 1986 required that the income from each foreign corporation owned between 10 and 50 percent by Americans be placed in a separate “basket” for the purpose of calculating the foreign tax credit limit. This provision imposes a potentially quite large tax cost on American firms participating as minority or 50 percent partners in international joint ventures. While some joint venture operations could be restructured to avoid the punishing impact of this provision, others could not, and as a result, American firms were uniquely disadvantaged in competition with firms from other countries to participate in international joint ventures. This disadvantage was particularly pronounced in the case of joint ventures operating in low-tax foreign countries.

American participation in international joint ventures fell sharply after 1986 as a consequence of the separate “basket” rules introduced by the Tax Reform Act of 1986. Figure 1 illustrates this decline in joint venture participation. Partly in response, Congress in 1997 changed (on a phased-out basis over a number of years) the separate “basket” treatment of international joint ventures, removing some (but not all) of the special tax cost associated with international joint venture participation by American companies. Separate “baskets” continue to be used to calculate foreign tax credit limits for such items as passive income, shipping income, and financial services income, and there is ample evidence that this treatment penalizes and thereby discourages American firms from participating in business ventures that are attractive to foreigners and would otherwise be attractive to Americans.

The U.S. tax system differs sharply from the systems used by other countries to tax their multinational firms. The impact of the unwillingness of the United States to grant “tax sparing” for investments in developing countries, or the use of separate “baskets” used to calculate foreign tax credit limits, while interesting in themselves, more importantly serve as illustrations of the effects of the U.S. tax system. Those who study the available quantitative information on the effect of the U.S. tax system do not doubt that it has an important influence on the behavior of taxpayers and the positioning of American firms in the global economy. The question that we face is how this insight should be used to enlighten American tax policy.

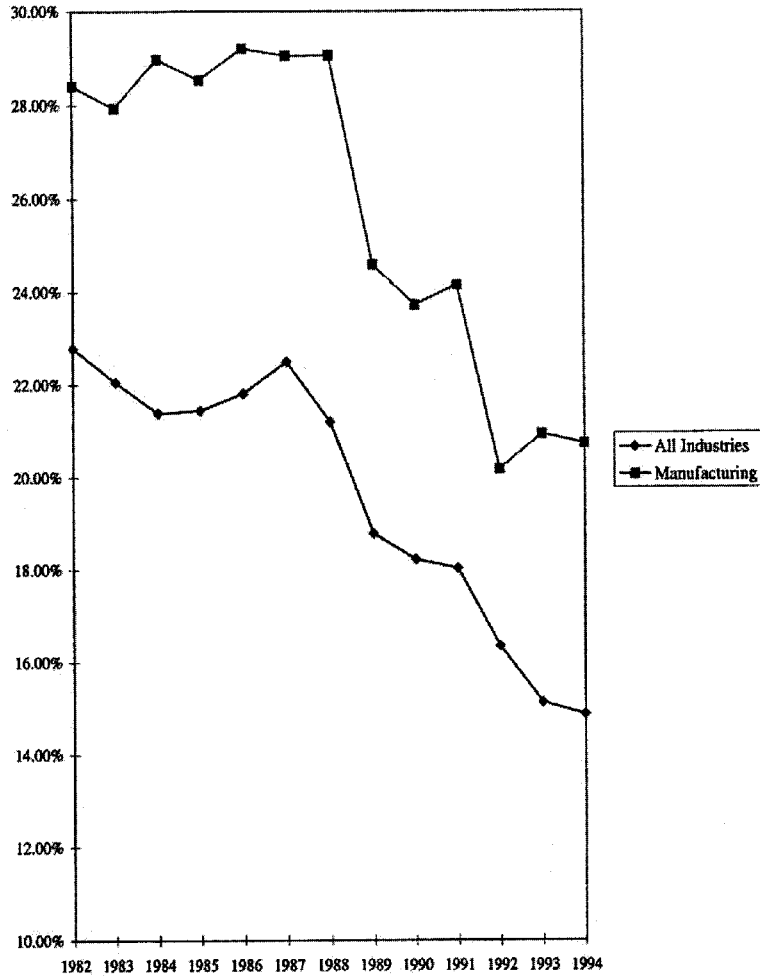


Fig. 1. Joint venture share of foreign affiliate assets, 1982-1994.

Source: U.S. Department of Commerce, Bureau of Economic Analysis. Note: The figure depicts the ratio of joint venture assets to assets of all U.S.-owned foreign affiliates.

Analysis of taxing foreign income

Until relatively recently, there was a commonplace belief that the U.S. policy of taxing foreign income while granting foreign tax credits was if anything too generous from the standpoint of advancing American interests, and could be justified only as a gesture that advances well-being around the world. This belief persisted in spite of the differing practices of so many other countries, and the evident impact of American tax policy on the foreign business activity of U.S.-owned firms. In recent years those who think about these questions have come to some very different conclusions, but in order to understand the latest thinking on these issues, it is helpful to appreciate what we used to believe, and where it has gone wrong.

An older framework for evaluating policy

Capital export neutrality (CEN) is the doctrine that the return to capital should be taxed at the same total rate regardless of the location in which it is earned. If a home country tax system satisfies CEN, then a firm seeking to maximize after-tax returns has an incentive to locate investments in a way that maximizes pre-tax returns. This allocation of investment corresponds to global economic efficiency under certain circumstances. The CEN concept is frequently invoked as a normative justification for the design of tax systems similar to that used by the United States, since the taxation of worldwide income with provision of unlimited foreign tax credits satisfies CEN. This is not exactly the system that the United States uses, since taxpayers are permitted to defer home country taxation of certain unrepatriated foreign income, and foreign tax credits are subject to various limits. Nonetheless, CEN is often used as a normative benchmark against which to evaluate contemplated changes to the U.S. system of taxing foreign income, since tax systems that satisfy CEN are thought to enhance world welfare.

The standard analysis further implies that governments acting on their own, without regard to world welfare, should tax the foreign incomes of their resident companies while permitting only a deduction for foreign taxes paid. Such taxation satisfies what is known as national neutrality (NN), discouraging foreign investment by imposing a form of double taxation, but doing so in the interest of the home country that disregards the value of tax revenue collected by foreign governments. From the standpoint of the home country, foreign taxes are simply costs of doing business abroad, and therefore warrant the same treatment as other costs. The home country's desired allocation of capital is one in which its firms equate marginal after-tax foreign returns with marginal pretax domestic returns, a condition that is satisfied by full taxation of foreign income after deduction of foreign taxes. This line of thinking suggests that the American policy of taxing foreign income while granting foreign tax credits fails to advance American interests because it treats foreign income too generously. In this view there is a tension between tax policies that advance national welfare (NN) by taxing after-tax foreign income, and those that advance global welfare (CEN) by taxing foreign income while permitting taxpayers to claim foreign tax credits. The practice of much of the world, including Germany, France, Canada, and the Netherlands, that effectively exempts foreign income from taxation, is, by this reasoning, difficult to understand, since it is inconsistent with either national or global interests.

The third of the standard efficiency principles is capital import neutrality (CIN), the doctrine that the return to capital should be taxed at the same total rate regardless of the residence of the investor. Pure source-based taxation at rates that differ between locations can be consistent with CIN, since different investors are taxed (at the corporate level) at identical rates on the same income. In order for such a system to satisfy CIN, however, it is also necessary that individual income tax rates be harmonized, since CIN requires that the combined tax burden on saving and investment in each location not differ between investors. While CEN is commonly thought to characterize tax systems that promote efficient production, CIN is thought to characterize tax systems that promote efficient saving. Another difference is that CIN is a feature of all tax systems analyzed jointly, whereas individual country policies can embody CEN or NN. As a practical matter, since many national policies influence the return to savers, CIN is often dismissed as a policy objective compared to CEN and NN.

It is important to clarify that there are important assumptions built into the standard normative framework that delivers CEN and NN as global and national welfare criteria, and in particular, it is critical that foreign firms are assumed not to respond to changes induced by homecountry taxation. Realistically, however, investment by domestic firms at home and abroad may very well influence investment by foreign firms, a scenario that is inconsistent with the logic underlying CEN and NN. If greater investment abroad by home-country firms triggers greater investment by foreign firms in the home country, then it no longer follows that the home country maximizes its welfare by taxing foreign income while permitting only a deduction for foreign taxes paid. From the standpoint of global welfare, if home and foreign firms compete for the ownership of capital around the world, and the productivity of an investment depends on its ownership, then it is no longer the case that the taxation of foreign income together with the provision of foreign tax credits necessarily contributes to productive efficiency.

Modern thinking on the desirability of taxing foreign income

Modern analysis of international tax systems tend to focus much more on tax-induced ownership changes than do the older views on the subject. Tax systems satisfy what is known as capital ownership neutrality (CON) if they do not distort own-

ership patterns. It is easiest to understand the welfare properties of CON by considering the extreme case in which the total stock of physical capital in each country is unaffected by international tax rules. In this setting, the function of foreign direct investment is simply to reassign asset ownership among domestic and foreign investors. If the productivity of capital depends on the identities of its owners (and there is considerable reason to think that it does), then the efficient allocation of capital is one that maximizes output given the stocks of capital in each country. It follows that tax systems promote efficiency if they encourage the most productive ownership of assets within the set of feasible investors.

Consider the case in which all countries exempt foreign income from taxation. Then the tax treatment of foreign investment income is the same for all investors, and competition between potential buyers allocates assets to their most productive owners. Note that what matters for asset ownership is comparative advantage rather than absolute advantage: if French firms are always the most productive owners of capital, but they do not have the resources necessary to own everything, then efficiency requires that French firms own the capital for which their rate of return difference with the rest of the world is the greatest. The United States would reduce world welfare by taxing foreign income while permitting taxpayers to claim foreign tax credits, since such a system encourages American firms to purchase assets in high-tax countries and foreign firms to purchase assets in low-tax countries. These tax incentives distort the allocation of ownership away from one that is strictly associated with underlying productivity differences.

CON is satisfied if all countries exempt foreign income from taxation, but the exemption of foreign income from taxation is not necessary for CON to be satisfied in this particular case. If all countries tax foreign income (possibly at different rates), while permitting taxpayers to claim foreign tax credits, then ownership would be determined by productivity differences and not tax differences, thereby meeting the requirements for CON. In this case the total tax burden on foreign and domestic investment varies between taxpayers with different home countries, but every investor has an incentive to allocate investments in a way that maximizes pretax returns. More generally, CON requires that income is taxed at rates that, if they differ among investors, do so in fixed proportions. Thus, CON would be satisfied if investors from certain European countries face home and foreign tax rates that are uniformly 1.2 times the tax rates faced by all other investors.

In order for the allocation of capital ownership to be efficient it must be the case that it is impossible to increase output by trading capital ownership among investors. This efficiency condition requires not necessarily that capital be equally productive in the hands of each investor, but that the potential gain of reallocating ownership to a higher-productivity owner be exactly equal to the cost of such a reallocation by offsetting ownership changes elsewhere. Since, taxpayers allocate their investments to maximize after-tax returns, the marginal dollar spent on new investments by any given investor must yield the same (expected, risk-adjusted) after-tax return everywhere. It follows that, if net (host country plus home country) tax rates differ between investments located in different countries, marginal investments in high-tax locations must generate higher pre-tax returns than do marginal investments in low-tax locations. Selling an asset in a low-tax location and purchasing an investment in a high-tax location increases output by the firm engaging in the transaction, but (generally) reduces output by the firm on the other side of this transaction. If both parties face the same tax rates, or face taxes that differ in fixed proportions from each other, then CON is satisfied, ownership reallocation would have no effect on total productivity, and the outcome is therefore efficient. If some countries tax foreign income while others do not, then it is impossible to restore CON without bringing them all into alignment, though individual countries have the potential to improve global welfare by moving their taxation of foreign income into conformity with an average global norm.

The welfare implications of CON are less decisive in settings in which the location of plant, equipment, and other productive factors is mobile between countries in response to tax rate differences. Tax systems then determine the location of production as well as patterns of ownership and control, so the net effect of taxation on global welfare depends on the sum of these effects. There is considerable statistical evidence that international tax rate differences influence the location of property, plant and equipment investment, which conforms to anecdotal accounts of tax-motivated investment in low-tax locations such as Singapore and Ireland. Hence pure source-based taxation at rates that differ between countries may encourage excessive investment in low-tax countries, even though it would satisfy CON. If one country were then to tax foreign income while providing foreign tax credits, it would have the effect of reducing the welfare cost of real capital misallocation, but do so at the cost of distorting the ownership and operation of industry. Whether the cost

of having too many factories in the Bahamas is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an empirical question, though the importance of ownership suggests that the attendant welfare impact of distorting ownership allocation can be very large.

The welfare properties of CON emphasize the allocation of ownership of a given volume of business activity between locations whose tax attributes differ. The taxation of foreign income also has the potential to influence rates of national saving and the sizes of domestic firms, though this effect is not explicitly incorporated in the analysis. National saving is affected by a large range of public policies including monetary policy, intergenerational redistribution programs such as social security, the taxation of personal income, estate taxation, and other policies that influence the discount rates used by savers. Business activity is likewise influenced by a host of fiscal, monetary, and regulatory policies. Given these various factors that influence national saving and corporate investment, it is appropriate to analyze the optimal taxation of foreign v. domestic income separately from the question of how much governments should encourage capital accumulation and total investment of home-based firms.

The same circumstances that make CON desirable from the standpoint of world welfare also imply that countries acting on their own, without regard to world welfare, have incentives to exempt foreign income from taxation no matter what other countries do. The reason is that additional outbound foreign investment does not reduce domestic tax revenue, since any reduction in home-country investment by domestic firms is offset by greater investment by foreign firms. With unchanging domestic tax revenue, home-country welfare increases in the after-tax profitability of domestic companies, which is maximized if foreign profits are exempt from taxation. Tax systems that exempt foreign income from taxation can therefore be said to satisfy “national ownership neutrality” (NON). Hence it is possible to understand why so many countries exempt foreign income from taxation, and it follows that, if every country did so, capital ownership would be allocated efficiently and global output thereby maximized.

National welfare is maximized by exempting foreign income from taxation in cases in which additional foreign investment does not reduce domestic tax revenue raised from domestic economic activity. This condition is satisfied if, to the extent that marginal foreign investment reduces domestic investment by domestic firms, it triggers an equally productive amount of new inbound investment from foreign firms. In more general cases, the welfare-maximizing tax treatment of foreign investment depends on the extent to which foreign investment substitutes for domestic investment lost due to new outbound FDI, and the relative productivities of foreign-owned and domestic-owned capital in the home country. If foreign investment and domestic investment are equally productive in the home country, but inbound foreign investment replaces only 75 percent of domestic investment lost due to outbound FDI, then the analysis implies that the optimal home-country policy is to tax 34 percent of the after-tax foreign income earned by home-country firms.

Implications for American tax policy

There is extensive evidence that tax systems influence the magnitude and composition of international economic activity, and there is good reason to believe that improved tax design has the potential to enhance the performance of national economies. The welfare principles that underlie the U.S. taxation of foreign income rely on the premise that direct investment abroad by American firms reduces the level of investment in the United States, since foreign competitors are assumed not to react to new investments by Americans. It follows from this premise that the opportunity cost of investment abroad includes foregone domestic economic activity and tax revenue, so national welfare is maximized by taxing the foreign incomes of American companies, whereas global welfare is maximized by providing foreign tax credits. If, instead, direct investment abroad by American companies triggers additional investment in the United States by foreign companies, which is likely in a globally competitive market, then entirely different prescriptions follow. National welfare is then maximized by exempting foreign income from taxation (NON), and global welfare is maximized by conformity in the systems of taxing foreign income among capital-exporting countries (CON).

It is tempting to think of international tax differences as influencing the location of economic activity rather than determining the ownership of assets around the world. In fact tax systems do both, but given the central importance of ownership to the nature of multinational firms, there is good reason to be particularly concerned about the potential for economic inefficiency due to distortions to ownership patterns. Tax systems that satisfy CON ensure that the identities of capital owners are unaffected by tax rate differences, thereby permitting the market to allocate

ownership rights to where they are most productive. Proposed and pending international tax reforms in the United States have the potential to affect national and global welfare. In order to evaluate these tax reforms properly, it is necessary to consider their implications for patterns of capital ownership throughout the world.

RESPONSES TO QUESTIONS FROM SENATOR GRASSLEY

Question 1. What are the latest trends in international competitiveness and what do they mean for the U.S. economy?

Answer. The world economy continues to grow more competitive, reflecting a trend that has persisted certainly since the early 1970s and very likely prior to that. The strength of American exports and American firms operating in foreign markets depends in part on the performance of foreign economies, which we do not control. The world economy is still reacting to the events of the last decade and early part of this decade, including the financial crises in Asia, South America, Russia, and elsewhere, the U.S. recession and stock market reversal, slow European growth, and continued Japanese stagnation. The weak performance of foreign economies has reduced demand for U.S. exports and contributed to the U.S. current account deficit and a falling value of the U.S. dollar. While foreign economies can be expected to grow in strength in the coming years, this growth is likely to be gradual; individual foreign firms with which American firms compete, however, have shown considerable innovativeness and ability to capture market shares around the world.

What these trends imply is that the U.S. economy needs to grow in strength in order to maintain its competitive position in the world. This has been true throughout the postwar era and is certainly no less true now. What tax policy can do to foster such growth is to provide American companies with efficient incentives and appropriate total tax burdens.

Question 2. We need to understand how reforming our international tax laws benefit the everyday American. We often hear that reforming our international tax laws will cause jobs to leave the United States. Do you know of any data or studies addressing this issue?

Answer. I agree that one often hears that efficiency-enhancing reforms might cause jobs to leave the United States. But in fact, the opposite is the case: U.S. tax reforms that improve the efficiency of the economy make the country more productive and thereby increase the demand for labor (and land) located here, which translates into more employment and higher wages.

The key to helping American workers is to adopt policies that enhance the productivity of labor in the United States, and to avoid policies that reduce productivity. All around the world, as well as within the United States, greater productivity is associated with higher wages and lower levels of unemployment. What does this have to do with tax policy? Tax laws that give firms inefficient incentives reduce the productivity of resources that firms use to produce output—and labor is the primary resource that firms use.

The question asks about studies. The most important and influential study of this issue is by Peter Diamond (of MIT) and James Mirrlees (of Cambridge University, England), entitled “Optimal taxation and public production,” and published in the March and June 1971 issues of the *American Economic Review*. This study is rather abstract in its formulation, and its argument therefore somewhat difficult to follow. Roger Gordon (of the University of California-San Diego) and I recently re-cast and extended this argument, and attempted an accessible explanation, in our paper “International taxation,” published in the *Handbook of Public Economics*, volume 4, Alan J. Auerbach and Martin Feldstein eds., (Amsterdam: North-Holland, 2002), pp. 1935–1995.

There are other empirical studies that attempt to examine directly the impact of foreign investment on domestic and foreign employment levels. These empirical efforts are fraught with difficulties, most notably that the general equilibrium impact of tax policies are impossible to evaluate by looking only at the employment practices of individual companies that invest abroad. While I usually prefer to analyze the impact of tax policies using data from actual experience, I am unaware of any reliable statistical evidence on this question. Since we have very powerful analytical studies that address this question, and they offer unambiguous answers, I believe that we should rely on their implications instead.

Question 3. You state that American companies do not benefit from the low tax rates in some countries because we use a worldwide system of taxation. But what about the benefit of deferral? We generally don’t tax active business income until it is brought home. If a company can defer bringing it back for a long time, they pay a low effective U.S. tax when you consider the present value of those future payments. Do you have any comment?

Answer. It is true that the United States permits companies to defer U.S. taxes on certain unrepatriated foreign profits, and that this deferral reduces the effective U.S. tax rate on foreign income. There are, however, two important mitigating considerations to bear in mind. The first is that the U.S. Subpart F rules limit the ability of American taxpayers to benefit from deferral, so only certain types of foreign income, and certain types of activities, permit a taxpayer to qualify for deferral. In part due to this limitation, American firms repatriate roughly half of their after-foreign-tax profits in dividends each year, and effectively repatriate more than that in the form of currently-taxed Subpart F income.

The second consideration is that the effective U.S. tax burden on foreign income significantly exceeds the effective tax rate calculated on the basis of the present value of U.S. tax payments. The reason is that firms undertake costly actions to avoid U.S. taxes, and the costs of these actions are properly included in the total burden imposed on foreign investment. All of international tax planning falls in this category. For example, firms are often willing to accept lower returns on new foreign investments financed out of retained foreign profits in order to defer repatriation (and the accompanying U.S. taxes). A naïve calculation of the present value of taxes would then significantly understate the ultimate burden borne by American firms doing business abroad.

Taken together, these two considerations suggest that the ability to defer U.S. taxation of foreign income, while partially mitigating the U.S. tax burden on foreign income earned by American companies, leaves a substantial burden. There is ample evidence that the behavior of American companies is affected by this burden; my testimony, for example, discussed the impact of introducing the “10–50 basket” on the reluctance of U.S. firms to participate in international joint ventures after 1986.

Question 4. In your testimony, you infer that lower taxes attract investment from states using a territorial tax system. If we repeal FSC–ETI, we will increase the tax rate on manufacturers in the U.S. Will that create disincentives for new investment in the U.S. manufacturing sector?

Answer. The impact of FSC–ETI repeal depends on how it is accomplished. If the current ETI system were simply removed without adoption of any mitigating business tax reduction, then yes, business investment in the United States would be adversely affected. I might note that the impact would not be quite as severe as some predict, since the removal of the ETI tax benefit will reduce the value of the U.S. dollar, thereby partly compensating for the loss of tax benefits by helping American exporters through another route.

If FSC–ETI repeal is part of a broad and sound package of revenue-neutral business tax reforms, then it should be expected to encourage investment in U.S. manufacturing. The reason is that efficient tax provisions make the United States a desirable place to invest. The current FSC–ETI system provides a more favorable tax treatment of domestic economic activity directed at exports than it does domestic economic activity directed at domestic sales, and as a consequence, it reduces efficiency somewhat. The resources that are currently devoted to export subsidies would create greater economic value if they were used instead to reduce other distortionary incentives created by the tax system.

Congress in reforming the FSC–ETI system has the opportunity to enhance efficiency and thereby improve the attractiveness of the United States as a place to invest. If FSC–ETI repeal is implemented without using the added tax revenue to reduce other business tax burdens, then the accompanying improvement in efficiency will not be sufficient to offset the greater burden on domestic manufacturing. If, on the other hand, the tax revenue generated by FSC–ETI repeal were to be used to reduce other tax burdens on American businesses, and these reductions are chosen wisely, then we can expect greater investment in American manufacturing as a result.

Question 5. Dr. Hines, in your testimony, you suggest the more traditional view generally held in the U.S. is that foreign investment by American firms reduces the level of investment in the U.S. Hence, many people believe we should tax the foreign income earned by U.S. companies on their overseas investment because it helps to discourage American companies from moving U.S. jobs overseas. However, you suggest there has been a gradual shift in thinking regarding the taxation of foreign source income. Specifically, you state that if direct investment abroad by American companies triggers additional investment in the U.S. by foreign companies, then the U.S. would benefit by exempting foreign income of American companies.

What evidence do you have that U.S. investment abroad triggers additional foreign investment in the U.S.?

Answer. We have indirect evidence that bears on this question. The available evidence indicates that the vast majority of foreign direct investment consists of acquisitions of existing companies, and not so-called “greenfield” investments in which

new plant and equipment is acquired in order to start new companies or expand old ones. This is consistent with modern theories of why firms undertake foreign direct investment: firms engage in foreign investment in order to exploit within-firm economies that make it more profitable for certain owners, and not others, to control foreign assets.

For a given total volume of business investment, the decision to acquire a foreign business means foregoing the acquisition of a substitute domestic business. From the standpoint of the economy as a whole, this leaves additional domestic businesses available for acquisition by foreigners. This is the market implication of a foreign direct investment process that is dominated by acquisitions of existing businesses.

It would be useful to buttress this conclusion with direct evidence of the impact of outbound foreign direct investment on the level of foreign investment in the United States. Unfortunately, there does not exist any reliable evidence of that sort, so we are left to draw inferences from indirect evidence. The good news is that the evidence we have is consistent with our theories of foreign direct investment, and both point in the direction of U.S. investment abroad triggering greater foreign investment in the United States.

Question. Does this mean we should abandon our current system of taxing foreign income and adopt the territorial used by many of our competitors?

Answer. Yes, the implication of thinking about foreign direct investment in a competitive world economic environment is that U.S. welfare would be enhanced by exempting foreign income from taxation. Adopting a territorial tax system would make the U.S. economy more efficient and would thereby enhance the well-being of Americans.

Question 6. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y re-sells the widgets (without changing them) for 125 to unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States currently tax the 25? Why or why not?

Answer. If the conditions posited by the question are in fact all satisfied, then no, the United States should not tax the 25 earned by the firm in Bermuda. The reason is that exempting foreign income from taxation improves the efficiency of the U.S. economy. Attempts to tax the 25 would discourage foreign business activity on the part of the U.S. manufacturing firm, and reduce its competitiveness relative to producers in other countries that are not taxed on their Bermuda profits. Over time, the U.S. manufacturing firm will shrink in size as it is overtaken by these competitors. If, instead, the United States were to exempt the 25 from taxation, the manufacturer would be more productive, and the resources (200 employees) that it employs in Bermuda and would otherwise have employed in the United States could instead be used by U.S. firms for whom they would be more productive. On net, this would improve the productivity of American labor and capital, improving wages and profit rates.

It is critical in answering this question that the 200 persons in Hamilton in fact are adding economic value in a way that makes a return of 25 appropriate for their actions. In the absence of arm's length transactions against which to compare the transfer price of 100 for the sale from the United States to Bermuda, the transfer price must be properly evaluated in other ways. The question posits that the widgets have not changed during their period of Bermuda ownership, so presumably the 200 Bermuda employees are engaged in marketing and other sales-related (but not manufacturing) services. If the return of 25 is appropriate for these activities, then it should be exempted from U.S. taxation. If, instead, some of the 25 is more properly attributed to the U.S. manufacturing operation (and the appropriate transfer price therefore somewhere between 100 and 125), then the domestic component of the 25 should be subject to U.S. taxation, but this is really a transfer pricing issue rather than one of the proper taxation of foreign income.

RESPONSE TO A QUESTION FROM SENATOR HATCH

Question. Professor Hines, in your testimony you seemed to be saying that if we want to raise American productivity and American incomes, we ought to follow something you call "capital ownership neutrality." You say that if we care about increasing the American standard of living, then we should exempt most or maybe even all overseas business profits from U.S. tax. I really find this idea intriguing. Can you tell me more about how you think the U.S. could move toward such a system? And in particular, does the proposal that Senator Allen and Senator Boxer just

spoke about, this dividends-received deduction on repatriated earnings, start moving us in that direction?

Answer. Tax systems satisfy “capital ownership neutrality” if they do not distort the worldwide pattern of capital ownership, thereby leaving market forces to determine ownership. The proposal for a dividends-received deduction, about which Senators Allen and Boxer spoke, would contribute only very little to capital ownership neutrality, for the simple reason that it is purely a temporary gesture. A permanent and complete exemption of foreign dividends from U.S. taxation, along with some other changes, would move the United States very strongly in the direction of national ownership neutrality and capital ownership neutrality. Temporary changes would have very little impact on ownership patterns, and therefore would not trigger the kind of efficiency-enhancing ownership reallocations that make national ownership neutrality and capital ownership neutrality desirable.

There are many other intermediate steps that the Congress might consider in moving toward a system that is consistent with national ownership neutrality and capital ownership neutrality. One might, for example, consider a permanent exemption from U.S. taxation of a certain fraction of foreign dividend income. This could be coupled with changes in the foreign tax credit rules that simplify the system and give taxpayers greater ability to apply credits for certain foreign taxes paid against U.S. taxes due on other sources of foreign income. The Subpart F rules might also be changed to permit deferral of U.S. taxation of foreign income in situations where deferral is now not possible.

A broad range of options is available to Congress. In considering these and other alternatives, I recommend that Congress guard against the natural urge to attempt to eliminate apparent tax avoidance opportunities wherever they appear. The object of sound tax policy is not to raise revenue at every turn. The object of sound tax policy is to raise needed revenue in the most sensible way, which means not taxing some economic activities and taxing others quite lightly. We do not do the United States and the world economy a favor by imposing a tight regime of taxing the foreign incomes of American companies. We can take steps to reform this system in a way that makes the economy more efficient, and thereby helps everyone, but doing so entails changing the way we have taxed income for many years.

PREPARED STATEMENT OF DAN KOSTENBAUDER

Mr. Chairman, Senator Baucus, and Members of the Committee, thank you for the opportunity to testify here today. My name is Dan Kostenbauder. I am Vice President—Transaction Taxes at Hewlett-Packard Company in Palo Alto, California. Bill Hewlett and Dave Packard founded HP in 1939. HP completed its merger transaction involving Compaq Computer Corporation on May 3, 2002. HP had worldwide revenue of over \$72 billion for the fiscal year ending October 31, 2002.

HP is a leading global provider of products, technologies, solutions and services to consumers and businesses. The company’s offerings span IT infrastructure, personal computing and access devices, global services and imaging and printing. HP expects to spend over \$4 billion on R&D this fiscal year. This investment fuels the invention of products, solutions and new technologies, so that we can better serve customers and enter new markets. HP invents, engineers and delivers technology solutions that drive business value, create social value and improve the lives of our customers.

Summary of Comments

My comments will focus on a few key topics:

Some general information about Hewlett-Packard Company and the high-tech electronics industry that should help to provide a context for our views on the need for improvements to the U.S. tax system to improve our international competitiveness,

Proposed reforms of the U.S. tax rules that apply to international activities of U.S.-based taxpayers, and

The benefits of encouraging U.S.-based taxpayers to move offshore cash into the U.S. economy.

Background on Hewlett-Packard Company

As a leading global information technology company, HP operates in numerous countries. In the United States, HP has over 65,500 employees. Of the \$4 billion that HP spends on R&D, 80% is spent in the United States—mostly to support high-paying jobs. In addition to sales of computers and printers, HP has a significant

nificant and growing services business. Last year HP Services generated 16 percent of HP's worldwide revenue and 37% of HP's worldwide profits.

HP also has significant operations overseas because business realities dictate that we do so. Our competitors are global in scope. It would be impossible for HP to succeed in the United States if we could not compete successfully outside of the United States. This is true for several key reasons.

First, many of our customers operate globally. They typically prefer to have one or a few IT technology providers. To meet the needs of these multinational customers, HP needs to have a significant presence to sell and support products outside of the United States. Quite simply, if we did not have a global presence, we would get fewer contracts with foreign-based or with U.S.-based multinational companies. Instead, those contracts might go to our foreign-based competitors—a result that no one on this Committee would think could be good for the American economy.

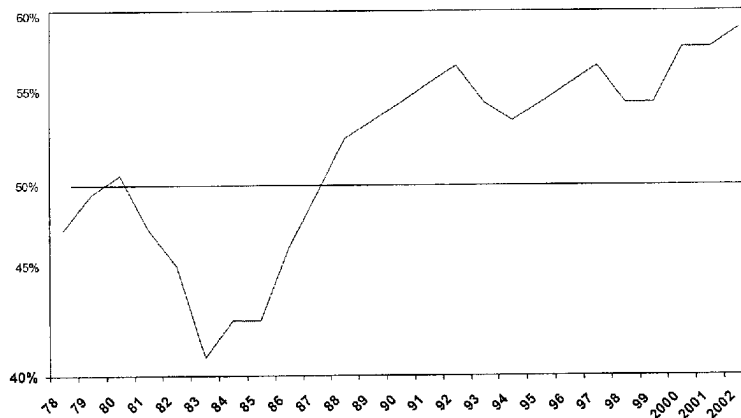
A second reason is that R&D is critical to high-tech companies. Our product life cycles are very short. In order to keep prices competitive, we need to amortize the costs of R&D over the maximum number of units sold worldwide. If we did not, our foreign competitors would eventually be able to under price our products and ultimately have the resources to do the R&D that we could no longer afford. This would leave us in the technological dust.

A third reason is that many products must be manufactured close to their markets. Usually it is not economically viable to ship products overseas that have relatively low values compared to their weight. In addition, with products like personal computers that fall in value very rapidly, supply chain considerations often dictate that they must be manufactured near their markets.

The following graph indicates the importance of HP's ability to compete in foreign markets. In our last fiscal year, about 59% of HP's trade revenues were from customers outside of the United States. (Prior to fiscal year 1999, the chart reflects the percentage of orders, rather than revenue, from outside of the United States.) The trend is clear.

Percentage of HP Revenue from Outside of the United States

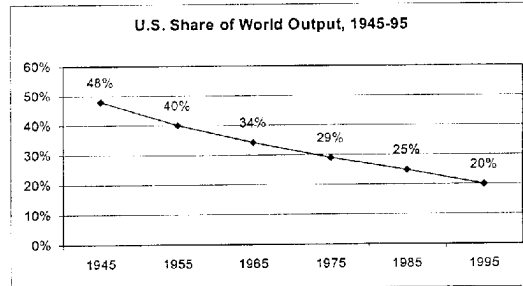
(Orders prior to fiscal year 1999)



The increased importance of foreign markets to HP is not an isolated phenomenon. The U.S. share of the world economy has declined due to faster economic growth abroad since World War II. A domestic company that limited itself to the U.S. market in 1945 would have foreclosed half the world market; today it would lose 80 percent.

The following graph illustrates this point for the whole U.S. economy.

Global economic trends



Source: Mathew J. Slaughter, *Global Investments American Returns*, 1998, p. 6.

HP has been affected in many significant ways by the high-tech recession that has lasted over three years. HP, along with many other U.S. exporters, almost certainly will lose the FSC/ETI tax benefits on exports in the near future. HP believes that one of the best ways to address the technology recession and to offset the loss of FSC/ETI would be the enactment of the international reform provisions detailed below.

The U.S. High-Tech Electronics

The technology industry has suffered a massive recession over the past three years that started with the bursting of the “NASDAQ bubble” and has accelerated with the weak business demand for technology products. We have seen overwhelming job losses in many parts of the country. This Committee heard testimony last week on the recession facing the U.S. manufacturing industry, but the technology sector has suffered a similar recession.

According to a report of the AeA (American Electronics Association) released in March of this year, the U.S. technology sector lost about 560,000 jobs in 2001 and 2002. The sector’s workforce fell 10 percent to 5.15 million in December 2002 from 5.7 million in December 2001. The technology sector lost 415,000 manufacturing jobs, a 20 percent decrease to 1.62 million jobs. Total high-tech services jobs fell by 144,600, or 4 percent, to 3.52 million.

The United States Needs International Tax Reform

We believe that Congress should enact forward-looking reforms to the international tax provisions of the Internal Revenue Code that will enhance the ability of American companies to compete in global markets and emphasize the strengths of the U.S. economy. Such reforms will benefit the bottom line of our company operations, benefiting our shareholders, employees and customers, and ultimately the U.S. economy.

HP believes that the Congress is faced with an excellent opportunity to examine U.S. international tax rules and adopt a system that makes sense for our early 21st century economy. As the Committee well knows, the bulk of our international tax rules were written over 40 years ago and largely reflected a much different economy.

In 1962, the United States was the world’s preeminent economic powerhouse. It did not need to consider issues of competitiveness—both for individual companies and the broader economy—as seriously as it does today.

Of the world’s largest companies in 1960, 18 of 20 were U.S. corporations, and they faced less foreign competition. Today, the situation is vastly different. In 2001, only 8 of the 20 largest companies (based on sales) were U.S. corporations. U.S.-based companies face very serious competition, both at home and abroad, from for-

eign-based companies that frequently operate under more advantageous home-country tax rules.

Another change since 1962 is that today the United States, many believe, should worry more about its own competitiveness compared to foreign countries as an attractive place to do business and establish company headquarters. “Inversion” transactions have been of concern to the Committee in recent years. While we can all agree that these transactions should be prevented, they point to a disturbing fact: many companies view the tax ramifications of having a U.S. headquarters negatively enough that they are willing to engage in these transactions. Beyond inversions, we see a similar concern expressed with regard to cross-border acquisitions—all too often the resulting combined business entity is foreign-headquartered, usually because of tax considerations. This matters because economic studies demonstrate that many jobs and economic opportunities follow the headquarters. Consequently, if the headquarters of a formerly U.S.-based company moves to Europe, chances are that many good, high-paying jobs and future economic activity also goes to Europe—not the United States. Furthermore, we understand that some promising U.S. start-up companies are being organized at the outset with foreign parent corporations.

The growing importance of the services sector is another major change from the early 1960s, when manufacturing dominated the U.S. economy. Today, the U.S. services sector is one of the most dynamic elements of our economy and it is where the United States enjoys a high “comparative advantage” over many foreign countries. In 2002, exports of services accounted for 30 percent of all U.S. exports. Consequently, there are real concerns about any approach to promoting U.S. exports that is limited to the manufacturing sector. HP believes that the U.S. tax laws should reflect the dominant position of our services sector and enhance its ability to compete overseas. Further, we believe the following changes would help to accomplish the goal of enhancing the international competitiveness of U.S. companies generally, and companies in the services sector specifically.

Congress Should Repeal the Foreign Base Company Rules

HP supports the reform of the U.S. international tax rules, particularly of Subpart F of the Code. HP also supports improvements to the Foreign Tax Credit rules.

The foreign base company sales income and foreign base company services income rules of Subpart F place major constraints on the ability of U.S.-based companies to operate in overseas markets—a restriction that is not shared by our foreign competitors.

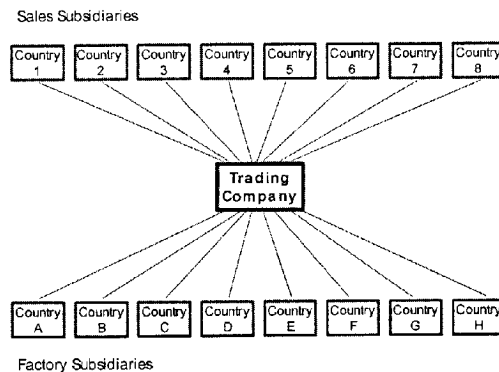
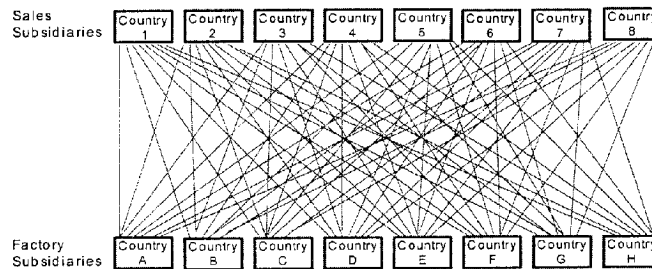
Like our foreign competitors, HP centralizes its sales activities in regional hubs (for regional markets, like Europe, Asia or Latin America) within a single controlled foreign corporation (“CFC”). It is too expensive to maintain redundant operations in each of several different countries within a single geographic region. The foreign base company rules, however, impose a current U.S. tax on income earned outside the CFC’s home country for transactions with a related party.¹

The following two graphics demonstrate why companies often conduct their international activities through “base companies” or trading companies. If a company has factories and sales companies in many different countries, it would be very complex and expensive to manage all of the different transactions necessary to allow each of the factories to sell into each of the different market countries. The complexity and expense would occur because of the need to replicate the many business processes necessary to facilitate crossborder transactions. Such processes include: VAT registration and compliance, foreign currency exchange exposure management, customs declarations, export controls monitoring, invoice preparation, invoice payment, cash management, accounting, withholding tax management, and many more.

The capability to manage such complex transactions would need to be replicated many times over unless a trading company is used. Tremendous cost savings are achieved by placing a regional or global trading company in the middle of transactions between production centers that supply goods or services and selling entities. The simplicity of the second graphic reflects the fact that each factory can conduct its business selling to only one customer, while each selling company needs to

¹FBCSI may result under when a CFC purchases personal property from anyone and sells it to a related person (or purchases personal property from a related person and sells it to anyone), if the property that is purchased is (1) manufactured outside of the CFC’s home country, and (2) sold for use, consumption, disposition outside such home country. This definition of FBCSI does not apply to property that is “manufactured” by the CFC. (The technical explanation accompanying the House Report on enactment of the FBCSI provision in subpart F includes the statement that because the definition covers only transactions involving both a purchase and a sale, it does not apply to income of a CFC from the sale of a product that it manufactures. H.R. Rep. No. 1447, 87th Cong. 2d Sess. (1962); 1962–3 C.B. 405, 466.)

purchase from only one supplier. Furthermore, it becomes vastly easier to add new factories or sales subsidiaries using this model. With increasing globalization, falling trade barriers (e.g., the economic integration of the EU countries and of China and Hong Kong) and improvements in technology, it is now more efficient and effective for foreign subsidiaries to conduct business on a regional or global basis than ever before.



With respect to the vast preponderance of transactions to which the Subpart F foreign base company rules apply, the transactions are between CFC's operating exclusively in foreign countries. Yet, the overly broad Subpart F rules impose current U.S. corporate income tax on such active business transactions. The U.S. approach to taxing foreign activities of U.S. taxpayers generally allows deferral of U.S. tax on active business income earned abroad. By imposing a current U.S. tax on strictly foreign transactions, the foreign base company rules place U.S. firms at a competitive disadvantage in the global marketplace.

Repeal of the foreign base company rules would permit a CFC to sell property or provide services in transactions involving related parties without generating currently taxable income. Also, the expense of complying with these complex rules would be avoided.

The original rationale in 1962 for the foreign base company rules was to prevent U.S. taxpayers from artificially shifting income into trading companies located in low-taxed jurisdictions by manipulating pricing. This concern could have arisen if one of the companies represented in the earlier graphics operated in the United States. Today, the IRS and many other country tax authorities are much more capa-

ble of enforcing the transfer pricing rules than they were when the foreign base company rules were enacted. In addition, the global enforcement of transfer pricing rules is much stronger due to better disclosure (attributable to contemporaneous documentation requirements), severe penalties, international exchange of information treaties, and Advanced Pricing Agreements between taxpayers and the Internal Revenue Service, as well as the tax authorities of other countries.

Congress Should Increase Foreign Tax Credit Carryover Period from 5 to 10 years

Reform of the foreign tax credit ("FTC") carryover rules is needed to ensure that U.S. companies are effectively protected against double taxation. Under current law, the amount of FTC's that may be claimed in a year is subject to a limitation, so that the credit is allowed only to offset U.S. tax on foreign source income. To the extent that the amount of creditable taxes for a given taxable year exceeds the limitation, the excess may be carried back two years and forward five years.

Problems of double taxation often arise because the foreign tax treatment of items of income and expense may differ from the U.S. tax treatment. For example, the same income may arise in different taxable years for foreign and U.S. tax purposes. As a result, foreign taxes may be imposed in a year during which little or no foreign income may arise under U.S. tax principles.

The rules for FTC carryovers seek to address this problem by allowing the FTC's to be carried over from years in which foreign taxes are imposed to years in which the foreign source income arises under U.S. tax principles. Extending the period for FTC carryforwards would allow companies to offset their U.S. tax liabilities in later years when they are profitable without facing the pressure of expiring FTC carryovers. The vagaries of the economy and normal business cycles are additional factors that sometimes prevent utilization of FTC's before their expiration.

This modification would allow U.S. taxpayers that had accrued or paid foreign taxes additional time to utilize their FTC carryovers.

Congress Should Remove the 90% Limitation on Claiming Foreign Tax Credits from the Alternative Minimum Tax

The regular corporate income tax allows companies a credit of 100 percent of the foreign taxes on income earned abroad, subject to various limitations and restrictions. Under the alternative minimum tax ("AMT"), however, only 90 percent of the AMT may be offset by FTC's that otherwise would be available. This rule causes double taxation of foreign income and thereby thwarts a fundamental and long-standing principle of U.S. tax policy.

The Joint Committee on Taxation April 2001 Simplification Study (JCX-27-01, 4/25/01) recommended that the corporate AMT be eliminated. The report concluded, "The original purpose of the corporate AMT is no longer served in any meaningful way." Furthermore, it has been estimated that the cost of tax compliance alone for the complexities costs companies many times the amount of AMT collected. Repeal of the entire AMT is an issue for another day. In terms of overall international competitiveness, however, eliminating the double taxation of international income clearly is appropriate.

The AMT has the perverse effect of penalizing U.S. global companies for distributing overseas earnings to U.S. parent companies to support domestic operations. Because of the AMT's limit on use of FTC's, earnings distributed from abroad are effectively taxed at a higher rate than domestic earnings, and certainly at a higher rate than the earnings of non-U.S. competitors operating in those same foreign markets. This puts U.S. companies in this position at a competitive disadvantage vis-à-vis their foreign competitors in overseas markets.

The United States Would Benefit by Encouraging Offshore Cash to Move Into the U.S. Economy

The Senate-passed Jobs and Economic Growth tax bill included a provision originally introduced as S. 596 by Senators Ensign, Boxer, Smith, Allen, Enzi and Bayh. It was adopted by voice vote after a 75-25 vote adopting a procedural motion on the floor to consider it. Similar bipartisan proposals have been introduced in the House.

S. 596 would, for a period of one year or less, impose a 5.25 percent toll charge on dividends or other transfers of foreign corporate earnings that exceed a company's historical average dividend flow. This toll charge would be imposed instead of the normal 35 percent tax. Any dividends taxed under the 5.25 percent toll charge would be permitted to claim only 15 percent of the foreign tax credits that otherwise would be allowed.

A recent PricewaterhouseCoopers analysis of the most recent IRS data—for 1999—shows that the average U.S. tax after taking foreign tax credits into account

on ordinary distributions (non-Subpart F) of foreign income was just 3.7 percent. This low effective tax rate is a consequence of U.S. tax laws that encourage companies to pay dividends from foreign companies operating in countries that subject their income to higher levels of foreign tax while discouraging payment of dividends from countries that impose lower rates of corporate income tax. Dividends from high-tax jurisdictions carry more foreign tax credits, which reduce U.S. tax liabilities on such dividends. On the other hand, lowtax foreign earnings carry few foreign tax credits, so companies have a powerful incentive to reinvest such earnings abroad rather than subject such earnings to the normal 35 percent U.S. corporate income tax rate.

In contrast to the U.S. system, many foreign countries do not tax dividends of earnings from outside their own countries. By excluding such earnings from domestic taxation, many other countries encourage the payment of such surplus foreign earnings as dividends back to those countries, where they can then be reinvested.

The structure of U.S. tax law that creates a significant incentive to leave foreign earnings offshore has in fact had a very substantial impact. Based on an examination of the financial statements of the S&P 500, a recent, independent JP Morgan study conservatively estimates that the pool of foreign earnings that has accumulated over the years and is eligible to be brought to the United States is about \$500 billion. This estimate is consistent with a PricewaterhouseCoopers' detailed review of IRS tax data. Much of this accumulated foreign investment is designated for financial reporting purposes as permanently invested overseas and thus there is no expectation of any U.S. tax being paid in the future.

Enactment of the proposed temporary toll charge on dividends of foreign earnings would encourage a permanent movement of a tremendous amount of cash into the U.S. economy. The JPMorgan study estimates that about \$300 billion would move from offshore to the U.S. economy. The impact of such a cash infusion would have an exceptionally powerful and positive short-term impact on the U.S. economy. If passed in the near future, the JPMorgan study anticipates:

A 1% cumulative increase in GDP growth (.5% in 2003 and .5% in 2004),

A 2-3% cumulative increase in U.S. investment during 2003-2004, and

A 3% reduction in corporate debt, which would strengthen corporate balance sheets and lower the interest rates on corporate bonds.

At a time when the U.S. economy, and particularly the high-tech sector, appears to be having a jobless recovery, the opportunity to generate increased U.S. investment and GDP growth should be seized upon. To demonstrate the relative significance of the incentives for growth and investment that the 5.25 percent toll charge proposal could generate, it would be useful to compare it to estimates of the economic impact of the recently-enacted Jobs and Growth Tax Relief Reconciliation Act of 2003.

Standard & Poors and Morgan Stanley Company estimated that the portion of the President's tax proposals that were enacted this year would increase GDP by about one percent in 2003. Bank of America estimated the impact at about .5 percent in 2004. Prudential Financial published a Research Report in June on the 5.25 percent toll charge proposal, stating: "We believe that a fund transfer of this magnitude would have significant macroeconomic implications, spurring growth, driving employment, stimulating domestic U.S. capital expenditures, easing the burden of under-funded pension programs, and in particular, helping hard-pressed U.S. manufacturing corporations to pay down debt and de-lever their balance sheets to better cope with deflationary pressures." The Invest in the USA proposal provides stimulus at levels similar to the just-adopted growth package, but at about 1% of the cost. This is an opportunity that we should not pass up!

A PricewaterhouseCoopers survey showed that the proposed change would result in an additional \$47 billion reinvestment in the United States from just 14 companies. The funds would be used to increase domestic investment in plant, equipment, and R&D; contribute to pension plans depleted by recent declines in the stock market; reduce domestic debt loads; increase dividends that could be productively redeployed; and raise equity market valuations by increasing funds available for share repurchases.

The rate of the toll charge proposal was chosen to strike a balance between generating revenue for the U.S. and encouraging dividend payments. Based on prior revenue estimates, it is likely that modest increases in the rate of the toll charge would reduce dividend flows significantly. The 3.7 percent additional U.S. tax burden on dividends of foreign earnings to the United States (based on the PricewaterhouseCoopers study referred to above) is very close to the current corporate cost of funds to borrow. Hence, if the toll charge rate were increased above the proposed level of 5.25 percent, less investment in the United States would be

stimulated. In addition, state income taxes and withholding taxes at source also increase the tax burden on dividends.

To encourage immediate economic stimulus, the reduced rate of tax would be effective for the first taxable year ending 120 days or more after the date of enactment. Thus, for example, if the bill was enacted on August 25, 2003 and the electing taxpayer is on a calendar year, the bill would apply to the taxpayer's taxable year ending December 31, 2003. To the extent that this proposal would be included in future legislation to be acted upon by this Committee, I would encourage the Committee to select effective dates that maximize the economic benefit in the near future in order to encourage the maximum amount of U.S. reinvestment as quickly as possible, while allowing companies sufficient time to plan for the movement of substantial amounts of cash in an orderly way.

Conclusion

I appreciate the opportunity the Committee has given me to share HP's views on possible changes to the U.S. income tax laws that apply to the foreign activities of U.S.-based taxpayers. The long-term international competitiveness of U.S. companies could be improved if the cost and complexity of the foreign base company sales income and services income provisions were removed from Subpart F of the Internal Revenue Code, and other international tax reforms adopted. In the short run, passage of the Invest in the U.S.A. Act of 2003 would act as a powerful stimulus to the U.S. economy. We encourage the Committee to pass legislation that includes both of these elements.

RESPONSES TO QUESTIONS FROM SENATOR GRASSLEY

Question 1. You recommend extending the foreign tax credit period to 10 years. Why did you choose this instead of changing the order in which credits are used up?

Answer. Increasing the carryforward period for foreign tax credits from 5 to 10 years would provide significant help in avoiding double taxation. Five years is frequently too short a period in which to overcome the effects of an adverse business cycle or extraordinary transactions that might interfere with a company's ability to use foreign tax credits. Extending the period to ten years should decrease significantly the number of companies that would be so affected.

Changing the order in which credits are used to a first in-first out approach would also help achieve the same result. In fact, many companies advocate taking both of these approaches at the same time. It is our understanding that the U.S. Treasury department supports extending the carryforward period but opposes changing the ordering rules. Treasury takes this position, at least in part, because of potential mismatches between foreign tax credits and the income on which they were imposed. Compared to more expansive proposals, Treasury's approach goes a long way toward helping companies to avoid double taxation of foreign earnings while minimizing revenue losses.

Question 2. Repeal of the foreign base company rules will cost around \$37 billion. Is there a more targeted way to fix the problems you are having with these rules?

Answer. Repeal would be the comprehensive way to address three adverse consequences of the foreign base company rules—higher tax costs, compliance burdens and complexity they impose on international operations of U.S.-based companies.

There are more targeted ways to address some of these problems. Transactions involving only foreign parties could be exempt from the foreign base company sales and services income rules. More narrowly, the EU (and perhaps other trade blocs) could be treated as one country for purposes of the foreign base company sales and services income rules. In addition, the substantial assistance rules imposed by the regulations under the foreign base company services income provision could be eliminated.

Question 3. You say you are a current FSC-ETI user, but much of this benefit depends on your level of U.S. manufacturing. What percentage of the manufacturing is done outside the U.S. as opposed to within the U.S.?

Answer. HP's FSC-ETI benefit is a function of U.S. manufacturing. The percentage of manufacturing done outside the United States as opposed to within the United States is not readily available because there is no SEC reporting requirement for us to track this information separately and because the complexities of our internal product flows (particularly after our Compaq merger) make it difficult to provide an answer to the Committee that we would have adequate confidence in.

As suggested in my testimony to the Committee at the hearing on July 15, however, HP manufacturing and selling activity is aligned with HP's high levels of foreign sales—almost 60% of HP's revenue is from customers outside of the United

States. On the other hand, about 48% of HP's total employees worldwide live in the United States. More than 1,000 HP employees live in each of the following states: California, Colorado, Georgia, Idaho, Maryland, Massachusetts, Nebraska, New Hampshire, New Jersey, Texas and Washington. In addition, the level of R&D that HP conducts in the United States (about 80%) is disproportionately higher than U.S. revenue (about 40%).

Question 4. How many percentage points does FSC-ETI reduce your tax liability?

Answer. HP has claimed an average of almost \$37 million of FSC-ETI benefit during the past three years. During this period HP reported average worldwide annual earnings of over \$1.4 billion. This means that the FSC-ETI benefit claimed for this period was about 2.6% of HP's worldwide income.

Question 5. You say that manufacturing should not receive export benefits because service is our fastest growing export sector. Are your services currently eligible for FSC-ETI benefits?

Answer. HP traditionally has been a manufacturing company and we believe that provisions in the U.S. tax laws that encourage manufacturing in the United States are good provisions to have. Of course, encouraging U.S. manufacturing through "export benefits" is what has led to the FSC-ETI controversy. In recent years, however, HP has committed to a strategy that involves significant expansion of our service businesses as well. Since the service sector of the U.S. economy is so important, my testimony questioned whether focusing only on incentives for the manufacturing sector would be the best policy judgment.

To illustrate that services jobs include many very good jobs for the U.S. economy, a description of the services provided by HP Services should be helpful. HP Services provides a comprehensive, integrated portfolio of IT services including customer support, consulting and integration, and managed services. Customer support provides a range of services from standalone product support to high availability services for complex, global, networked, multi-vendor environments. Consulting and integration provides services to design, build and integrate IT infrastructure. Managed services offers a range of IT management services, both comprehensive and selective, including transformational infrastructure services, client computing managed services, managed web services, and application services, as well as business continuity and recovery services. HP Services teams with the leading software, networking and services companies to bring complete solutions to our customers.

Services performed by HP in the United States are not eligible for FSC-ETI benefits.

Question 6. We heard testimony last week that every dollar of finished goods manufacturing sales creates 76 cents in services income and 67 cents in other manufactured products. Do you have any comment on that from a service industry perspective?

Answer. Certainly every dollar spent on service activities generates additional services income and manufacturing income. I am not aware of studies that quantify these amounts, however.

Question 7. I have voted for the Homeland Investment Act, but I have a few questions that need to be answered.

a. Your support of the Homeland Investment Act assumes that U.S. investment is best for our economy. In promoting your international tax reforms, you say being internationally competitive and expanding in foreign markets is good for U.S. jobs and the U.S. economy. If your claims are true, then why should we care whether you invest your foreign profits offshore or in the U.S.? Please explain these seemingly inconsistent positions.

Answer. HP's positions are not inconsistent. We believe that both proposals would stimulate the U.S. economy. The Homeland Investment Act will stimulate economic growth in the United States by significantly increasing the liquidity of many U.S. companies. As they put this cash to use, the U.S. economy will grow. In addition, if reforms of the U.S. international tax rules allow U.S.-based companies to be more competitive in foreign markets, we believe that growth of the U.S. economy will be stimulated.

Growth based on our ability to compete in foreign markets will generate not only more jobs, but also better jobs. The wages for production workers employed by U.S. companies without global operations have been estimated by Mark Dorms to be 9.5% to 15.2% less than those for U.S. companies with global operations. ["Comparing Wages, Skills, and Productivity between Domestically and Foreign-Owned Manufacturing Establishments in the United States." 1998. In *Geography and Ownership as Bases for Economic Accounting*, NBER Studies in Income and Wealth, vol. 59. Chicago and London: University of Chicago Press, pp. 235-255. (With J. Bradford Jensen.)]

b. The Joint Committee estimates that this proposal will lose about \$4.4 billion over 10 years. Given that we have a limited amount of money for international reform, is it better to use this money to do permanent foreign tax credit and subpart F reform, or is it better spent doing this repatriation proposal?

Answer. We strongly urge the Finance Committee to analyze the assumptions underlying the Joint Committee on Taxation revenue estimate to ensure that they are consistent with the information provided to the Committee by Senators Smith, Ensign and Boxer and by the companies that are working on this proposal. Given that the structure of the proposal is to reduce the tax rate on dividends paid in excess of a base amount, we remain puzzled by the estimate that projects a revenue loss over the 10-year scoring period. There will be such a large amount of earnings that will be subject to U.S. taxation that otherwise would go untaxed that we do not see how this proposal could possibly result in a decline in U.S. revenue.

We view the Homeland Investment Act as an economic stimulus measure that would encourage growth in the U.S. economy. JP Morgan and the Bank of America have estimated that \$300 billion to \$400 billion of cash would move into the U.S. economy in response to homeland investment legislation. The JP Morgan study estimates that the Homeland Investment Act would stimulate the U.S. economy over the next couple years as much as the \$350 billion economic growth package that the Congress passed in May. Such additional stimulus, even if it has an estimated cost of about \$4 billion, seems to be very appropriate at this time. It is imperative for the United States to move from a jobless recovery to a robust recovery that once again creates new jobs and other opportunities, and this proposal will help to accomplish that objective. At a cost of about \$4 billion, HP believes that Congress should enact the homeland investment provision. Use of dynamic scoring would likely show that this cost would be paid for by economic growth. Although proposed international tax reform is clearly necessary from a policy perspective, significant reforms (such as repeal of the foreign base company sales and services rules) will result in a higher revenue cost with less immediate impact on the U.S. economy.

c. How much money does your company have "trapped" in foreign jurisdictions, and in which countries is it trapped?

Answer. It is important to understand that the cash under discussion is "trapped" outside of the United States, but not within any particular foreign country.

Current U.S. tax rules encourage HP to continue to invest such cash anywhere but the United States. HP's 10-K filed with the Securities and Exchange Commission for our fiscal year ending October 31, 2002, indicated that "HP has not provided for U.S. federal income and foreign withholding taxes on \$14.5 billion of undistributed earnings from non U.S. and Puerto Rican operations as of October 31, 2002 because such earnings are intended to be reinvested indefinitely." Most of the \$14.5 billion referred to above represents earnings from active business operations in Puerto Rico, Ireland and Singapore.

d. What does your company do with the trapped money at the present time?

Some of the cash is kept in very liquid investments as a financial reserve.

Most of the cash is loaned to other HP subsidiaries outside of the United States. These funds are then used by HP's foreign subsidiaries to finance the growth of their active businesses, including inventories, accounts receivable, and leases of HP equipment.

e. What would your company do with it if they could repatriate it?

Answer. HP U.S. operations would become stronger and more competitive. If HP moved cash from offshore to the United States in response to a homeland investment provision, it would have several consequences. First, during the recent high-tech electronics recession, HP's U.S. borrowings have grown. We would set aside funds to repay these loans, which would strengthen our balance sheet as well as provide some additional earnings (interest rates on our U.S. borrowings are higher than the interest rates on offshore cash investments). It is likely that some portion of the funds would be used to fund U.S. employee benefit plans and R&D. We have not developed specific plans for other uses of the cash. Having a stronger U.S. cash position, however, should enable HP to take risks that that might be imprudent with lower levels of cash.

It is important to realize that improvements to HP's balance sheet alone help us compete around the world. We have a significant business leasing HP equipment that would benefit from any improvement in HP's borrowing costs and access to credit. HP is beginning to achieve greater success than ever before in providing a wide range of outsourced information technology services to our largest customers, whether they are based inside or outside of the United States. In addition to technical capability and global reach, having a strong balance sheet is a critical factor in our ability to compete for and win such business.

f. What level of repatriations has HP maintained under present law?

Answer. During the past three years, the average amount of gross cash dividends paid by foreign subsidiaries to HP in the United States was almost \$ 1.5 billion per year.

g. From which countries has HP paid dividends under present law?

Answer. Foreign subsidiaries of HP in about 25 countries have paid dividends to HP in the United States during each of the past three years. These countries include Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Korea, Malaysia, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan, Turkey and the United Kingdom.

h. Why will this tax break cause you to build facilities in the U.S. that would be uneconomic under present law?

Answer. I would not characterize a homeland investment provision as a “tax break.” Instead, it removes the impediment under U.S. tax laws for U.S. based companies to pay dividends out of foreign earnings. As indicated above, it is not certain that HP would use additional U.S. cash to build additional facilities. However, it is clear that having more cash in the United States would help to make HP a stronger company that would enable us to compete more effectively.

i. Does the location of accumulated funds in their U.S. treasury center as opposed to their overseas treasury center have that huge an impact on HP’s investment decisions?

Answer. Yes. While HP’s investment decisions are driven by a variety of considerations, our current “hurdle” rate (i.e., the threshold rate at which it is profitable to make investments) is substantially higher for U.S. than foreign investments because of the imbalance HP is experiencing between available U.S. and foreign cash. Enactment of the homeland investment legislation would equalize the relative hurdle rates for evaluating investments, and thus would improve the relative position of the United States when we evaluate future investments.

j. Why not make homeland investment permanent? Do you think that this temporary relief should henceforth be included in Congress’s anti-recession toolbox?

Answer. The homeland investment provision is a cost-effective economic stimulus that will have maximum effect if it is available for a short period of time. Making a homeland investment provision permanent would be such a major change to the U.S. tax system that it would be premature at this time because the necessary consensus for such change has not been reached. Also, it is unclear that a permanent solution would clear up the problems of the past that has resulted in about \$500 billion effectively being trapped offshore.

There are two classic models that countries use to tax the foreign operations of domestic companies—worldwide or territorial systems. I am not aware of any major trading partner that has a “pure” system under either approach. The United States uses the worldwide model. Making a homeland investment provision permanent would move the United States along the continuum between these two approaches significantly toward the territorial approach. As a country, we have not developed a consensus that we should move so far in that direction so quickly. Furthermore, because other countries that have adopted the territorial approach have not adopted “pure” territorial systems, it is virtually certain that the United States would not adopt a “pure” territorial system either. Adding a homeland investment provision to the existing U.S. tax system definitely would be far from a pure territorial system. One could anticipate that other provisions might be adopted to customize any U.S. version of a territorial system. Without having had a thorough national debate about the merits of moving toward a territorial system and particularly without having developed a consensus about the nature of any adjustments to a pure territorial system that the Congress would consider appropriate, it is too early to say that such a provision should be permanent.

If a homeland investment provision was adopted and it proved to be quite successful, a future Congress certainly might consider adopting a similar measure. From HP’s perspective, however, it is not at all clear that this provision would become part of an anti-recession toolbox for several reasons. The political consensus to adopt a homeland investment provision during the current period of economic weakness has been slow to develop, so it is unclear whether it would be achievable under future circumstances. Although the U.S. economy has experienced regular business cycles, during the last three years the U.S. high-tech electronics industry has witnessed one of the longest periods ever of downturn followed by a slow recovery. Because of this prolonged period of weak economic performance in the high-tech sector coupled with other recent HP-specific events, HP is more interested in a homeland investment provision than it probably would have been had such a provision been actively considered in prior periods of recession and recovery. Similar experience of other high-tech companies helps explain why the homeland investment idea has a

large number of supporters in that sector at this time. Another consideration is that the amount of offshore cash held by controlled foreign corporations that would be available for payment to the United States for many years would be far smaller than the pool available today. This means that the stimulus effect of a homeland investment provision adopted during the next few economic downturns probably would be significantly smaller than it would be today. In addition, until this Congress, companies have never had any expectation of a homeland investment provision being enacted, so it would not have had any impact on their decision-making. Future Congresses, on the other hand, would have to consider whether having a homeland investment provision in their “toolbox” would influence company decision-making in ways not intended. As this Congress considers a homeland investment provision, however, that would not seem to be a significant concern. Assuming that a homeland investment provision is enacted this year, I personally would advise management at HP not to base any of their decisions on the prospect that such a provision would be enacted again in the future.

Question 8. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y re-sells the widgets (without changing them) for 125 to unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y are attributable to economic functions that Y performs in Bermuda. Should the United States currently tax that 25? Why or Why not?

Answer. The United States should *not* currently tax that 25 earned in Bermuda for two reasons. First, the transfer price from X to Y is appropriate, so the income earned by X that is subject to U.S. income tax is based on an arm’s length transfer price that reflects fair compensation to X for activities conducted and risks taken in the United States. Second, the activity of Y in buying and selling widgets is an active business, so the earnings of Y from that business should be deferred under the U.S. tax principle that taxation is deferred on active business income until dividends of those earnings are paid to the United States. However, the United States does currently tax the 25 as Subpart F foreign base company sales income provisions.

PREPARED STATEMENT OF PAMELA OLSON

Mr. Chairman, Senator Baucus, and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing focusing on international tax policy and competitiveness issues. I applaud the Committee for holding this hearing to examine U.S. tax policy and its effect on the international competitiveness of U.S.-owned foreign operations. The importance of our international tax rules to the competitiveness of U.S. businesses and workers is well known to this Committee, as evidenced by the fact that the Committee has previously approved legislation addressing many issues in the international area. Unfortunately, this Committee’s good work on those issues in previous sessions has not resulted in enacted legislation. Nevertheless, the need for changes, such as the changes previously approved by this Committee, continues. Indeed, with the growing importance of international competitiveness to the economy, the need is even more immediate.

Many areas of our tax law are in need of reform to ensure that our tax system does not impede the efficient, effective, and successful operation of U.S. companies and the American workers they employ in today’s global marketplace. In keeping with the focus of today’s hearing, I will address my remarks this morning to the tax policy issues specific to U.S.-based companies competing in markets around the world.

Introduction

Both the increase in foreign acquisitions of U.S. multinationals and the corporate inversion activity of the past few years evidence the potential competitive disadvantage created by our international tax rules. The concern this Committee faces today is that our tax code has not kept pace with the changes in our economy. From the vantage point of the increasingly global marketplace in which U.S. companies compete, our tax rules appear outmoded, at best, and punitive of U.S. economic interests, at worst. Most other developed countries of the world are concerned with setting a competitiveness policy that permits their workers to benefit from globalization. As former Deputy Secretary Dam observed last year, we, by contrast, appear to have based our international tax policy on the principle that we should tax our competitive advantages.

Our income tax system as a whole dates back to shortly after the turn of the last century. Much has changed since then. Of course, significant changes have been made to the tax code as well. In the international area, we added the subpart F rules back in 1962. Those rules have not advanced with advances in the economy. We also made fairly significant changes to the international tax rules in 1986. Many of the 1986 changes had dubious economic underpinnings in 1986. They also have not advanced with advances in the economy.

The global economy looked very different in 1962 than it looks today. The same is true of the U.S. role in the global economy. Forty years ago the U.S. was dominant, accounting for over half of all multinational investment in the world. With a dominant role, we were free to make decisions about our tax system essentially on the basis of a closed economy. Moreover, our trade partners generally followed our lead in tax policy.

Things have changed. When the international rules were first developed, they affected relatively few taxpayers and relatively few transactions. Today, there is hardly a U.S.-based company that is not faced with applying the U.S. international tax rules to some aspect of its business.

Globalization—the growing interdependence of countries resulting from increasing integration of trade, finance, investment, people, information and ideas in one global marketplace—has resulted in increased cross-border trade, and the establishment of production facilities and distribution networks around the globe. Technology will continue to accelerate the growth of the worldwide marketplace for goods and services. Advances in communications, information technology, and transport have dramatically reduced the cost and time taken to move goods, capital, people, and information around the world. Firms in this global marketplace differentiate themselves by being smarter: applying more cost efficient technologies or innovating faster than their competitors. The returns are much higher than they once were as the benefits can be marketed worldwide.

The significance of globalization to the U.S. economy since the enactment of subpart F is apparent from the statistics on international trade and investment. In 1960, trade in goods to and from the U.S. represented just over six percent of Gross Domestic Product (GDP). Today, trade in goods to and from the U.S. represents over 20 percent of GDP, a threefold increase, while trade in goods and services represents more than 25 percent of GDP today. It is worth noting that numerous studies confirm a strong link between trade and economic growth. Trade appears to raise income by spurring the accumulation of, and raising the returns to, physical and human capital.

Cross border investment, both inflows and outflows, also has grown dramatically in the last 40 years. In 1960, cross border investment represented just over one percent of GDP. In 2001, it was more than 11% of GDP, representing annual cross-border flows of more than \$1.1 trillion. The aggregate cross border ownership of capital is valued at \$16 trillion. In addition, U.S. multinational corporations are now responsible for more than one-quarter of U.S. output and about 15 percent of U.S. employment.

Globalization and Competitiveness and U.S. Tax Policy

At the same time companies are competing for sales, they are also competing for capital: U.S.-managed firms may have foreign investors, and foreign-managed firms may have U.S. investors. Portfolio investment accounts for approximately two-thirds of U.S. investment abroad and a similar fraction of foreign investment in the U.S.

The U.S. tax rules have important effects on international competitiveness both because of the integration of domestic activities of U.S. multinational companies with their foreign activities and because repatriated foreign earnings of foreign investments are subject to U.S. domestic tax. Increasingly, the flow of goods and services is not through purchases between exporters and importers, but through transfers between affiliates of multinational corporations. The rules governing transfer pricing, interest allocation, withholding rates, foreign tax credits, and the taxation of actual or deemed dividends affect these flows.

As a general rule, the ideal tax system should seek to minimize distortions to trade or investment relative to what would occur in a world without taxes. Every country makes sovereign decisions about its own tax system, so it is impossible for the U.S. to level all playing fields simultaneously. But we can ensure that our own rules minimize the barriers to the free flows of capital that globalization necessitates. Similarly, every country makes sovereign decisions about its labor markets, environmental regulations, and health and safety regimes. Fortunately, we have had enough wisdom over the years to avoid attempting to level these playing fields. But our attempts to level the playing field in tax policy have often erected costly

barriers to the free flows of capital that maximizing our international competitiveness necessitates.

The question we must answer is what we can do to increase the competitiveness of U.S. businesses and workers. Professor Michael Graetz observed in his book, *The Decline (and Fall?) of the Income Tax*:

The internationalization of the world economy has made it far more difficult for the United States, or any other country for that matter, to enact a tax system radically different from those in place elsewhere in the world. In today's worldwide economy, we can no longer look solely to our own navels to answer questions of tax policy.

Professor Graetz is right. We must write tax rules that take into account what other countries are doing. If what they are doing is inconsistent with improving their own international competitiveness, then we should not follow. But if they appear to be moving in ways that will improve their ability to compete, then we must reconsider the extent to which our rules impede the flow of capital of US businesses, necessitate inefficient business structures and operations, and leave US companies and workers in a less competitive position.

U.S. Taxation of Income Earned Abroad

Given the significance of competitiveness concerns, we should consider the ways in which our tax system (1) differs from that of our major trading partners to identify aspects that may hinder the competitiveness of U.S. companies and workers, and (2) creates barriers to efficient capital flows. About half of the OECD countries employ a worldwide tax system similar to that of the United States. The practical effect of a worldwide system is a tax on U.S. companies repatriating their earnings to the extent foreign tax credits are unavailable to offset U.S. taxes. That tax creates a hurdle to companies bringing profits back to the United States. It means U.S. investments abroad often face a higher hurdle than if a foreign competitor made the same investment. That is a hurdle foreign competitors in territorial tax systems do not face, for example, and a hurdle foreign competitors investing in the U.S. do not face. This creates an incentive for U.S. companies to keep their income abroad, which can increase the cost of investment in the United States. That is a result that disadvantages U.S. workers.

Even limiting comparisons of our system to that of countries using a worldwide tax system, U.S. multinationals can be disadvantaged when competing abroad. This is because the U.S. worldwide tax system, unlike other worldwide systems, can tax active forms of business income earned abroad before it has been repatriated, and it often imposes stricter limits on the use of foreign tax credits that prevent double taxation of income earned abroad.

Limitations on Deferral

Under the U.S. international tax rules, income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent corporation level only when such income is distributed by the foreign subsidiary to the U.S. parent in the form of a dividend. An exception to this general rule is provided with the rules of subpart F of the Code, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries, without regard to whether that income is actually distributed to the U.S. parent. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. However, the reach of the subpart F rules extends well beyond passive income to encompass some forms of income from active foreign business operations. No other country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity.

Several categories of active business income are covered by the subpart F rules. Under subpart F, a U.S. parent company is subject to current U.S. tax on income earned by a foreign subsidiary from certain sales transactions. Accordingly, a U.S. company that uses a centralized foreign distribution company to handle sales of its products in foreign markets is subject to current U.S. tax on the income earned abroad by that foreign distribution subsidiary. In contrast, a local competitor with sales in that market is subject only to the tax imposed by that country. Moreover, a foreign competitor that similarly uses a centralized distribution company with sales into the same markets also generally will be subject only to the tax imposed by the local country. While this subpart F rule may operate in part as a "backstop" to the transfer pricing rules that require arms' length prices for inter-company sales, this rule has the effect of imposing current U.S. tax on income from active marketing operations abroad. U.S. companies that centralize their foreign distribution facilities therefore face a tax penalty not imposed on their foreign competitors.

The subpart F rules also impose current U.S. taxation on income from certain services transactions performed abroad. In addition, a U.S. company with a foreign subsidiary engaged in shipping activities or in certain oil-related activities, such as transportation of oil from the source to the consumer, will be subject to current U.S. tax on the income earned abroad from such activities. In contrast, a foreign competitor engaged in the same activities generally will not be subject to current home-country tax on its income from these activities. While the purpose of these rules is to differentiate passive or mobile income from active business income, they operate to subject to current tax some classes of income arising from active business operations structured and located in a particular country for business reasons wholly unrelated to tax considerations. In other words, in seeking to capture as much passive international income as possible, subpart F captures a large share of active income as well, putting the companies that earn this active income at a distinct competitive disadvantage.

Limitations on Foreign Tax Credits

Under the worldwide system of taxation, income earned abroad potentially is subject to tax in two countries—the taxpayer’s country of residence and the country where the income was earned. Relief from this potential double taxation is provided through the mechanism of a foreign tax credit under which the tax that otherwise would be imposed by the country of residence may be offset by tax imposed by the source country. The United States allows U.S. taxpayers a foreign tax credit for taxes paid on income earned outside the United States.

The foreign tax credit may be used to offset U.S. tax on foreign-source income but may not offset U.S. tax on U.S.-source income. The rules for determining and applying this limitation are detailed, complex, and can have the effect of subjecting U.S.-based companies to double taxation on their income earned abroad. The current U.S. foreign tax credit regime also requires that the rules be applied separately to separate categories or “baskets” of income. Foreign taxes paid with respect to income in a particular category may be used only to offset the U.S. tax on income from that same category. Computations of foreign and domestic source income, allocable expenses, and foreign taxes paid must be made separately for each of these separate foreign tax credit baskets, further adding to the complexity of the system.

The application of the foreign tax credit limitation to ensure that foreign taxes paid offset only the U.S. tax on foreign-source income requires a determination of net foreign-source income for U.S. tax purposes. For this purpose, foreign-source income is reduced by U.S. expenses that are allocated to such income. Under the current rules, interest expense of a U.S. affiliated group is allocated between U.S. and foreign-source income based on the group’s total U.S. and foreign assets. The stock of foreign subsidiaries is taken into account for this purpose as a foreign asset (without regard to the debt and interest expense of the foreign subsidiary). These rules thus treat interest expense of a U.S. parent as relating to its foreign subsidiaries even where those subsidiaries are equally or more leveraged than the U.S. parent. This over-allocation of interest expense to foreign income inappropriately reduces the foreign tax credit limitation because it understates foreign income. The effect can be to subject U.S. companies to double taxation. Other countries do not have expense allocation rules nearly as extensive as ours.

Under the current U.S. rules, if a U.S. company has an overall foreign loss in a particular taxable year, that loss reduces the company’s total income and therefore reduces its U.S. tax liability for the year. Special overall foreign loss rules apply to re-characterize foreign-source income earned in subsequent years as U.S.-source income until the entire overall foreign loss from the prior year is recaptured. This re-characterization has the effect of limiting the U.S. company’s ability to claim foreign tax credits in those subsequent years. No comparable recharacterization rules apply in the case of an overall domestic loss. However, a net loss in the United States would offset income earned from foreign operations, income on which foreign taxes have been paid. The net U.S. loss thus would reduce the U.S. company’s ability to claim foreign tax credits for those foreign taxes paid. This gives rise to the potential for double taxation when the U.S. company’s business cycle for its U.S. operations does not match the business cycle for its foreign operations.

These rules can have the effect of denying U.S.-based companies the full ability to credit foreign taxes paid on income earned abroad against the U.S. tax liability with respect to that income and therefore can result in the imposition of the double taxation that the foreign tax credit rules are intended to eliminate.

Double Taxation of Corporate Income

While concern about the effects of the U.S. tax system on international competitiveness may focus on the tax treatment of foreign-source income, competitiveness

issues arise in very much the same way in terms of the general manner in which corporate income is subject to tax in the United States.

Prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the United States was one of the few industrialized countries that failed to provide some form of integration of corporate and individual income taxes. Income from an equity-financed investment in the corporate sector was taxed twice, first as profit under the corporate income tax and again under the individual income tax when received by the shareholder as a dividend or as a capital gain on the appreciation of corporate shares. In contrast, under a fully integrated tax system, the double tax would be eliminated and a single tax would be imposed on corporate profit. Most OECD countries offer some form of integration under which corporate tax payments are either partially or fully taken into consideration when assessing shareholder taxes on this income, eliminating or reducing the double tax on corporate profits.

The prior non-integration of corporate and individual tax payments on corporate income applied equally to domestically earned income or foreign-source income of a U.S. company. The double tax increased the "hurdle" rate, or the minimum rate of return required on a prospective investment. To yield a given after-tax return to an individual investor, the pre-tax return must be sufficiently high to offset both the corporate level and individual level taxes paid on this return.

Whether competing at home against foreign imports or competing abroad through exports from the United States or through foreign production, the double tax made it less likely that the U.S. company could compete successfully against a foreign competitor.

To address the high effective tax rate on corporate equity investments, JGTRRA partially integrated corporate and individual taxes by providing relief from the double tax at the individual level through reduced tax rates on corporate dividends and capital gains. The maximum tax rate on dividends paid by corporations to individuals and on individuals' capital gains is reduced to 15 percent in 2003 through 2008. For taxpayers in the 10 percent and 15 percent income tax rate brackets, the rate on dividends and capital gains is reduced to 5 percent in 2003 through 2007, and to zero in 2008.

Because JGTRRA reduced the effective tax rate on income earned in the corporate sector, many more investments can achieve a desired after-tax return (after both corporate and individual taxes are paid) than under the prior non-integrated tax system. As a result, projects that could not attract equity capital in a non-integrated tax system because they might not be sufficiently profitable are able to attract equity capital in the present partially integrated system. Nevertheless, taxes on equity investments in the corporate sector are still higher than they would be under a fully integrated system. In the context of competitiveness, this may mean that a project that would otherwise be undertaken by a U.S. company, either at home or abroad, is instead undertaken by a foreign competitor. An additional concern is that the present relief from the double tax is scheduled to expire in 2009. To help ensure the competitiveness of U.S. companies, the present relief from the double tax for dividends and capital gains should be made permanent.

Additional Issues Involving Business Taxation

Mr. Chairman, in addition to the need to reevaluate our international tax rules, there are other tax policy issues that require consideration.

The President's February budget contained a number of tax provisions in addition to those that were eventually enacted in JGTRRA that are also intended to strengthen the economy. Those proposals affect a wide range of areas, including encouraging saving, strengthening education, investing in health care, increasing housing opportunities, protecting the environment, encouraging telecommuting, and providing incentives for charitable giving. They also include specific proposals to rationalize the tax laws, such as the repeal of section 809, and to simplify the tax laws, such as a permanent expansion of section 179, and to improve tax administration. To maintain their favorable effects and provide greater certainty for economic and financial planning, the Budget proposed to extend several tax provisions that expire in 2003 and 2004, and to make permanent the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001.

The President's budget also proposes to make permanent the research and experimentation tax credit. Research is central to American businesses' ability to compete successfully in the global economy. It results in new processes and innovative products that open up new markets and create job opportunities. American businesses can continue to compete only if they stay at the forefront of technological innovation. The research credit encourages technological developments that are an essential component of economic growth and a high standard of living in the future. A perma-

ment research credit would remove the uncertainty about its availability in the future and thereby enable businesses to factor the credit into their decisions to invest in research projects.

The current system of tax depreciation also merits reevaluation. The 2000 *Treasury Report to Congress on Depreciation Recovery Periods and Methods* identified a number of issues with the current system of tax depreciation. Each issue represents a potential avenue to improving the tax system, and may warrant further study. One such issue is that the current system lacks a firm conceptual rationale. For example, it does not reflect inflation-indexed economic depreciation. This means that tax depreciation allowances can deviate significantly from those required to properly measure income and from those that would provide a uniform investment incentive for all assets.

A second issue in depreciation policy is that the current system is dated. The asset class lives that serve as the primary basis for assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and production processes in existing industries have changed.

A third issue is that the current depreciation system suffers from an ambiguous system for determining each asset's cost recovery period. This ambiguity contributes to administrative problems, makes it difficult to integrate new assets and activities into the system rationally, and inhibits rational changes in class lives for existing categories of investment.

Finally, in addition to these broad issues, the existing system is hampered by a number of narrower controversies, including the proper determination of the recovery period for real estate, the possible recognition of losses on the retirement of building components, and the presence of cliffs and plateaus in cost recovery periods that distorts the relationship between economic life and tax life.

The corporate alternative minimum tax (AMT) is an alternative tax system to the regular tax system. When investments and other expenses are large relative to a company's taxable income, as occurs during economic downturns, alternative minimum tax may be owed. Corporate AMT payments represent a pre-payment of tax that the taxpayer will get back when and if the taxpayer returns to a sufficient level of profitability.

A significant problem with the AMT that is especially relevant today is that the AMT reduces the stabilizing property of the corporate income tax, raising tax liabilities just when the taxpayer is most troubled economically. In general, tax payments should help stabilize the economy by falling as the economy's performance declines, thereby reducing the impediment taxes place on consumption, investment, and production. The AMT tends to impose an increased tax burden during an economic downturn, which prolongs periods of economic weakness by reducing business activity. During an economic downturn, companies that seek to maintain a constant level of investment and employment are more likely to pay AMT or pay larger amounts of AMT. This is because AMT adjustments and preferences will represent a larger portion of their taxable income than during periods of high profitability.

The AMT also limits the use of net operating losses (NOLs) which tend to increase during economic downturns. Under the AMT, NOLs may not reduce a taxpayer's alternative minimum taxable income (AMTI) by more than 90 percent. The Job Creation and Worker Assistance Act of 2002 temporarily waived the AMTI limitation for NOL carrybacks arising in 2001 and 2002 as well as carryforwards to those years. In view of the slow pace of the economy recovery, the President's Budget proposed to waive the AMTI limitation for NOL carrybacks originating in 2003, 2004, and 2005, as well as for NOLs carried forward into those years. This change would provide appropriate tax relief for businesses in difficult financial straits.

Another aspect of the AMT is that it limits the use of foreign tax credits. Foreign tax credits can offset no more than 90 percent of the tentative minimum tax. Excess AMT foreign tax credits can be carried forward 5 years or back 2 years. Because the foreign tax credit is intended to ensure that foreign income of US corporations is not double taxed, the AMT's limitation on the use of foreign tax credit should be reconsidered.

It has been observed that "it is difficult to predict the future of an economy in which it takes more brains to figure out the tax on our income than it does to earn it." That is the situation we face. Our tax laws are extraordinarily complex. A recent IRS study of the burden and cost of complexity to individual taxpayers put the burden well in excess of three billion hours per year and the cost well in excess of \$60 billion per year. And that is just the individual side. The rules on the business side are even worse. While large businesses can grapple with it, many small and medium-size businesses cannot. The challenge for businesses trying to comply with the

law—or the IRS trying to administer and enforce it—is enormous. It is time for us to undertake a serious effort to simplify our tax rules.

The complexity is nowhere more evident than in our international tax rules. A reexamination is needed, including of the fundamental assumptions underlying the current system. We should look to the experiences of other countries and the choices they have made in designing their international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules and to significant reforms within the context of our current system.

The many layers of rules in our current system arise in large measure because of the difficulties inherent in satisfactorily defining and capturing income for tax purposes, particularly in the case of activities and investments that cross jurisdictional boundaries. However, the complexity of our tax law itself imposes a significant burden on U.S. companies. Therefore, we must not lose sight of the need to simplify our international tax rules.

RESPONSE TO A QUESTION FROM SENATOR GRASSLEY

Question. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y re-sells the widgets (without changing them) for 125 to unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States currently tax that 25? Why or why not?

Answer. Under the U.S. international tax rules, income earned abroad by a foreign subsidiary generally is subject to U.S. tax at the U.S. parent corporation level only when such income is distributed by the foreign subsidiary to the U.S. parent in the form of a dividend. An exception to this general rule is provided with the rules of subpart F of the Internal Revenue Code, under which a U.S. parent is subject to current U.S. tax on certain income of its foreign subsidiaries without regard to whether that income is actually distributed to the U.S. parent. The focus of the subpart F rules is on passive, investment-type income that is earned abroad through a foreign subsidiary. The reach of the subpart F rules, however, extends well beyond passive income to encompass some forms of income from active foreign business operations. This feature of our subpart F rules raises concern that subpart F can operate to create an inappropriate impediment to the competitiveness of U.S.-based multinational enterprises.

The impact of the subpart F rules on some forms of active foreign business operations is illustrated in the situation described in your question. If Company X is a domestic company, the subpart F rules provide that Company X would be subject to current U.S. tax on the active business income of the type earned by its foreign subsidiary Company Y. The active business income earned outside the U. S. by Company Y also may be subject to local income or other tax, and a foreign tax credit would be available to Company X for any local income tax. Thus, the 25 earned by Company Y would be subject to full U.S. tax on a current basis.

In contrast, if Company X were not a U.S. company, the 25 earned by Company Y generally would be subject to local tax only, which in the facts described in your question would be zero. If Company X were located in a country with a territorial tax system, the home country would not impose tax even when the 25 earned by Company Y is distributed to Company X. Thus, the 25 earned by Company Y would never be subject to tax outside the country in which it was earned. Alternatively, even if Company X were located in a country with a worldwide tax system, the home country would impose tax only when the 25 earned by Company Y is distributed to Company X. Thus, the 25 earned by Company Y would be subject to tax in Company X's home country only upon repatriation. This illustrates how U.S.-based companies may be disadvantaged under the subpart F base company sales rules relative to companies based in countries with a territorial system or with a worldwide system without rules like the U.S. subpart F base company sales rules.

It should be noted that the facts described in your question state that the transfer pricing analysis of the related-party transactions between Company X and Company Y is defensible. Therefore the transfer prices are consistent with the results that would have occurred had Company X and Company Y been dealing at arm's length and the 25 earned by Company Y is attributable to its active business operations. The purpose of our transfer pricing rules is to ensure that Company Y is properly treated as earning the amount of income attributable to its economic functions, and income may be reallocated under the transfer pricing rules to achieve the arm's length, economic results.

No other country has rules comparable to the U.S. subpart F rules in terms of the extent to which active business income is taxed on a current basis. Thus, a U.S.-based multinational enterprise faces a tax burden not imposed on its foreign competitors, which would be taxed on such income in their home countries upon repatriation or not at all. A system that did not impose current tax on active business income earned outside the United States by foreign subsidiaries would put U.S. companies on a more level playing field with their foreign competitors.

RESPONSE TO A QUESTIONS FROM SENATOR SMITH

Question. I echo the concerns that a number of my colleagues on both the Senate and House tax-writing committees have made regarding our opposition to the proposed IRS rule requiring U.S. banks to report the deposit income on accounts held by non-resident aliens. I still have concerns over the proposed rule and would like to know if the Treasury plans on officially withdrawing it? If so, when, and, if not, why not?

As I said in my letter to Secretary Snow in February, this rule, if enacted, would help drive much foreign investment out of the U.S. into other countries. At this time when our economy may be on the verge of some form of recovery, the last thing we need is a policy to discourage that investment to leave our capital markets.

Answer. It is more important today than ever that no safe haven exist anywhere in the world for the funds associated with illicit activities. Greater transparency can aid in preventing illicit activities by making it more difficult to conceal them.

Treasury and the IRS are concerned about the use of offshore bank accounts by U.S. taxpayers to avoid or evade taxes. We must address the potential for tax evasion through the use of offshore accounts or entities in order to maintain the confidence of all Americans in the fairness of our tax system.

Studies have shown that information that is reported to the IRS is significantly more likely to be reported on a tax return. In order to obtain the information we need to ensure compliance with U.S. tax laws, we must be prepared, in appropriate cases, to provide comparable information to our treaty partners. The proposed regulation, if finalized, would reduce opportunities for offshore tax avoidance or tax evasion by facilitating the exchange of information important to tax compliance. Such exchange of information would be pursuant to a U.S. income tax treaty and subject to strict protections with respect to confidentiality of taxpayer information.

The information reporting in the proposed regulation is similar to the information reporting currently required for other kinds of investment income paid to foreign persons, including interest paid on other debt instruments, and is identical to the information reporting currently required with respect to interest on bank deposits paid to Canadian residents. Information reporting also is required for all manner of investment income paid to U.S. persons.

Enhancing appropriate information exchange pursuant to our bilateral tax treaties in appropriate circumstances, subject to strict protections of the confidentiality of taxpayer information, is an important means of reducing opportunities for tax avoidance in the offshore sector. This proposed regulation is just one element of our multi-faceted effort to protect the interests of honest taxpayers who are prepared to pay their fair share of U.S. taxes and who should not have to bear a greater burden because of the few who are less than honest.

RESPONSES TO QUESTIONS FROM SENATOR BUNNING

Question 1. Along with a number of my colleagues on both the Senate Finance and Banking Committees, I contacted Secretary Snow earlier this year to express my opposition to the proposed I.R.S. regulation requiring U.S. banks to report the interest income on accounts held by nonresident aliens. According to the Treasury Department and Commerce Department, U.S. banks have more than \$1 trillion of deposits from overseas. Most of these funds appear to be bank-to-bank deposits, but a significant portion presumably is in nonresident alien accounts. Could you please provide a detailed breakdown of the sources of foreign deposits, both by origin and type of deposit? Moreover, does the Treasury Department believe that the regulation will lead to the loss of any deposits?

Answer. Treasury data provide a \$45 billion figure for the bank deposits of individuals, institutions, and entities, and the balances of foreign brokers (a type of deposits recently added to this data category), from the 15 countries covered by the proposed regulation. We do not have data that is limited to the deposits of individuals, which is what the proposed regulation covers. (Data are from Treasury International Capital (TIC) System, "US Banking Liabilities to Foreigners".)

The \$45 billion figure includes:

(1) demand and time deposits and nonnegotiable certificates of deposit from foreign individuals, foreign partnerships, and foreign non-financial corporations from the 15 countries;

(2) negotiable certificates of deposit from all foreign persons (including foreign governments and financial institutions as well as other foreign non-financial corporations and foreign individuals and partnerships) from the 15 countries; and

(3) balances of foreign brokers from the 15 countries.

As the proposed regulation does not apply to deposits of foreign corporations, banks, brokers, or governments, which are the main foreign holders of U.S. deposits, and only applies to foreign individuals resident in the 15 countries, the total U.S. deposits covered by the proposed regulation is likely to be significantly less than \$45 billion.

The \$45 billion figure is less than one percent of total foreigners' financial assets in the United States. The \$45 billion figure also is less than one percent of total U.S. bank deposits.

Treasury data do not show an outflow of funds surrounding prior changes in the information reporting rules. For example, similar concerns regarding the potential outflow of funds were voiced when identical reporting rules currently in place for Canadian residents were first proposed, but the predicted capital flight did not occur when the reporting rules were implemented.

Nonresidents have many reasons for depositing money in U.S. banks, including our nation's political and economic stability, the strength and stability of our financial institutions, and the quality of our regulatory supervision.

Question 2. Foreigners withdrew a significant amount of time deposits, \$40 billion on an annualized basis, in the first quarter of 2001 following the initial announcement of the proposed rule. Do you think this was a coincidence, or could it have been associated with the announced rule?

Answer. The change in deposits in the first quarter of 2001 does not appear to be related to the announcement of the original proposed regulation relating to information reporting for bank deposit interest paid to foreign persons. Rather, as the numbers below reveal, the change in deposits in the first quarter of 2001 reflected an unusually high amount of deposits as of December 2000 rather than an unusually low amount of deposits as of March 2001.

The Flow of Funds quarterly data on Foreigners' Time & Savings Deposits was as follows (in billions):

Sept. 2000—\$98
 Dec. 2000—\$107.2
 Mar. 2001—\$97.2
 Jun. 2001—\$97.8

The level of total foreign deposits in U.S. banks as of March 2001 was consistent with the level as of September 2000 and the level as of June 2001.

(The reduction in deposits of \$10 billion between December 2000 and March 2001 was multiplied by 4 to obtain the referenced annualized reduction of \$40 billion. Note, these figures include deposits of foreign governments and foreign banks from all countries. As discussed in response to the prior question, deposits of individuals generally, and of individuals in the 15 countries covered by the current proposed regulation in particular, make up a small subset of total U.S. bank deposits.)

Question 3. European Union officials have stated that the interest-reporting regulation is a measure of whether the United States supports an EU scheme known as the savings tax directive. The White House, however, already has announced that the Administration will not participate in the European Union's so-called savings tax directive. How does the Treasury Department's position on the savings tax directive differ from the President's position?

Answer. The Treasury Department's position with respect to the European Union's Savings Directive is identical to the President's position.

The Savings Directive is a pending internal EU initiative regarding the exchange of information for tax purposes among EU countries with respect to certain cross-border payments. The United States is not a party to this EU initiative.

The United States has tax information exchange relationships through bilateral treaties and agreements, including bilateral income tax treaties with countries that are members of the European Union. These relationships provide us with information that is critical to our ability to enforce the U.S. tax laws. The provisions of bilateral income tax treaties and tax information exchange agreements, which are subject to our required conditions regarding the strict protection of the confidentiality of taxpayer information, are the only means by which the United States exchanges tax information.

Question 4. In the past, you have stated that the interest-reporting regulation was revised to take into account the comments received on the January 2001 regula-

tions. The only meaningful difference between the original regulation and the revised regulation, however, is that the new version applies to depositors from a narrower range of nations. Could you specifically cite the comments that guided the change in the proposed regulation?

Answer. The proposed regulation was revised to take into account the concern expressed by the banking industry that the regulation could cause foreign depositors from some countries to withdraw their funds from U.S. banks because of worries about the potential misuse of such information for purposes of violence if it were to be obtained by their own governments. These concerns of the banking industry in this regard were focused on less-stable countries. The United States generally does not have tax treaties with such countries, and tax information would not under any circumstances be provided to any country with which the United States does not have a tax treaty or tax information exchange agreement.

Any foreign government that receives tax information pursuant to a treaty or tax information exchange agreement with the United States is subject to stringent restrictions. It is required to keep such information confidential and to use such information only for tax administration purposes. Moreover, the IRS closely monitors the administrative law and practice of the countries with which the United States has treaties or agreements that would permit tax information exchange in order to ensure compliance with these legal requirements.

Thus, there was no real potential for misuse of the information that would have been covered by the original proposed regulation. Nevertheless Treasury recognized the overbreadth of the original proposed regulation, which would have required information reporting with respect to residents of countries with which the United States does not have an income tax treaty or tax information exchange agreement under which such information could be used. Accordingly, responding to the banking industry's concerns about the perceived threat, Treasury and the IRS withdrew and revised the proposed regulation. The revised proposed regulation would require reporting only for bank deposit interest paid to residents of 15 specified countries (e.g., Australia, New Zealand, and various European countries), all of which are countries with which the United States has a bilateral tax treaty and a strong reciprocal exchange of information relationship. The Florida Bankers Association, which was very active in communicating the banking industry's concerns about the potential implications of the original proposed regulation, has welcomed this narrowing of the proposed regulation. Identical reporting regulations are currently in place for interest paid to residents of Canada, another country with which the United States has a bilateral tax treaty and a strong reciprocal exchange of information relationship.

Question 5. You stated that the re-proposed regulation will facilitate the goal of ensuring compliance with U.S. tax laws, but the United States does not tax this income. Could you please indicate how this regulation assists in the enforcement of U.S. tax law? Specific examples of how this regulation will help achieve that goal would be helpful as would references to existing tax treaties and tax information exchange agreements, along with the sections that require the collection of information that is not needed for domestic enforcement purposes.

Answer. It is more important today than ever that no safe haven exist anywhere in the world for the funds associated with illicit activities. Greater transparency can aid in preventing illicit activities by making it more difficult to conceal them.

Treasury and the IRS are concerned about the use of offshore bank accounts by U.S. taxpayers to avoid or evade taxes. We must address the potential for tax evasion through the use of offshore accounts or entities in order to maintain the confidence of all Americans in the fairness of our tax system.

Studies have shown that information that is reported to the IRS is significantly more likely to be reported on a tax return. In order to obtain the information we need to ensure compliance with U.S. tax laws, we must be prepared, in appropriate cases, to provide comparable information to our treaty partners. The proposed regulation, if finalized, would reduce opportunities for offshore tax avoidance or tax evasion by facilitating the exchange of information important to tax compliance. Such exchange of information would be pursuant to a U.S. income tax treaty and subject to strict protections with respect to confidentiality of taxpayer information.

The information reporting in the proposed regulation is similar to the information reporting currently required for other kinds of investment income paid to foreign persons, including interest paid on other debt instruments, and is identical to the information reporting currently required with respect to interest on bank deposits paid to Canadian residents. Information reporting also is required for all manner of investment income paid to U.S. persons.

Enhancing appropriate information exchange pursuant to our bilateral tax treaties in appropriate circumstances, subject to strict protections of the confidentiality of taxpayer information, is an important means of reducing opportunities for tax

avoidance in the offshore sector. This proposed regulation is just one element of our multi-faceted effort to protect the interests of honest taxpayers who are prepared to pay their fair share of U.S. taxes and who should not have to bear a greater burden because of the few who are less than honest.

Question 6. Congress repeatedly has examined the tax treatment of interest paid to nonresident aliens and always decided not to tax the income. Congress also has never sought to require the reporting of this income. According to legislative records, lawmakers were motivated by a desire to attract capital to the U.S. economy. Could you explain, therefore, how the interest-reporting regulation is consistent with existing law?

Answer. The exchange of information for tax purposes is a longstanding tenet of U.S. international tax policy. The importance of tax information exchange between the United States and other countries has long been recognized by Congress. In 1983, for example, Congress enacted the Caribbean Basin Economic Recovery Act, which contains provisions designed to foster negotiation of tax information exchange agreements. In particular, section 274(h)(6) of the Internal Revenue Code allows deductions to U.S. taxpayers for the expenses of a convention held in certain foreign jurisdictions (which deductions otherwise would be limited under the Code), provided that the jurisdiction has a tax information exchange agreement with the United States that meets specified minimum standards. The minimum standards for tax information exchange reflected in section 274(h)(6) form the basis of current international standards in this area.

In its advice and consent role with respect to U.S. income tax treaties, the Senate Foreign Relations Committee has repeatedly expressed strong opposition to any perceived softening of the United States' commitment to full tax information exchange. In 1999, the Foreign Relations Committee expressed its concern about the potential for bank secrecy rules to operate to limit access to information: "The Committee would have serious concerns with respect to a proposed treaty if the other country restricted access to this information and were unwilling to change its internal laws to accommodate full exchanges of information. The exchange of information provisions in treaties are central to the purposes for which tax treaties are entered into, and significant limitations on their effect, relative to the preferred U.S. tax treaty position, should not be accepted in negotiations with other countries that seek to have or maintain the benefits of a tax treaty relationship with the United States."

The Internal Revenue Code provides that Treasury and the IRS may require information reporting even though such investment income is not subject to taxation in the United States. The information reporting in the proposed regulation is identical to the information reporting currently required with respect to interest on bank deposits paid to Canadian residents and is similar to the information reporting currently required for other kinds of investment income paid to foreign persons, including interest paid on other debt instruments.

Question 7. Earlier in its tenure, the Bush Administration agreed to give the EU and its WTO-inconsistent regime for licensing banana imports more than five years of transition. Given this precedent, what length of transition relief do you feel would be appropriate for American users of ETI?

Answer. The issue of transition relief in connection with the current-law ETI provisions is an important one. Compliance with the WTO rules will require repeal of the ETI provisions, which were enacted in 2000 to replace the prior-law FSC provisions. The ETI provisions provide a significant benefit to many U.S. companies and we believe that the required repeal should be coupled with other changes to our tax law that will help enhance the competitiveness of U.S. companies and American workers in today's global marketplace.

Given the significance of the changes that will be made to our tax rules, a period of transition relief for those companies that have made plans and decisions based on the availability of the ETI rules certainly is reasonable. Indeed, transition relief is typically included in this kind of tax law changes. However, the WTO considered the transition relief that was provided in 2000 when the FSC provisions were repealed, subject to transition rules, and the ETI provisions were enacted. The WTO made clear in its opinion regarding the ETI provisions that this transition relief was itself a violation of WTO rules. Therefore, the inclusion of transition relief in the legislation needed to come into compliance with our WTO obligations will require discussion with the European Union. It is not clear what the European Union will be willing to accept in terms of transition relief but the shorter the transition period, the less the risk of retaliation by the European Union.

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. During today's question and answer period, you mentioned several studies that indicate that for every job created overseas by a U.S. corporation creates two jobs in the United States. Could you please provide me with these studies?

Answer. There are two studies that provide valuable information regarding the complementarity between the foreign activities and outlook of U.S.-based multinational corporations and their current and future contribution to the domestic economy. They are: OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, 1998, and Laura D'Andrea Tyson, "They Are Not Us: Why American Ownership Still Matters," *American Prospect*, Winter 1991. My answer mistakenly combined two separate points from these studies which I have corrected below.

The first point relates to the relationship between U.S. operations abroad and exports from the United States. The foreign affiliates of U.S. corporations rely heavily on exports from the United States. When it comes to the export of American manufactured products, U.S. multinationals are their own best customer. Rather than displacing exports from the United States, the international activities of U.S. multinational corporations generate a net trade surplus. The Organization for Economic Cooperation and Development study referenced above finds that \$1.00 of outward foreign direct investment is associated with \$2.00 of additional exports and an increase in the bilateral trade surplus of \$1.70.

The second point relates to the positive relationship between the international activities of U.S. companies and employment and jobs here in the United States. In the Tyson study referenced above, Professor Tyson, former Chair of the Council of Economic Advisors, has pointed out a number of political, strategic, and economic reasons why maintaining a high share of U.S. control over global assets is important to our national interest. These include the fact that U.S. multinationals locate over 70 percent of their employment and capital assets in the United States; that is, over two jobs in the United States for every job abroad and more than \$2.00 of capital assets for every \$1.00 of assets abroad. Their pay and investment per employee in the United States is greater than in either developed or developing countries. Finally, U.S. multinationals conduct a very large percentage of their research and development domestically, which is critical to maintaining our technological leadership.

The bottom line is that the global success of U.S. companies competing in today's economy matters in terms of economic growth and jobs in the United States.

Question 2. During the same period, you mentioned that Treasury agreed that job creation and job retention is one of the primary goals of our international tax system although your testimony was more focused on tax provisions that would benefit U.S. corporations operating overseas. Could you please provide me with any provisions not included in your testimony that you believe would benefit U.S. manufacturing, including costs associated with these options?

Answer. It is important to begin with an appreciation of the fact that multinational corporations' international operations are closely linked to their domestic operations. Over half of U.S. exports are produced by multinational corporations. More than 40% of those exports are sold to foreign affiliates of the U.S. producer. The consequence of that relationship is that changes to the international tax rules under which U.S. multinational corporations operate affects their global competitiveness and, therefore, the competitiveness of their domestic operations. The competitiveness of U.S. exporters also affects the competitiveness of their domestic suppliers, who may not export themselves but, who through their sales to exporters, depend on and are part of the global marketplace. Changes to the international tax rules may have a less direct effect on U.S. operations, but the effect is particularly important in the increasingly global marketplace.

There are also changes that would affect positively and directly U.S. operations, some of which are included in the Administration's mid-session review of the FY 2004 budget. The mid-session review includes several proposals that would strengthen the economy and benefit manufacturing, including several proposals that would provide incentives for investment and innovation. For example, it would make the following provisions permanent: the reduced tax rates for dividends and capital gains enacted under JGTRRA at a cost of \$57 billion and \$44 billion, respectively, for FY 2003-13; the increase in the amount of investment that may be expensed at a cost of \$24 billion for FY 2003-13; and the research and experimentation tax credit at a cost of \$68 billion for FY 2003-13.

Other areas of business taxation merit consideration, and many of them have been included in various bills introduced to address the need to bring our tax law into compliance with the World Trade Organization rules on export subsidies. They

include the following: (1) Reduce corporate income tax rates in order to boost profitability, such as the tax rates that largely apply to small and medium-sized enterprises; (2) Reduce the burden of the corporate alternative minimum tax (AMT), such as by reducing or eliminating the AMT depreciation adjustment, expanding taxpayers' ability to use losses and foreign tax credits to reduce AMT tax liability, and increasing the number of small corporations that are exempt from the AMT; (3) Extend the NOL carryback period beyond two years so that taxpayers who experience losses have the ability to increase their cash flow through the refund of income taxes paid in prior years; (4) Shorten depreciation recovery periods where tax depreciation may be slower than economic depreciation, such as for certain real estate; and (5) Simplify tax rules to reduce compliance burdens, such as rules related to cost capitalization and long term contracts. These changes would have a particularly positive effect on cyclical and capital intensive industries, such as manufacturing.

PREPARED STATEMENT OF H. DAVID ROSENBLOOM

Mr. Chairman and Members of the Committee: Thank you for the opportunity to express my views on "U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations."

My name is David Rosenbloom. I am an attorney engaged in the private practice of tax law and have specialized in the field of international taxation for nearly 30 years. I was International Tax Counsel at the United States Treasury Department from 1978 through early 1981. I have taught international taxation at five U.S. law schools and at educational institutions in many foreign countries. I am presently Director of the International Tax Program at the New York University School of Law and a lecturer at the Faculty of Law of the University of Sydney, in Sydney, Australia.

It is commendable that the Committee is focusing specifically on tax policy relating to international, or cross-border, taxation. This is a complex subject and, all too often, it has become a stepchild in the midst of larger, more general tax legislation. My intent today is to describe a context in which the international tax issues facing the Committee might be considered.

I am, of course, aware of the pressures to reduce the burden on taxpayers in the international area, as in others. Such pressures always exist, and often stem from justified and well-documented concerns. There are, however, other important facets to tax policy in addition to tax reduction.

No reasonable person would oppose the goal of maintaining competitiveness of U.S.-owned foreign operations. It is surely in the interest not only of the owners themselves but of the nation as a whole for U.S. business enterprise to prosper in the international arena. The real question, however, is exactly what international competitiveness implies for tax policy. If it implies rules that guarantee the ability to stand toe-to-toe on the proverbial level playing field with foreign firms pursuing active business endeavors, that is one thing. If it implies adopting in U.S. law the most taxpayer-favorable provisions from the laws and practices of every other industrialized country, that is quite a different proposition.

The present international tax rules of the United States can certainly be improved and, in the process, the competitiveness of U.S.-owned foreign operations enhanced. The inbound aspects of those rules, relating to foreign persons investing in the United States, date for the most part from 1966. The outbound aspects relating to controlled foreign corporations—a focus of today's hearing—were adopted in large part in 1962. Much has obviously changed in the interim, and all aspects of the rules could usefully be re-thought. As in other areas of U.S. tax policy, the substantive reach of our rules has come to exceed by far the grasp of tax administration, with the result that the law is much more intricate and bewildering than either necessary or desirable.

My personal preference in regard to outbound taxation would be to revamp the rules completely in the name of simplicity, administrability, fairness, and competitiveness. This would lead to far more sweeping changes than are presently being contemplated. Among the concepts I would favor would be: (a) a targeted exemption system for active business income earned in developed countries and other countries with acceptable tax systems, whether that income is earned in a foreign corporation or not; (b) a tightening of rules with respect to income not attributable to an active business and income derived in, or through the use of, tax havens; (c) the flexibility through international tax treaties to tailor the basic rules to fit particular circumstances; and (d) a broad authorization to the Internal Revenue Service to ensure that the new rules do not allow, but rather actually deter, tax sheltering activity.

The United States has always been a leader in international taxation, not a follower. When we adopted legislation with respect to controlled foreign corporations in 1962, we stood alone in the world. Last week I attended a conference in Austria where representatives of a number of countries discussed recent developments in CFC legislation and related case decisions in Italy, France, Finland, the United Kingdom, Sweden, New Zealand, Australia, Canada, Germany, Austria, Japan, Norway, and several smaller countries. The CFC rules in these countries are all modeled to some extent on the U.S. rules from 1962, though they differ from ours in various respects.

It appears that most countries that have adopted CFC laws have employed either a "black list" or a "white list" to classify countries. This classification has been used to identify home country shareholders that are taxed on income of controlled foreign corporations in "black list" countries and that benefit from deferral of taxation in "white list" countries. In my view, this general approach is something the United States should consider. The implicit judgment in our law that all foreign jurisdictions are alike is strikingly incorrect and leads to substantial problems both in the rules we adopt and in their application. There are doubtless political implications to making distinctions between countries, but we appear capable of making such distinctions in other areas and I see no reason why the tax area is unique.

In any event, it is clear that the trend in the rest of the world is toward tightening home country taxation of foreign operations and foreign income, particularly operations and income in tax havens. In these circumstances especially, the Committee should take time to consider carefully where the all-important lines between current taxation and deferral should be drawn. I urge you not to rush, in the name of competitiveness, to surrender segments of the U.S. tax base without at least considering countervailing measures with respect to income that is not active business income and income benefiting from a tax haven regime.

For 1998, the Revenue Service received reports with respect to approximately 46,000 controlled foreign corporations owned by approximately 1,750 domestic corporations, as well as with respect to controlled foreign corporations owned by individuals. There are probably also many CFCs for which there has been no reporting. Thus, CFC legislation is not relevant only to the Fortune 500. Many CFCs are not engaged in active businesses, many are located in tax haven jurisdictions, and many cannot make any reasonable claim to a competitiveness concern. There is unquestionably a "tax shelter" component to CFC planning and implementation. I am concerned that the legitimate competitiveness interests of some companies may carry on their coattails unjustified benefits for persons whose foreign "operations" would be deemed unworthy of protection by just about everyone.

A great deal of the recent discussion of outbound international tax policy has focused on how we tax the income of controlled foreign corporations, but our foreign tax credit rules are, in my view, even more problematic. Excruciatingly complicated, interpreted and reinterpreted in ways that can defy understanding, these rules are now the province of a very limited group of specialists. It is largely for that reason, as well as my understanding that little revenue derives from the taxation of foreign active business income, that I would favor exemption of such income when it is earned in jurisdictions that have real tax systems comparable in some way to our own.

My comments have focused on controlled foreign corporations. There is much to be said in addition about joint ventures and other outbound issues, including special industry and special jurisdiction questions, transfer pricing, source rules, and the relationship between statutory law and international tax treaties. As I have indicated, my preference would be to re-think all these matters before undertaking more piecemeal reforms, but I recognize that may not be practical. In the circumstances, I recommend that the Committee proceed carefully, considering tightening along with loosening, and that it strive to do no harm to an existing and functioning U.S. international tax system that, truly, is not so bad.

In fact, although that system can surely be improved, it is wrong to emphasize the dysfunctionality of the present rules. Those rules have served the country well for more than 40 years, and, in that time, I have not noticed any terrible deterioration of U.S. economic interests. Particular aspects of the rules have, on occasion, produced distortions, but the distortions have been identified and eventually removed. There have also been some anecdotes relating to the general burden that the rules impose, but there will always be anecdotal evidence of the adverse effect of tax rules.

I think it important to recognize that there is no other tax system in the world that *works* better than, or even as well as, the present U.S. system: it touches the lives of more than 150 million people year in and year out, and does so with virtually no corruption, surprisingly little error, and remarkable efficiency, given the

scope of the system and the complexity of our national economic life. Both the system as a whole and the agency that administers it are national treasures—the envy of just about every other country that has devoted serious thought to these subjects. In my judgment these sentiments apply to the international aspects of the system no less than to the rest of it.

Such are the principles I think should inform any fresh view of the important subject of today's hearing. The moment appears to offer one of the rare opportunities in my professional lifetime for Congress to take such a fresh view and consider genuine international tax reform. I hope it will do so.

I would be pleased to respond to any questions that Members of the Committee may have.

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August 7, 2003

VIA E-MAIL & U.S. MAIL

Mr. Brad Cannon
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Cannon:

This is in reply to a July 30 letter from Chairman Grassley requesting that I answer a series of questions posed by him and Senator Hatch. The questions, and my answers to the questions, are enclosed.

Sincerely,



H. David Rosenbloom

HDR/nmo
Enclosures

QUESTIONS

From Senator Charles E. Grassley

Question 1. You urge us not to surrender our tax base in the name of competitiveness without focusing on measures to combat passive income hidden in tax havens. Do any of the proposals you heard during the hearing possibly enable tax haven activity?

Answer: Of course. Tax haven activity is what the core proposals (to eliminate foreign base company sales and services income and to allow repatriation of earnings at a tax rate of 5.25 percent) are all about. Companies want to engage in more tax haven activity; Treasury wants to enable them to do so. Most taxpayers do not need new rules in order to operate competitively in, or repatriate profits from, high-tax countries like France, Germany, the United Kingdom, or Japan.

I would, however, distinguish between “tax haven activity” and “passive income” in tax havens. In general (there are exceptions), the proposals are not intended to alleviate U.S. taxation of what we normally think of as passive income (such as portfolio dividends, interest, royalties, etc.). They are intended to alleviate U.S. taxation of other income from tax haven activity. See the answer to Question 13.

Question 2. Your testimony seems to indicate that foreign tax credit issues should take priority over subpart F issues. Is that correct, and if so, why?

Answer: That is not correct. I did not intend to establish priorities between foreign tax credit issues and subpart F issues, except in the following sense: Discussions of outbound issues have tended to focus on subpart F, which has always been a highly contentious subject; I think the credit receives too little attention as a source of problems. The two sets of (interrelated) rules form the backbone of our present system for taxing outbound investment and, I believe, should be reconsidered in tandem.

Question 3. You state that we derive little revenue from foreign active business income. Please expound on this statement.

Answer: I am neither an economist nor a revenue estimator, and I do not have access to tax return data except in the form of summaries regularly published by the Revenue Service as Statistics of Income. However, my understanding from informal discussions and economic papers I have read is that tax revenues falling in the general "basket" of the foreign tax credit limitation are small — under \$10 billion per year according to the most recent available data. A great deal of those revenues are (a) royalties and (b) foreign source export income — so-called section 863(b) income. Neither of these types of income is what I would consider foreign active business income in my view, although the classification of some royalties could be debated. Tax revenues attributable to dividends are under \$1 billion per year, and revenues attributable to non-passive subpart F income are probably about the same.

Question 4. How would an exemption system work for foreign active business income? Please integrate this with your idea of a good list and bad list of acceptable tax countries.

Answer: I developed some thoughts on an exemption system in From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, XXVI Brooklyn Journal of International Law 1525 (2001), a copy of which I enclose. The article was intended to initiate a debate; I know that various issues need to be further developed. In addition, my ideas have evolved in some respects since the article was written, though not in general.

I favor exemption for active business income earned in jurisdictions having a “real” income tax system, whether that income is derived by a branch or a controlled foreign corporation. I would recommend taxing all other income currently — both income earned in other jurisdictions and income not qualifying as active business income (*i.e.*, passive income). I would use a “white list” of countries to define an “exemption zone” and the familiar tax treaty concept of income attributable to a permanent establishment to define what is meant by foreign active business income qualifying for exemption.

In identifying countries having a “real” income tax system I would not be guided by tax rates alone. Rather, I would look to countries that seem to be imposing a genuine income tax at a reasonable level on business activity within their borders. The identification process would not be either so vague or so hard as it may sound. The vast majority of countries qualifying for the exemption zone would be easy to name. There should be little difficulty (not no difficulty) with most of Europe, various countries in Latin America, South Africa and several other African countries, Japan, Korea, and many other countries in

Asia. Active business income in these countries would be exempt both when earned and when repatriated. (Of course, related expenses would not be deductible and there would be a toll charge on transfers of appreciated assets into the exemption zone.) Income earned in countries not on the list and passive income not qualifying as active business income would be subject to U.S. taxation when earned regardless of how many layers of corporate solution there were between the U.S. taxpayer and the income. There would be close cases — countries whose classification would be difficult. I would have two inclinations for these cases: (1) I would err on the side of favoring exemption, if only on a tentative (temporary) basis; and (2) I would rely on the U.S. treaty network, which is much more flexible than legislation, to expand the basic list of countries in the exemption zone, to review the zone from time to time, and to provide limits in some cases (perhaps to certain industries) within which exemption would be available. The policy goal in all cases would be to provide complete exemption for genuine business activity not carried on in a tax haven.

Question 5. You say we should not necessarily adopt the most taxpayer favorable practices of other industrialized countries. Treasury testimony states that if another country is doing something to improve its international competitiveness, then the U.S. should match those moves to keep itself competitive. Would you discuss your difference in view?

Answer: I think the United States should lead, not follow, in the area of international taxation. Therefore, as a matter of principle I am skeptical about copying tax provisions from other countries. Moreover, it is fundamentally misconceived to extract particular provisions from other countries' tax systems for importation into the U.S. system. Every country's tax system is an integrated whole, containing taxpayer-favorable and taxpayer-unfavorable aspects. Many proposals to "reform" the international tax rules of the United States point to specific rules that other countries have adopted; aspects of those other countries' tax systems that are not so favorable to taxpayers are usually disregarded. If the United States "cherry picks" favorable rules from other countries, we will end up with a system that is more favorable than any other single country. Why should the United States want such a system?

In that connection, I doubt very much that U.S. companies are suffering economically as a result of U.S. tax rules by comparison to companies resident in other countries. A glance at the daily business pages suggests that U.S. companies have more than kept up with the rest of the world, through good times and bad. Furthermore, if the U.S. international tax system is so unfavorable to U.S. companies, it is hard to understand the enormous multinational enterprises that company representatives have described to the Committee as being endangered by our "noncompetitive" rules. If the rules are so bad, how did the companies grow so large? The proposal to tax repatriated earnings at a 5.25 percent

rate is claimed to bring home hundreds of billions of dollars. How did disadvantaged U.S. companies earn so much abroad under the present U.S. rules?

Finally, I believe the real competitiveness problem facing U.S. companies is aggressive tax planning and aggressive transfer pricing by other U.S. companies. Most of the international "reforms" currently under discussion will make the problem worse.

Question 6. Could you explain how a “black list” or a “white list” might work with respect to controlled foreign corporations? Could you give examples of countries that might appear on such lists?

Answer: I have attempted to explain how a “black list” or “white list” might work with respect to controlled foreign corporations, in the answer to Question 4. For various reasons, a “white list” is probably more acceptable than a “black list,” which might be seen as carrying a suggestion of disapproval. In compiling a white list my inclination would be to begin with the U.S. treaty network, discarding certain jurisdictions (as was done in the Jobs and Growth Tax Relief Reconciliation Act of 2003) and possibly assigning some jurisdictions for further analysis in the treaty negotiation process. I would be inclined to include in the list certain non-treaty countries where there is a U.S. investment presence and a genuine income tax system (*e.g.*, Brazil, Argentina). My white list would easily encompass the vast majority of countries where there is substantial U.S. investment.

I am under no illusion that the process of compiling a white list would be easy. There are treaty jurisdictions that would raise issues (for example, Ireland, which has a 12.5 percent corporate tax rate) and there are jurisdictions where there is substantial U.S. investment but that are not treaty countries and may not have a tax system that would meet the standard I propose (for example, Nigeria). However, the process of treaty negotiation could be used to broaden an initial list and perhaps to place certain limitations on exemption established through such negotiations. (It has long been a source of puzzlement to me that the United States has not used its treaty program as a more coherent part of its international tax policy.)

Question 7. Apart from providing exemption to active income in certain counties, what other changes would you recommend in the U.S. international system?

Answer: If Congress is interested in international tax reform, I recommend that it concentrate, first and foremost, on relieving the administrative burden on the Internal Revenue Service. This can be done by a combination of (a) simplifying the rules as much as possible by limiting elections and alternatives and (b) according the Service enough resources to perform its job. (I would also recommend careful exploration of the possible use of the private sector in applying the tax laws.) No other goal comes close to this one in importance. The Service does not have the information or resources to administer the statute as it stands. The "reforms" that have been proposed would place substantial additional pressure on the Service, particularly in regard to transfer pricing.

Insofar as specific recommendations are concerned, I will address inbound issues, which are a substantial piece of the picture, in the answer to Question 12. Other pieces appear in my answers to Question 8 and to Senator Hatch's Question 2.

The rules relating to individuals have many discontinuities and gaps, and I believe that application of the international rules to individuals is a subject that merits more attention than it usually receives. For example, I would deal more forcefully with foreign trusts most of which I believe are simply devices for tax avoidance. In addition, I think the anti-abuse measures presently in the Code (Personal Holding Company rules, Foreign Personal Holding Company rules, Foreign Investment Company rules, Passive Foreign Investment Company and Qualified Electing Fund rules) should be combined into a unified statutory framework.

The treatment of income in possessions and territories such as the Virgin Islands, Guam, and the Northern Marianas, deserves further review and, in all probability, revision.

On a broader canvas, the source rules (particularly for sales of tangible personal property, rents and royalties, and income from derivative contracts) should be revised to make them (a) more defensible as an economic matter and (b) easier to administer. (The source rules are intended to operate in a "neutral" manner, defining the boundaries of potential U.S. taxation but not themselves imposing tax; tax rules, exemptions, and exceptions should fall in sections 871, 881-882, and related sections.)

In addition, I think the arm's-length method of policing transfer pricing is nearly random in its application. My inclination would be to move, though probably not entirely, in the direction of more formulary methods.

There are doubtless other areas worthy of careful review (the outbound regime of section 367 and the treatment of related party debt come to mind), but I do not have a recommendation to offer at this time in these areas.

Question 8. You suggest giving IRS authority to deal with tax shelters and other potential abuses; how would you recommend that that be done?

Answer: As a matter of legislative methodology, I believe Congress should outline, as clearly as possible, the objectives that it wishes to pursue through the statute (including its position on shelters and abuses) and then allow the Revenue Service flexibility to deal with transactions consistent with the Congressional purpose. Section 9722 of the Internal Revenue Code, relating to “sham transactions” in Chapter 99 of the Code (coal industry health benefits), provides as follows:

If a principal purpose of any transaction is to evade or avoid liability under this chapter, this chapter shall be applied (and such liability shall be imposed) without regard to such transaction.

If a provision like this is suitable for Chapter 99, I see no reason why it is not equally suitable for the entirety of Title 26 (by substituting “title” for “chapter” in the statutory language quoted above). If the language is deemed too open-ended for such general application, a requirement of implementing regulations might be added. This approach would be vastly preferable to Congressional efforts from time to time to identify particular abuses and address them individually. That has proven to be a huge waste of Congressional time and energy and merely a way of forcing taxpayers to move from one type of abusive transaction to another.

Question 9. You suggest some tightening together with some loosening; could you give some specific examples?

Answer: This question appears to be the same as Senator Hatch's Question 2. Please refer to my answer to that question.

Question 10. You suggest that the international trend is toward greater home country taxation of foreign income and foreign operations; do you have any specific examples?

Answer: Yes. Rather than reiterating material from my testimony I am enclosing Chapter 2 and the Appendix from Daniel Sandler's book, Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries (London: Kluwer Law International, 1998). Professor Sandler is on the Faculty of Law of the University of Western Ontario, in London, Ontario. As of 1998 he identified 18 countries with CFC legislation. In 1986 there were six; in 1962, there was one (the United States). Today, there are approximately 25. Surely this is a trend. Furthermore, the notion that we are alone in taxing what the United States refers to as foreign base company income of CFCs appears to be false. (Other countries simply use different terminology.)

Question 11. You say that a number of other countries have adopted CFC rules; do you know what kinds of issues have arisen under those rules?

Answer: I do not know the specific interpretative issues that have arisen in those countries but, as the material authored by Professor Sandler indicates (see answer to Question 11), many countries have engaged in legislative revisions of their first essays in this area. Those revisions, I assume, stem from issues that have come up in the political process in the countries in question. (For examples of such issues I enclose portions of a chapter from a recent report by the Board of Taxation, an independent advisory body, to the Australian Government on potential revisions of that country's CFC rules; the Government has agreed to some, but not all, of the proposed revisions.)

I do know that a number of countries that have adopted CFC rules face two types of issues that we do not face in the United States: implications for tax treaty commitments and consequences under the jurisprudence of the European Court of Justice interpreting the European Community Treaty. We are obviously not concerned (directly) with the latter issue. And insofar as tax treaties are concerned, the unique "saving clause" that appears in all U.S. income tax treaties reserves to the United States the right to tax U.S. persons as if the treaties had not gone into effect, with certain limited exceptions; since we do not surrender the right to tax U.S. persons, there are no treaty issues that arise for us as a result of our CFC rules.

Question 12. What changes would you recommend insofar as inbound international taxation is concerned?

Answer: The rules here are far less developed, and have received much less interpretative attention, than the rules relating to outbound taxation. Moreover, the inbound rules call for considerable judgment in their application to particular facts, and this has proved difficult for tax administration. In addition, problems arise from the difference in terminology between the statute and the treaties. At a minimum, I would change domestic law so that it coincides, or at least more clearly meshes, with the language used in the treaties, and so that there are no interstices into which income and transactions can fall. In addition, the “effectively connected” rules are unique in the world and have some peculiar aspects: they both overinclude income (through the “residual force of attraction” rule of section 864(c)(3)) and they underinclude income (by reaching only limited categories of foreign source income under section 864(c)(4)). I would change both points. Although I would want to carefully consider the alternatives, I probably would favor entirely dropping the “effectively connected” concept, which was based on our understanding of European law in the 1960s, but which today seems rather quaint.

In addition, our taxation of non-business income at source is no longer synchronized with our taxation of U.S. persons, and the relationship should be re-established; that would mean, at a minimum, a reduction in statutory rates.

Question 13. Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y resells the widgets (without changing them) for 125 to unrelated parties in the United States and throughout the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States currently tax that 25? Why or why not?

Answer: In my view it should. The United States has taxed that 25 of income for 41 years on the theory that there is no compelling reason for the income to be lodged in Bermuda since there is no manufacturing or ultimate sales activity there. (If there were sound economic reasons for the sales office to be in Hamilton, the office would be situated there even if there were no tax savings from doing so.) Here are the considerations:

(a) Current Treasury proposals would have the United States forego taxation of the 25. If those proposals are enacted, the fact pattern described in the question will become extremely common and will not be limited to companies that have employed it in the past or that presently have operations outside the United States; there will be a hard-to-gauge revenue loss attributable to income presently earned in the United States, and there will be a loss of U.S. employment (those hires in Hamilton are not likely to be U.S. persons because (i) it is hard to persuade most Americans to live and work outside the United States and (ii) Americans are expensive);

(b) There will be substantial added pressure on tax administration; the 25 earned by Y is defensible according to the question but, in the real world, that figure (a

function of the transfer price between X and Y) will have to be tested; companies will have a strong incentive to push the 25 higher by having Y sell widgets for less than 100; they will tend to transfer intangible assets to Bermuda and shift risks there in an effort to make the proper transfer price very difficult to determine;

(c) Sales back to the United States are especially problematic, but they illustrate a more general problem; there is no compelling reason why Bermuda has been inserted in the business cycle here; it captures a slice of profit that might otherwise be earned in the United States;

(d) The argument in favor of not taxing the 25 earned by Y is that, if there is no U.S. tax, there will be more widget sales by X, and that could mean more manufacturing jobs in the United States; that argument, however, would support exemption of income attributable to a 200-employee sales office in Des Moines; it is hard to see why U.S. tax policy should encourage a U.S. company to move its sales function outside the United States in order to obtain a reduction of its taxes;

(e) exempting the sales function anywhere is a peculiar way of boosting U.S. employment; a general reduction in the corporate rate would benefit more companies, operate more equitably, and be more understandable to everyone; it is hard (for me at least) to see why Congress should favor one type of U.S. employment over others;

(f) If the facts are changed so that the widgets are manufactured and sold to Y by Z, a wholly owned German subsidiary of X with a widget factory in Munich, the result under present law would be the same: U.S. taxation of the 25 earned in Bermuda; the argument for eliminating U.S. tax in this situation is probably stronger than in the situation

described in the question but, again, the argument for surrendering U.S. taxation would still be much stronger for sales with ultimate consumption outside the United States than for sales back to the United States.

From Senator Orrin G. Hatch

Question 1. Professor Rosenbloom, I agree with you that the foreign tax credit rules are a real problem. Congress created too many of these provisions in pure revenue grabs, without thinking about how this hurts U.S. jobs and U.S. incomes. First, do you agree with me that the goal of the foreign tax credit should be to eliminate, as much as practicable, the double taxation of foreign earnings? Second, can you go into a little more detail on two or three of the most pressing issues for foreign tax credit reform?

Answer: I do not endorse the suggestion that many of the foreign tax credit rules were “pure revenue grabs.” In my judgment the culprits here have been (a) a tendency to extend principles to their logical extremes without paying sufficient attention to practical implications and (b) disregard of the limits of tax administration. The rules have sometimes, quite unexpectedly, produced revenue gains, which have then made the rules difficult to alter.

Nevertheless, I do agree that the goal of the foreign tax credit should be to eliminate, as much as practicable, the double taxation of foreign earnings. The problem is how to define “foreign earnings.” With only limited exceptions the United States has generally maintained control over critical definitions in our tax law. I think this is sound policy, but it will inevitably produce situations in which other countries — Tanzania, to take a published example — define the earnings they consider foreign (and thus theirs to tax) in a way that differs from the U.S. definition. In such cases there are dangers of double taxation because of a difference in view as to what are foreign earnings. Tax treaties attempt to deal with these problem cases and, by and large, have been successful. But there are many countries with which the United States has not been able to conclude a tax treaty (for example, Tanzania).

Other (interrelated) problems with the present foreign tax credit rules are that they extend beyond the tax administration capabilities of the Internal Revenue Service; they distort taxpayer activity in a variety of ways; they create a tremendous compliance burden; and in the hands of persons knowledgeable about the rules, they produce results that are superior to an exemption system. It is partly for that last reason that I would favor serious consideration of exempting foreign active business income — income attributable to real business activity in a jurisdiction having some similarity, from the standpoint of taxation, to the United States.

I would identify the following as the most pressing issues for foreign tax credit reform — assuming the United States is to retain a foreign tax credit system for avoiding international double taxation:

- (a) Reduce the number of foreign tax credit limitation baskets to two or, at most, three;
- (b) Revise, simplify, and liberalize the rules governing the deemed paid credit, and eliminate technical restrictions on claiming the credit, but also enact a “use it or lose it” rule under which foreign taxes would cease to give rise to credits if they have not been reported on a U.S. tax return (as a result of a repatriation) within, say, five years of the year in which they accrued;
- (c) Eliminate the carryback of foreign tax credits;
- (d) Revisit the allocation and apportionment rules so that they are less vague and more prescriptive (*i.e.*, they say what should be done, not the factors that might be considered); in apportioning interest or other expenses I would be inclined not to take into account expenses of foreign affiliates (too difficult to administer in light of foreign currency

effects, hybrid debt, and other aspects of operations abroad). However, if that choice is made, I recommend mandating it and not making it subject to an election.

Of these suggestions, the last is by far the most contentious.

Question 2. Professor Rosenbloom, you mentioned the Committee ought to be thinking about how to tighten the rules along with loosening them. Can you be more specific about your thinking here?

Answer: I assume this question is aimed at what I would recommend short of the type of thorough overhaul of the outbound rules that is my preference.

The most glaring problem with subpart F is its lack of flexibility. The statute was drafted at a time when Congress was not in the practice of giving regulatory authority to the Revenue Service to interpret rules in accordance with their purposes. As a result, the statute is ossified: frozen in time and suited to deal with the problems that Congress foresaw (and it foresaw a great deal) in 1962. Changes have required legislation, and this has always been very cumbersome. If reform is in the air, I would think reform should come with an articulation of purpose and a mandate to the Revenue Service to adopt rules necessary to deal with transactions not consistent with that purpose.

In addition, if reform is undertaken in the name of competitiveness, I think Congress should express disfavor for foreign activity and income that cannot legitimately lay claim to a competitiveness concern. This would certainly include activity and income that is passive and most, if not all, tax haven activity and income. There is a large "free rider" problem in subpart F and other outbound rules. The multinationals do not own subpart F, and I think there are substantial numbers of undeserving cases that benefit under the present rules and that would benefit more from their loosening.

In line with these general comments, I suggest the following:

(1) provide the Revenue Service with authority to issue regulations aimed at furthering the purposes of any reform, including taking steps to address situations inconsistent with those purposes;

(2) adopt a general “branch rule” (not limited to foreign base company sales income) along the lines of — but not as mechanical as — section 954(d)(2);

(3) change the references to place of creation or organization in section 954(c)(3)(A) so that the reference is to the standard of residence used by the foreign country for its own tax purposes;

(4) address and clarify in the statute the “substantial assistance” issue relating to foreign base company services income (currently dealt with only in the regulations), if rules relating to such income are retained;

(5) allow the Revenue Service to designate other types of income to be added to the list of identified types of foreign personal holding company income in section 954(c);

(6) if any foreign base company sales income rules are retained, address the issue of contract manufacturing, which presently represents a large hole in the statute.

Finally, in view of the fact that the international tax rules are extremely complicated, and that revising them is a complex, difficult, time-consuming task, my most general recommendation would be to convene a formal committee of experts to consider changes in those rules.

CHAPTER 2 CONTROLLED FOREIGN COMPANY REGIMES

The Appendix to this book provides a brief summary of the salient features of the CFC provisions in the eighteen countries that have enacted such legislation. This book does not review the various regimes in any detail.¹ However, a number of general comments can be made. In many of the countries concerned, the CFC provisions probably form the most complex part of an already complex revenue code. Certain countries, such as France, use broadly worded provisions that can give rise to significant uncertainty. However, even in France, there are few court decisions that concern the interpretation of the CFC legislation that has now been in place for over 15 years. In Canada, which has had CFC legislation for almost 25 years, there have been relatively few cases interpreting the provisions.² In Japan, there has only been one reported court decision concerning the CFC provisions.³ The possible reasons for this dearth of jurisprudence are discussed in Chapter 7.

The number of countries, particularly OECD member countries, that have adopted CFC legislation has increased dramatically.⁴ A number of commentators have questioned the validity of the legislation in certain jurisdictions, at least insofar as it potentially conflicts with tax treaties entered into by the country concerned.⁵ The CFC regimes in countries that are

¹ The most comprehensive review of CFC legislation is found in Arnold (1986). He reviewed the legislation in the only countries that had such legislation in 1986: Canada, France, Germany, Japan, the United Kingdom and the United States. His book contains a more complete account of the history of the CFC legislation in those countries. Further analysis of the legislation found in other countries since that time, and amendments to the legislation in the six countries Arnold reviewed can be found in the various texts and articles in the Bibliography.

² Recent decisions include *Alexander Cole Limited v. MNR* [1990] DTC 1894 (Tax Court of Canada); *Canada Trustco Mortgage Company v. MNR* [1991] DTC 1312 (Tax Court of Canada), currently on appeal to the Federal Court Trial Division (Appeal No. T-589-92). Both cases concerned the issue of whether the income from certain activities constituted "active business income" (previously, an undefined term), and was therefore exempt from the application of the CFC provisions.

³ Tokyo District Court, decisions dated 19 September 1990 (1368 Hanrei Jiho 53); appeal dismissed by the Tokyo High Court, 27 May 1991. See discussion in Tokuoka and Takagi (1991).

⁴ In the three years since the first edition of this book was published, the number of countries with CFC legislation increased from 10 to 18.

⁵ In the United States, the issue was raised in 1964 by Beemer (1964). A number of articles have suggested that France's CFC provisions, or at least certain aspects of it, may be contrary to France's tax treaties; see, for example: Kiernan (1991-92), Dargahi (1991, p. 15), de Waal (1994) and Douvier (1995). The validity of Denmark's CFC legislation has also been questioned: see Pedersen (1995). Baumgärtel and Perlet (1995, p. 79) suggest that Germany's PFIC legislation may contravene its tax treaties but for the

members of the EC may also be subject to attack as being contrary to certain provisions of the EC Treaty.⁶ There have been only three cases (two of which are currently on appeal) in which a taxpayer has challenged a country's CFC provisions as being contrary to a tax treaty. These cases are discussed in Chapter 7.

In order to consider the interaction between CFC legislation and tax treaties, it is necessary to have a basic understanding of the various countries' CFC regimes. The general structure of the legislation in all 18 countries is essentially the same: all or a portion of the undistributed income of a CFC is taxed in the hands of its domestic shareholders as the income arises rather than when distributed.

United States

The United States was the first country to enact CFC legislation,⁷ although it has had legislation dealing with "incorporated pocketbooks" since 1937.⁸ The 1962 CFC legislation stemmed from President Kennedy's 1961 proposal to eliminate deferral for virtually all income of controlled foreign corporations. Not surprisingly, the proposal was strongly opposed by multinational corporations. The legislation introduced by Congress was intended to be a compromise. The legislation adopted a transactional approach: only passive income and certain "base company" income of CFCs was attributed to United States shareholders who held at least 10 per cent of the voting shares of the CFC. Many technical amendments have been made since that time, although the original legislation remains largely intact.

Since the introduction of CFC legislation, other anti-haven measures have been enacted, including the passive foreign investment company (PFIC) rules in 1986. The PFIC rules are similar to foreign investment fund (FIF) legislation found in other countries. They are designed to eliminate the benefit of deferral when a United States taxpayer owns shares in a foreign corporation (not necessarily controlled by United States residents), 75 per cent or more of whose gross income is passive or 50 per cent or more of whose assets are passive.

domestic treaty override introduced in the PFIC provisions. Raventós (1995, p. 167) suggests that the compatibility of Spain's CFC legislation with its tax treaties "is an issue which needs to be carefully explored". With respect to CFC legislation generally, see Oliver (1995).

⁶ Magnin and Rautalahti (1995) suggest that the Finnish regime may be subject to attack under the EC Treaty. Baumgärtel and Perlet (1995, pp. 78-79) suggest that the Germany's extended PFIC rules, introduced in 1994, "contradict the purpose of the EC's harmonization efforts". In *Bricom Holdings*, discussed in Chapter 7, the taxpayer indicated that it wished to reserve the opportunity of arguing before a higher court that the application of the United Kingdom's CFC legislation was contrary to Article 52 of the EC Treaty. I raised the problem of the interaction between the United Kingdom's CFC legislation and the EC Treaty in a case note on *R. v. Inland Revenue Commissioners, ex p. Commerzbank AG* [1993] STC 605—see Sandler (1993) at 519. Similar concerns have been raised in France: see, for example, Douvier (1995).

⁷ Now found in subpart F of the Internal Revenue Code of 1986 (the Code), and regulations.

⁸ The foreign personal holding company provisions, now found in Part III, subchapter G, chapter 1 (ss. 551 et seq.) of the Code.

Germany

Germany undertook a review of its taxation of foreign-source income shortly after CFC legislation was enacted in the United States. Germany's 1972 CFC legislation⁹ is based largely on the United States provisions. Like the United States, Germany adopted a transactional approach under which only passive income and certain base company income of the CFC is attributed. It differs from the United States legislation in two primary ways: first, it attributes tainted income to all German shareholders regardless of the size of their shareholding; and second, it limits the geographic scope of the legislation to jurisdictions in which the rate of tax payable by the CFC on tainted income is less than 30 per cent. Passive income is defined as income that is not described in an enumerated list.¹⁰

The German legislation follows a "deemed dividend" approach. Further, AStG s. 10(5) specifically provides that tax treaty provisions applicable to distributed dividends apply to income attributed under the CFC legislation. As a result, German corporate taxpayers could benefit from the participation exemption in certain favourable tax treaties. German corporate taxpayers could also avoid the application of the CFC provisions if the tainted income was earned through a foreign permanent establishment located in a country whose treaty with Germany exempted the income of the foreign permanent establishment from tax in Germany. While most of the newer German double tax treaties contain an "activity proviso" applicable to either or both of the participation exemption and permanent establishment exemption, a number of tax treaties do not.¹¹

Significant changes were made to the AStG by the Tax Amendment Act 1992, which introduced Germany's PFIC rules.¹² The PFIC rules were further amended under the Anti-abuse and Tax Clarification Act, effective 1 January 1994. The PFIC rules serve three primary purposes. First, they remove attributed income that is "income with capital investment character"¹³ from

⁹ Sections 7-14 of the *Aussensteuergesetz* (AStG).

¹⁰ The list is set out in AStG ss. 8(1) and (2).

¹¹ Activity provisos are discussed under the heading "Germany" in Chapter 5.

¹² See, particularly, AStG ss. 7(6), 10(6), and 20(2).

¹³ AStG s. 10(6) defines income with capital investment character as "income of the foreign intermediate company derived from the possession, administration, preservation of the value of, or the increase in the value of, legal tender, receivables, stocks and bonds, shares or similar assets". Originally, there were four exceptions: (i) income stemming from certain listed activities (active activities under the CFC list, excluding investment fund activities) (active business exception); (ii) income from companies in which the foreign company holds a participation of at least one-tenth (holding exception); (iii) income stemming from financing foreign permanent establishments or foreign corporations in the same group (the intra-group financing exception—which is broader than the active financing business exception in the CFC list); and (iv) income representing arm's length income for services rendered by the foreign company (service income exception). The taxpayer has the burden of proof with regard to the exceptions. The intra-group financing exception was amended with effect from 1994. Now, if the taxpayer can prove that the income with capital investment character is derived from financing foreign permanent establishments or companies engaged in an active business (active group financing), 60 per cent of the active group financing income is subject to attribution under the PFIC rules. The remaining 40 per cent of the active group

the benefit of a participation exemption in an applicable tax treaty. AStG s. 10(6) states that AStG s. 10(5) does not apply where attributed income includes income with capital investment character and if the income with capital investment character exceeds the lesser of 10 per cent of the gross tainted income of the CFC or DM 120,000, applied on a per-CFC or per-taxpayer basis. Second, the PFIC rules preclude a German corporation from avoiding the CFC legislation by earning income with capital investment character through a foreign permanent establishment that benefits from a treaty exemption. AStG s. 20(2) specifically provides that double taxation on income with capital investment character derived by a foreign permanent establishment shall be relieved by a tax credit rather than an exemption. AStG s. 20(1) states that this provision shall not be affected by any treaty provision to the contrary. Third, German shareholders that own at least 10 per cent of the shares of a foreign corporation (even if it is not German-controlled) are subject to attribution on income with capital investment character if gross income with capital investment character exceeds either (1) 10 per cent of entire gross receipts of the foreign corporation; or (2) DM 120,000, applied on a per-foreign corporation or per-taxpayer basis.

Canada

Canada's 1972 tax reform introduced "foreign accrual property income" (FAPI) provisions, Canada's CFC legislation. Although enacted in 1972, the legislation did not become effective until 1976.¹⁴ Like the United States, the provisions are transactional based, rather than entity based. The FAPI provisions apply to passive income and certain base company income of the CFC, regardless of its location.

The 1992 Report of the Auditor General of Canada criticized the FAPI rules and led to a study of the regime by the Public Accounts Committee of the House of Commons.¹⁵ In response to the Auditor General's report, the Minister of Finance introduced amendments to the FAPI regime in the February 1994 budget. These proposals were revised twice and were finally enacted in June 1995 with effect from February 1994. The 1995 amendments introduced a number of important changes to the FAPI regime that expanded the income included in computing FAPI: passive income is more clearly defined and the scope of base company income has significantly expanded.

Canada also introduced FIF rules in 1984.¹⁶ Under these rules, if a resident of Canada has an interest in a non-resident entity (not necessarily Canadian controlled) that derives its value primarily from portfolio investments and one

financing income is taxed under the general CFC rules, so that such income is characterized as a dividend for treaty purposes and can benefit from a participation exemption in an applicable tax treaty. Income from group financing of passive activities is fully attributed under the PFIC rules and cannot benefit from a participation exemption in a tax treaty.

¹⁴ Now ss. 91-95 of the Income Tax Act S.C. 1970-71-72, c. 63, as amended (the ITA). These provisions are supplemented by substantial regulations (in Part LIX of the Regulations)

¹⁵ Arnold (1993).

¹⁶ ITA s. 94.1.

of the main reasons for the investment is to significantly reduce the Canadian tax payable on the resident's foreign-source income, the taxpayer is subject to tax utilizing a deemed rate-of-return method.

Japan

Japan adopted its anti-haven measures in 1978.¹⁷ In contrast to the legislation previously introduced in the other countries, Japan's legislation utilizes an entity approach rather than a transactional approach. Either all or none of the income of the CFC is attributed, depending on the location of the CFC and the nature of its income. The original legislation included an exhaustive three-part black list of tax haven countries; unless the CFC carried on predominantly industrial or commercial activities, all of its income was attributed to resident shareholders holding 10 per cent or more of the shares of the CFC. Although the Japanese regime continues to apply an all-or-nothing approach, it eliminated the black list with effect from 1 April 1992 and replaced it with a test based strictly on the comparable effective tax rate in the foreign jurisdiction; at the same time, the ownership threshold for attribution to a resident shareholder was reduced from 10 per cent to 5 per cent.

France

France enacted CFC legislation in 1980.¹⁸ Similar to Japan's CFC legislation, the French legislation attributes all of the income of the CFC, but only to French corporations that own a substantial interest—originally, at least 25 per cent of the shares—in the CFC. The French regime also contains certain exemptions, whereby no attribution occurs if the CFC's operations do not have the principal effect of "localizing" profits in a country in which the CFC is subject to a privileged tax regime. France designates jurisdictions subject to the provisions, although on an unofficial basis; the list is not definitive. France's control threshold was a significant variation from that of the then exiting regimes; the CFC need not be French-controlled for the regime to apply.

France amended its CFC regime with effect from 30 September 1992. The ownership threshold was reduced to 10 per cent and a monetary threshold was introduced so that a foreign corporation is considered a CFC if a French corporation has an investment of at least Ffr 150 million in the corporation. In addition, the legislation was extended to foreign permanent establishments of French corporations in order to counteract abuse of France's territorial regime. The reduction of the ownership threshold aligns the CFC provisions with France's participation exemption for foreign-source dividends. Previously, French corporations that owned more than 10 per cent but less than 25 per cent of the shares of a foreign corporation could benefit from the

¹⁷ Special Taxation Measures Law (STML) articles 40-4 to 40-6 (individuals) and articles 66-6 to 66-9 (corporations). The legislation is supplemented by a number of Enforcement Orders.

¹⁸ Article 209B of the Code Général des Impôts (CGI).

participation exemption but avoid the application of the CFC regime. The extension of the legislation to foreign permanent establishments corrected a loophole in the legislation; previously, the income of a foreign subsidiary of a French parent corporation was attributable to the parent under the CFC legislation but the income of a foreign permanent establishment, even if identical in nature to that of a subsidiary, was exempt from domestic taxation because France taxed its resident corporations on a territorial basis. For structures in existence on 30 September 1992, the 1992 amendments do not apply until 1 January 2003, subject to certain conditions.

United Kingdom

The United Kingdom's CFC legislation was introduced in 1984, following an extended period of consultation that began in 1980. The legislation formed part of the response to the abolition of exchange controls in October 1979. Like the United States, the United Kingdom has had certain limited anti-haven measures aimed at incorporated pocketbooks since 1936.¹⁹ Like Japan's CFC legislation, the United Kingdom's CFC legislation²⁰ attributes all income of particular CFCs in designated jurisdictions subject to a number of specified exemptions. The tax authorities publish an administrative white/grey list of countries to which the CFC regime does not apply or does not apply unless the CFC benefits from certain specified tax incentives.²¹ The legislation only taxes corporations resident in the United Kingdom that hold 10 per cent or more of the shares of the CFC. Capital gains of the CFC are excluded from attribution under the regime, although a similar regime applies to capital gains of certain closely-held foreign corporations.²²

In 1995, the Inland Revenue published a consultative document that proposed significant changes to the CFC regime.²³ The proposals were precipitated by the move to a self-assessment system in the United Kingdom. The proposals included the abolition of the distribution exemption,²⁴ an increase in the ownership threshold for the application of the regime to 20 per cent, a reduction in the amount attributed to an amount based on 80 per cent of the CFC's profits, and the incorporation of the administrative white/grey list into regulations. The newly-elected Labour government announced in its first budget, on 2 July 1997, that it would introduce draft legislation later in the year that would take into account the representations made in response to the consultative document; in particular, the government announced that it would not abolish the participation exemption.

¹⁹ Now TA 1988 s. 739.

²⁰ Now found in Part XVII, Chapter IV (Ss. 747–56) and related Schedules of the Income and Corporation Taxes Act 1988, as amended (TA 1988).

²¹ The most recent list is reproduced in [1993] *Simon's Tax Intelligence* 1304. See further, Chapter 5 under the heading, "United Kingdom".

²² Section 13 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992).

²³ Inland Revenue, 1995.

²⁴ The current distribution exemption is described in the Appendix.

New Zealand

New Zealand reviewed its taxation of foreign source income in a consultative document issued in December 1987 that included proposals for both CFC and FIF regimes. Its CFC legislation became effective on 1 April 1988 to a list of 61 low tax jurisdictions or territories and specified types of companies in nine other countries. The regime became fully effective on 1 April 1993²⁵ after a number of previous postponements.

Unlike the CFC regimes in other countries, New Zealand's legislation applies to all income of the CFC wherever it is located and whatever its business activities or motives for establishment. The intent of the CFC regime is to eliminate any tax benefits that can be derived from foreign investment as opposed to domestic investment. There is a short white list of countries to which the legislation does not apply because the high rate of local tax coupled with New Zealand's foreign tax credit do not make the application of the regime worthwhile.²⁶ The legislation does not contain any exemptions; unless the CFC is resident in one of the white-list countries, all of its income is subject to attribution.²⁷

New Zealand also introduced FIF legislation in 1988. This legislation was repealed retroactively (so that it never, in fact, came into effect) and a new FIF regime was introduced in 1993. The FIF regime complements the CFC regime; together, they are intended to eliminate completely the benefit of deferral of tax on foreign-source income of any resident taxpayer. Two separate regimes are used only for practical compliance reasons. A shareholder subject to tax under the CFC regime must calculate the attributed income on a branch-equivalent basis: that is, an exact calculation of the CFC's income using New Zealand's tax rules. Because exact calculations may not be feasible for shareholders subject to the FIF regime, they have a number of options for determining their share of attributed income, including a deemed rate-of-return method.

²⁵ The primary provisions of the CFC legislation are now found in ss. CG 3-CG 13, GC 7, GC 8 and GC 10 of the Income Tax Act 1994. The legislation was previously contained in Part IVA of the Income Tax Act 1976, as amended.

²⁶ The list of countries is found in Schedule 3, Part A, and the list of tax preferences (which, if used by a Sch. 3, Part A country, causes it to lose its immunity from the CFC regime) is found in Schedule 3, Part B to the Income Tax Act 1994. The list originally comprised seven countries, Australia, Canada, France, Germany, Japan, the United Kingdom and the United States. France was deleted from the list in 1993 and Norway was added in 1996. The current list comprises the following: Australia (except from offshore banking units); Canada (except from international banking centres and non-resident-owned investment corporations); Germany (except for companies benefiting from certain regional tax incentives); Japan; Norway; the United Kingdom (except for companies benefiting from the enterprise zone concession); and the United States.

²⁷ Evidently, the government was at one time considering limiting the application of the provisions to passive income from specified companies: see *Tax News Service* (1991), Vol. 25, No. 1, p. 13, 16 January.

Sweden

Prior to 1990, Sweden had limited provisions aimed at the transfer of capital to tax haven countries, the 1933 “Luxembourg rule”.²⁸ The rule was originally introduced because, in 1933, Sweden did not impose exchange controls. In 1939, exchange controls were adopted in response to the Second World War and were renewed annually until 1989.

With the elimination of exchange controls, Sweden introduced CFC legislation with effect from 1 January 1990.²⁹ As originally enacted, the legislation potentially applied only to CFCs resident in non-treaty countries. The reason for this limitation was unclear, but was unlikely the result of any concern that CFC legislation would be considered inconsistent with treaty obligations. In 1993, the exclusion for non-treaty countries was replaced with a legislative white list of treaty countries. A CFC resident in a listed treaty country is excluded from the regime so long as the treaty provisions afford treaty protection to the CFC. Only Australia, Cyprus, Malta, Malaysia, Spain and Thailand are excluded from the list. The Luxembourg rule was abolished at that time.

Sweden’s regime is similar to that in New Zealand, although it is not as widely applied; all income of the CFC in a non-designated country, without exception, is subject to attribution to resident shareholders who hold at least 10 per cent of the capital or voting power of the CFC.

Australia

In 1987, Australia moved from what was essentially an exemption system to a credit system for foreign-source income of resident corporations.³⁰ Following the announcement by New Zealand, Australia’s closest trading partner, of its intention to introduce comprehensive CFC legislation, Australian revenue officials began to study the regimes adopted elsewhere. The original proposals, somewhat similar to the 1961 Kennedy proposals in the United States, suggested that deferral be eliminated when income of any type is derived by companies resident in low-tax jurisdictions. A strong business lobby criticized the ambit of the proposals. Australia’s CFC legislation, enacted with effect from 1 July 1990,³¹ contained a number of important concessions that made the rules more politically pragmatic, but also much more complex. The regime applies a transactional approach, in that only “tainted income” of the CFC is subject to tax. However, there is no attribution

²⁸ Under the Luxembourg rule, formerly s. 2(12) of the National Income Tax Act, a foreign holding company controlled mainly by Swedish citizens and effectively managed by individuals resident in Sweden was subject to domestic taxation on the same basis as a Swedish economic association.

²⁹ Section 16(2) of the National Income Tax Act.

³⁰ Previously, foreign business income taxed in the country of derivation, interest and royalty income taxed in non-treaty countries, and all dividends from foreign companies were exempt from tax in Australia. Interest and royalty income from treaty countries were subject to tax in Australia in accordance with the treaty provisions.

³¹ Part X of the Income Tax Assessment Act (ITAA).

if a significant portion (more than 95 per cent) of the CFC's profits are from an active business. In addition, the legislation contains a list of "comparable tax jurisdictions": if the CFC is resident in a listed country, the legislation does not apply unless the tainted income of the CFC benefits from designated tax concessions;³² if it does, only tainted income that benefits from such concessions is attributed. Like all of the newer regimes, Australia has added its own features, such as a *de facto* control test, and the distinctions in the nature of income subject to attribution that depend on whether the CFC is resident in a listed or unlisted country.

Australia introduced a FIF regime with effect from 1 January 1993.³³ The FIF regime applies to an Australian taxpayer who has an interest in an offshore fund (any non-resident corporation or trust as well as certain foreign life insurance policies) that holds mainly passive assets. The income of the fund is attributed to the taxpayer at the end of the year in proportion to the taxpayer's interest in the fund at that time. There is no minimum ownership requirement, although there is a *de minimis* exemption where the taxpayer's interests in FIFs do not exceed Aus\$50,000 in the aggregate.

Norway

Norway enacted CFC legislation with effect from 1 January 1992.³⁴ The legislation applies to any Norwegian resident shareholder if Norwegian residents control, in the aggregate, at least 50 per cent of the shares or capital of the CFC. Norway's regime applies an entity approach, although it distinguishes between treaty and non-treaty jurisdictions. It only applies if the CFC is resident in a "low tax country", which is defined as a country in which the CFC pays less than 2/3 of the tax that would be payable if the CFC was resident in Norway. If the CFC is resident in a non-treaty jurisdiction, its income is subject to attribution and no exemptions are available. However, if the CFC is resident in a treaty jurisdiction and is not exempt from treaty benefits, no income is attributed unless the income of the CFC is "mainly" of a passive character.

³² There are 61 listed comparable tax jurisdictions of which 24 contain designated tax concessions: see Schedules 9 and 10 to the Income Tax Regulations. On December 24, 1996, the Treasurer of Australia released an information paper that proposed certain changes to the manner in which Australia taxes foreign-source income. These proposals included the creation of a substantially shorter list of "truly" comparable tax jurisdictions for CFC purposes. The proposed list includes Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States. Tainted income that arises in these countries will only be attributed if it benefits from a designated concession and the active business income test is not met. The paper further recommended that the existing list of comparable tax jurisdictions be retained and updated as a "repatriation list". Non-portfolio dividends and branch profits from repatriation list countries will be exempt from tax in Australia if the foreign-source income is from an active business. See Treasurer of the Commonwealth of Australia (1996). The CFC proposals in the discussion paper were incorporated in the May 1997 budget. The foreign-source income proposals in the budget are discussed in Dirks (1997).

³³ Part XI of the ITAA.

³⁴ Chapter 7 of the Company Tax Act.

Finland

A 1979 government committee report³⁵ proposed the introduction of CFC legislation in Finland. The report was criticized on the basis that the Committee did not determine the extent of the abuse of base companies before its proposals were made. No further action was taken by the Finnish government at that time.

In 1993, the government undertook extensive base-broadening reforms and in 1995 introduced CFC legislation as an extension of such reforms.³⁶ The CFC regime differs substantially from the 1979 proposals. Under the existing regime, either all or none of the income of a CFC is attributed to domestic shareholders; attribution depends first on the residence of the CFC and then on the nature of the CFC's income. The legislation does not apply to CFC's resident in a white list of treaty countries so long as the CFC benefits from the treaty provisions. Otherwise, if the CFC is resident in a tax haven, which is determined by applying a comparative tax approach, all of the income of the CFC is attributed unless the main part of the CFC's income is derived from industrial production in its country of residence; a CFC that is a holding company is excluded only if the main part of its income is derived from a company resident in the same country that belongs to the same Finnish group as the holding company and that carries on industrial production in that country. The Finnish legislation has been described as a "somewhat eclectic collection of ideas found in other countries".³⁷

Spain

Spain originally proposed CFC legislation in a government White Paper on Corporation Tax Reform issued in May 1994 that addressed concerns arising from the internationalization of Spain's economy. As originally proposed, the regime would have been similar to that of France, in that any resident who owned more than 25 per cent of the CFC would have been subject to attribution. The proposals were heavily criticized by the business community, and in the course of Parliamentary debates, a number of significant amendments were made.

The CFC measures were enacted with effect from 1 January 1995.³⁸ The legislation adopts many features of other regimes, although it has also incorporated a number of unique features. The ownership requirement was increased from the proposed threshold of 25 per cent to 50 per cent or more. Accordingly, a foreign company is a CFC only if one Spanish resident, together with related persons, controls, directly or indirectly, the foreign

³⁵ Kansainvälisten yritysten verotustoimikunnan mietintö 1979:4 (An Official Government Committee Report on the Taxation of Multinational Corporations).

³⁶ Act on the Taxation of Participants in Foreign Intermediary Bodies, Act 1217/1994. The decision to enact CFC legislation was likely influenced by the introduction of such legislation in Norway and Sweden.

³⁷ Miherkentä, 1995.

³⁸ Act 42/1994, art. 2 (individuals) and art. 10 (corporations).

company. Only passive income and certain base company income of a CFC is subject to attribution, although if the CFC is resident in a designated tax haven,³⁹ there is a rebuttable presumption that all of the income of the CFC is passive and that the attributed income is equal to 15 per cent of the value of the shareholder's participation (generally based on acquisition cost) of the CFC.

Indonesia

Indonesia introduced CFC measures with effect from 1 January 1995.⁴⁰ Evidently the legislation was introduced in response to concerns about the outflow of capital to tax havens. The legislation applies an entity approach and is applicable only to CFCs resident in a legislative black list of 32 countries. The legislation is extremely brief and is silent on a number of significant issues. The legislation applies if residents of Indonesia own at least 50 per cent of the shares of the CFC and the shares are not traded on a stock exchange. If this is the case, the after-tax profits of the CFC are deemed to be distributed as dividends to the extent that they have not actually be distributed within a prescribed time period. There are no guidelines on how after-tax profits are determined: that is, whether Indonesian tax laws or the foreign country's tax or accounting rules are used to determine such profits.

Portugal

Portugal introduced CFC legislation with effect from 19 February 1995.⁴¹ The regime is jurisdiction based; all income of the CFC is attributed where the CFC is subject to a nominal rate of tax of 20 per cent or less (15 per cent for CFCs resident in Macao). There are alternative ownership threshold tests: first, similar to France's original regime, the legislation applies to a resident of Portugal who controls more than 25 per cent of the shares or capital of the CFC, regardless of whether the CFC is controlled by residents of Portugal; second, if residents of Portugal control more than 50 percent the CFC in the aggregate, those residents holding more than 10 per cent of the shares of the CFC are subject to attribution. Otherwise, the legislation shares many characteristics of the regimes found in other countries.

³⁹ There are 48 designated tax havens, listed in Royal Decree 1080/1991 of 5 July 1991, with effect from 25 July 1991. The designated list was originally developed with respect to other Spanish legislation. Under this legislation, residents of these tax havens that derive income or capital gains in Spain do not qualify for the tax benefits available to non-residents in general or EU residents in particular. In addition, expenses incurred by residents of Spain with respect to services related to transactions carried on, directly or indirectly, with residents in a designated tax haven are not deductible unless the Spanish resident can provide that the expense relates to transactions carried on for valid economic reasons.

⁴⁰ Income Tax Law 1994, art. 18(2). The provision is supplemented by a Minister of Finance's Decree, Number 650/KMK.04/1994, effective 1 January 1995. See further, Hadiyanto (1995).

⁴¹ Decree law no 37/95.

Denmark

Denmark introduced limited CFC legislation in May 1995 as part of a package of international anti-avoidance measures.⁴² The legislation applies if a Danish corporation controls more than 50 per cent of the shares or voting rights of a tax-haven subsidiary that is engaged mainly in financial activities. Only the income from financial activities is attributed to the Danish parent company. The legislation was applicable from 1995, although Danish companies that have existing foreign financial subsidiaries in tax havens will not be subject to the CFC legislation in respect of such subsidiaries until 1998.

Korea

The Republic of Korea introduced CFC legislation with effect from 1 January 1996.⁴³ The legislation is jurisdiction based. A foreign corporation is a CFC if it is related to resident shareholders and is resident in a country in which all or a significant portion of the CFC's income is not taxed or is subject to an effective rate of less than 15 per cent. If the foreign corporation is a CFC, subject to certain active business exemptions, its "distributable retained earnings"⁴⁴ are attributed to residents who own more than 20 per cent of shares of the CFC.

Hungary

In late 1996, Hungary's Parliament approved the introduction of CFC legislation, effective January 1, 1997.⁴⁵ The legislation applies only to CFCs resident in a country that does not impose corporate tax on the income of non-residents or does so at an applicable rate of less than 10 per cent. However, it does not apply to CFCs resident in countries with which Hungary has concluded a double tax treaty. Under the CFC provisions, a corporation resident of Hungary that holds directly or indirectly at least 25 per cent of the CFC for at least 30 days and at the end of the year must include in income dividends received from the CFC. In this respect, the CFC legislation acts as an exception to the dividend exemption provided under domestic law. In addition, undistributed profits of the CFC, determined in accordance with the rules of the foreign country, must also be included in the income of the resident corporation in proportion to its shareholding in the CFC. The CFC provisions are extremely brief and there are numerous questions concerning

⁴² Law No. 312 of 17 May 1995, which introduced new s. 32 into the Corporate Tax Act. Other measures introduced include new section 5e of the Tax Assessment Act, which provides that a Danish company cannot deduct interest on a loan, the proceeds of which are used to generate foreign income that is exempt from Danish tax under a tax treaty. Denmark also terminated its treaty with Portugal effective 1 January 1995 in order to prevent Danish resident companies from using companies established in the Madeira Free Zone.

⁴³ Law for Coordination of International Tax Affairs, Chapter IV.

⁴⁴ See Appendix, under the heading, "Korea, Republic of".

⁴⁵ Law No. 81 of 1996 (LXXXI of 1996) on Corporate Income Tax and Dividend Tax.

the manner in which they will actually apply. One anomalous feature is that no relief is given in respect of dividends subsequently paid out of previously attributed income. In effect, the undistributed profits of the CFC are taxed twice: first in the year in which they arise, and subsequently in the year in which they are distributed.

Mexico

Mexico introduced CFC legislation effective 1 January 1997 as part of its annual tax reform.⁴⁶ The definition of a CFC under the regime is extremely broad and includes any type of investment in a tax haven. The legislation applies to a black list of 65 jurisdictions, generally limited to classical tax havens.⁴⁷ Under the regime, residents of Mexico must include in their income their pro rata share of all income of the CFC.

South Africa

South Africa introduced CFC legislation effective 1 July 1997. Previously, South Africa taxed both individuals and corporations on a source basis. It relaxed certain exchange controls in 1997, and, as a consequence, adopted the residence (worldwide) basis of taxation for investment income. The CFC legislation was adopted at the same time as an anti-avoidance mechanism. A CFC is defined as an entity (including a trust) that is effectively managed outside of South Africa in which residents of South Africa own, directly or indirectly, more than 50 percent of the participation or voting rights. If these conditions are met, all investment income of the CFC (including annuities, interest, rent, royalties, and other similar income, but excluding dividends) is attributed to South African resident participants in the CFC pro rata, unless the foreign tax paid or payable by the CFC on its investment income is more than 85 percent of the tax that would have been payable had the CFC been resident in South Africa. Investment income is not included if it is effectively connected to a "substantive business enterprise" carried on by the CFC through a permanent establishment that is suitably equipped to conduct the principal business of the enterprise. The legislation provides that an excluded countries list can be established, although none has been established to date.

Elsewhere

Countries that have not enacted CFC legislation may have other domestic anti-avoidance legislation that is aimed at similar situations. Two examples are provided here.

⁴⁶ The legislation was introduced in the Law that creates and reforms existing tax laws, published in the Official Gazette, 30 December 1996. The legislation is contained in the Mexican Income Tax Law (ITL) and is distributed among a number of sections.

⁴⁷ For example, the Channel Islands and the Isle of Man are included, as well as the Netherlands Antilles, Hong Kong, Barbados, Bermuda, Cyprus and others. Madeira is included, although the Canary Islands and Corsica are not. Ireland, Luxembourg, the Netherlands, Singapore and Switzerland are not on the list.

Italy

In Italy, under the provisions of the Finance Act of 1992, the government was empowered to introduce CFC legislation within one year. On 29 April 1992, the government published a list of countries to which limited anti-haven legislation would apply. Under the provisions of this legislation, Italian resident companies may not deduct costs or expenses arising from transactions with companies resident in non-EC countries with a "preferential tax regime" unless the resident company can establish either that the principal and actual purpose of the haven company is to carry on an industrial or commercial activity, or that the transactions have a business purpose and have in fact been concluded. A country is considered to have a preferential tax regime if the income of the resident company is not subject to tax or is subject to less than one-half of the Italian tax rate on income of an identical nature. A Ministerial decree lists countries that are considered to have a preferential tax rate. This black list of countries is comprised of three parts: 26 countries considered to be tax havens in all circumstances; countries that are generally considered tax havens except in certain specified circumstances; and countries that are generally exempt except in certain specified circumstances. The legislation is radically different from the CFC legislation in other countries, although it is aimed at similar transactions to those covered in the base company provisions in other CFC regimes.⁴⁸

In 1995, Italy introduced further anti-avoidance legislation applicable to resident companies with foreign business operations that move their residence (or seat) from Italy. In these circumstances, the resident company is deemed to dispose of its foreign business operations at fair market value unless the operations are transferred to a permanent establishment located in Italy.

The Netherlands

The Netherlands has limited measures designed to prevent residents from accumulating passive income in non-resident entities.⁴⁹ Resident individuals are subject to a tax equal to 6 per cent⁵⁰ of the value of their shares in non-resident investment companies that, directly or indirectly, have invested more than half of their assets in portfolio investments.^{51,52} Passive investments

⁴⁸ For further detail, see Manganelli, 1992.

⁴⁹ Individual Income Tax Act of 1964 (IB), Art. 29a introduced in 1970; Corporate Income Tax Act of 1969 (Vpb.), Art. 28b, applicable with effect from 1 July 1990.

⁵⁰ If over 50 per cent of the investment company's assets are property other than debt claims, the tax is 4.8 per cent of the value of the shares. If 70 per cent or more of the assets are in the form of bank deposits, the rate is 7.2 per cent of the value of the shares. If the resident individual can demonstrate that the actual income of the non-resident investment company is less than the applicable deemed percentage, the taxpayer will be taxed on the lower amount.

⁵¹ Portfolio investments is not a defined term in either the individual or corporate anti-avoidance rules. The term derives its meaning from case law and administrative practice. For the purposes of IB, Art. 29a, the general rule is that if the activities of the non-resident investment company do not exceed that of an

include securities, real property, mortgage loans, bank accounts and debt claims (including rights arising out of life insurance agreements). Shares of mortgage banks and insurance companies that are traded on qualifying stock exchanges are exempt from these provisions. The provisions do not apply if the non-resident investment company pays dividends in excess of the deemed income.

Dutch corporate taxpayers are subject to similar anti-avoidance rules. A corporate taxpayer that holds an interest of at least 25 per cent in a non-resident company or other entity whose assets are more than 90 per cent portfolio investments⁵³ must value the interest at its fair market value.⁵⁴ Any increase or decrease in the value of the interest is included annually in the

individual investor who obtains capital gains and regular income from his or her investments, then the assets of the company are treated as portfolio investments.

⁵² The purpose of the legislation is to put non-resident investment companies on par with Dutch investment organizations which are subject to no income tax so long as they distribute all of their income within 8 months after the close of their accounting year and the income is taxed in the hands of the recipient. The value of the investment and the make-up of the assets of the non-resident investment company are determined at the beginning of the calendar year.

⁵³ The term "portfolio investments" has the same meaning as under IB, Art. 29a: see above, fn. 50. Parent companies that perform activities such as decision-making, managing, or financing group companies are generally not considered to hold shares in their subsidiaries as portfolio investments. If the parent company and the subsidiary are involved in the same business, the shares of the subsidiary are not considered to be a portfolio investment. Finally, intermediary holding companies of international groups are generally not considered to hold their non-resident participations as portfolio investments.

⁵⁴ This rule is not generally applicable if the non-resident company is resident in another EC Member State by virtue of the legislation that implements the EC Parent-Subsidiary Directive (90/435/EEC): Vpb., Art. 13g.

taxpayer's taxable income unless the participation exemption applies.⁵⁵ A special flat rate of 15 per cent applies to the first revaluation gain that results from the application of these rules.

⁵⁵ In order for the participation exemption to apply, two conditions must be met: the shares of the non-resident entity cannot be held as a mere portfolio investment; and the non-resident entity must be subject to a national tax on profits, whatever its rate, in its resident country. Because the interest in the foreign entity will unlikely meet the first condition, it is unlikely that Vpb., Art. 29a and the exemption can apply simultaneously.

APPENDIX
SUMMARY OF CONTROLLED FOREIGN COMPANY
LEGISLATION

Adapted, expanded and updated (1997) from Table 23 in Arnold (1986)

The Appendix summarizes the major features of the CFC provisions in the 18 countries that have enacted such legislation as of the beginning of 1997. The Appendix is derived from and utilizes the same analytical framework of Table 23 in Arnold (1986). Arnold's original table provided information on the CFC legislation in the first six countries that adopted such measures, the United States, Germany, Canada, Japan, France, and the United Kingdom. In the first edition of this book, I expanded and updated Arnold's original table to include the 10 countries that had adopted CFC measures by 1994 (the four additional countries being Australia, New Zealand, Norway, and Sweden). The Appendix in OECD (1996) again updated and expanded Arnold's original work (although not in table form) to include the 14 OECD countries that had enacted CFC legislation by 1996 (adding Denmark, Finland, Portugal, and Spain). This Appendix adds Korea, Indonesia, Hungary, and Mexico, the four remaining countries that enacted CFC legislation between 1994 and the beginning of 1997. Due to the number of countries that are described in the Appendix, it cannot be produced in table form. I acknowledge, with thanks, the permission of the OECD to use the Appendix in OECD (1996) as the basis for updating the material to its current form.

Australia***Definition of a CFC***

(1) Strict control test: at the end of the CFC's accounting period, five or fewer Australian residents (including an Australian partnership, trust or other resident entity together with its associates) control 50% or more of the CFC (each must own at least 1%);

(2) *de facto* control tests: one resident shareholder owns 40% or more of the CFC, unless the Commissioner of Taxation is satisfied that control is exercised by non-residents holding all or some of the remaining interests (objective *de facto* control); or at end of the CFC's accounting period, five or fewer Australian residents, while not holding 50% or more of the CFC, effectively control it (subjective *de facto* control);

(3) indirect and constructive ownership rules.

Definition of a tax haven

Regulations include a list of designated comparable tax jurisdictions (i.e. non-tax havens), subject to certain exceptions (essentially a white list, where designated concession income in listed countries is described in two broad categories: general and specific).

Attributed income

(1) If CFC resident in an unlisted country, then all "tainted" income attributed. Tainted income includes passive income (interest, royalties, capital gains, etc.), tainted sales and tainted services income;

(2) if CFC resident in a listed country, only tainted income that benefits from an "eligible designated concession" is attributed;

(3) in addition, certain income of the CFC is attributed automatically, and is not dependent on the active income test. This income includes certain categories of trust income, and, in a listed country, foreign source income and trust amounts of the CFC that have not been subject to tax in a listed country.

Domestic taxpayers to whom income of CFC is attributed

(1) Every member of a group that actually controls the CFC (the member must hold at least a 1% interest in the CFC) at end of year;

(2) if not a member of the control group, must hold a substantial interest (10% or more), measured in terms of the greatest of: shareholdings, voting rights, rights to dividends or rights to distributions on winding up;

(3) indirect and constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity Where the tainted income is less than 5% of total income (or in the case of listed countries, tainted eligible designated concession income less than 5% of total eligible designated concession income), the CFC carries on its business through a permanent establishment in its country of residence, it keeps its accounts in accordance with commercially accepted accounting standards, and is in existence at the end of the year, then no attribution.

Motive N/A

Publicly traded CFC N/A

De minimis Where the CFC is in a comparable tax jurisdiction (i.e. a listed country), there is no attribution if the designated concession income is:

- (a) less than Aus\$50,000, in the case of CFC's with a gross turnover of more than Aus\$1 million, or
- (b) 5% of gross turnover, in the case of CFCs with a gross turnover of less than Aus\$1 million.

The *de minimis* exemption does not apply to certain trust income, which is attributed regardless of its amount.

Relief provisions

Foreign taxes (1) Australian companies holding at least 10% of CFC (non-portfolio investor) entitled to tax credit for foreign taxes paid;

(2) portfolio investors entitled to deduct foreign taxes paid in determining amount attributed.

Losses (1) Losses of a CFC may be carried forward indefinitely (although pre-1 July 1989 losses may only be carried forward seven years), subject to certain restrictions;

(2) categories of losses are defined and segregated: interest, passive (other than interest), offshore banking, and other (i.e. active);

(3) no consolidation.

Subsequent dividends Dividends paid out of previously attributed income are exempt up to the amount previously included in assessable income.

Subsequent capital gains on sale of shares of CFC Consideration received is reduced by the amount of undistributed attributed income apportioned to the interest disposed.

Canada***Definition of a CFC***

Foreign affiliate status and controlled foreign affiliate status are determined with reference to a taxpayer resident in Canada. A condition of being a controlled foreign affiliate of a taxpayer is that the non-resident corporation is a foreign affiliate of the taxpayer. A foreign affiliate of a taxpayer is a non-resident corporation in which the taxpayer owns not less than 1% of the shares of a class of the non-resident corporation's capital stock, and the taxpayer and related persons own not less than 10% of the shares of a class of the non-resident corporation's capital stock. A controlled foreign affiliate of a taxpayer resident in Canada is a foreign affiliate of the taxpayer more than 50% of whose voting shares are owned by:

- the taxpayer;
- the taxpayer and not more than 4 other persons resident in Canada;
- not more than 4 persons resident in Canada, other than the taxpayer;
- persons who do not deal at arm's length with the taxpayer; or
- the taxpayer and persons who do not deal at arm's length with the taxpayer.

Definition of a tax haven

None.

Attributed income

- (1) Passive income and capital gains from passive property;
- (2) income from the provision of services (including the insurance of Canadian risks) where the amount paid is deductible or relates to an amount that is deductible by any person carrying on business in Canada in respect of which the affiliate is a CFC or a related person;
- (3) income of "purchasing affiliates" from the sale of property the cost of which is deductible, in whole or in part, by non-arm's length Canadians;
- (4) income from the insurance or reinsurance of Canadian risks;
- (5) income from debt and lease obligations (including licences of intangible property) of residents of Canada;
- (6) income from an "investment business", being a business carried on by a CFC the principal purpose of which is to derive income from property (including interest, dividends, rents, royalties or any similar returns or substitutes therefor), income from the insurance or reinsurance of risks, income from the factoring of accounts receivable, or profits from the disposition of

investment property. Special rules apply to banks, trust companies, credit unions and insurance companies (see below under “Exemptions: Industrial or commercial activity”).

Domestic taxpayers to whom income of CFC is attributed

(1) Any taxpayer who owns not less than 1% of the shares of any class of the CFC at the end of the year *and* who with related persons owns not less than 10% of the shares of any class of the CFC at the end of year and in respect of whom the CFC is a controlled foreign affiliate.

(2) constructive ownership rules apply (for the 10% ownership requirement).

Exemptions:

Distribution N/A

Industrial and commercial activity (1) Income from the sale of property—not FAPI if:

(a) the property sold in Canada is created in the country of residence of the CFC;
or

(b) more than 90% of the CFC’s gross revenue is derived from sales to arm’s length persons.

(2) income from insurance of Canadian risks—not FAPI if more than 90% of CFC’s gross premium income is derived from the insurance of non-Canadian risks of arm’s-length persons.

(3) income from debt and lease obligations of residents of Canada—not FAPI if more than 90% of CFC’s gross income from indebtedness is derived from arm’s length non-residents.

(4) Where a CFC is engaged in an “investment business”, then subject to (3) above, its income is excluded from FAPI if it has more than 5 full-time employees and either:

(a) the affiliate’s business is the business of a bank, trust company, credit union, or insurance company, or of a trader or dealer in securities or commodities; the activities are regulated in the country in which the business is principally carried on; and the business is not conducted principally with non-arm’s-length persons; or

(b) the affiliate’s business is the development of real estate for sale, lending money (including arm’s length factoring of trade receivables and purchases of foreign resource rentals and royalties), leasing or licensing of property (including authorising the use, production, or reproduction of property, including information) or insurance; and the business is not conducted principally with non-arm’s length persons.

Motive N/A

Publicly traded CFC N/A

De minimis Cdn\$5,000.

Relief provisions

Foreign taxes Foreign accrual taxes grossed up and allowed as a deduction in computing income (similar to a tax credit).

Losses (1) Foreign accrual property income (FAPI) is net of FAPI and other losses (including capital losses from passive income) but not net of active business losses;

(2) FAPI losses may be carried forward 5 years;

(3) no consolidation of profits and losses of all foreign affiliates, but limited relief by way of foreign accrual tax (see "Foreign taxes", above).

Subsequent dividends Deductible.

Subsequent capital gains on sale of shares of CFC Relief by way of adjustment to cost of shares.

Denmark***Definition of a CFC***

- (1) At any time during an accounting period, a company resident in Denmark controls more than 50% of the share capital or voting power of the CFC;
- (2) the CFC must be engaged “mainly” in financial activities (“mainly” has been interpreted as meaning that more than 50% of the assets (based on fair market value) of the CFC are used in financial activities);
- (3) indirect ownership rules;
- (4) no constructive ownership rules.

Definition of a tax haven

Foreign tax “substantially lower” than Danish tax. The foreign tax rate will be considered substantially lower if any of the following conditions are met:

- (1) effective rate of foreign tax less than 25%;
- (2) the CFC has entered into an agreement with the foreign tax authorities with regard to the tax rate or the tax base;
- (3) the tax haven applies different internal tax rules depending on where the parent company of the CFC is resident.

— the Danish tax authorities do not intend to publish a white list or black list of tax jurisdictions.

Attributed income

Net income from financial activities (including interest, dividends, royalties, financial leasing, capital gains from disposal of shares and other securities). As a result of the definition of a CFC, there is no attribution unless the CFC is engaged mainly in a financial activities business.

— special rules apply if the CFC is the holding company of a local subsidiary (i.e., a subsidiary located in the same jurisdiction as the holding company). Essentially, the income of the holding company and subsidiary are consolidated when determining whether the CFC rules apply.

Domestic taxpayers to whom income of CFC is attributed

- (1) A Danish company that holds, directly or indirectly, more than 50% of the shares or controls more than 50% of the voting power of a CFC;
- (2) no constructive ownership provisions.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A but see above "Attributed income".

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Credit given for foreign taxes paid.

Losses (1) CFC's losses may be carried forward for five years;

(2) generally, no consolidation.

(3) if Danish parent qualifies for and elects voluntary joint taxation, any losses of CFC can be offset against profits of Danish parent.

Subsequent dividends) Exempt from tax to the extent of
Subsequent capital gains on sale of shares of CFC) the Danish parent's "account of deductions" for the CFC. Account of deductions equals previously attributed income from CFC less any dividends or capital gains exempt from tax under an applicable treaty. Taxable dividends or capital gains from shares of CFC are reduced by the balance of the account. Any positive balance in account can be carried forward indefinitely.

Finland***Definition of a CFC***

- (1) At the end of the CFC's accounting period, Finnish residents control 50% or more of the CFC's capital or voting power or have a right to at least 50% of the yield on the assets of the foreign entity;
- (2) indirect and constructive ownership provisions;
- (3) no minimum ownership requirements.

Definition of a tax haven

- (1) Foreign tax less than 3/5 of tax that entity would have paid had it been resident in Finland;
- (2) there is a statutory "white list" of treaty countries (not all treaty countries are included), exempting companies resident therein so long as such companies are included in the ambit of the treaty.

Attributed income

All income.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any resident taxpayer who owns at least 10%, directly or indirectly, of the capital of the CFC or who has a right to at least 10% of the yield on assets of the foreign entity;
- (2) constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity No income of the CFC is attributed if the main part of the CFC's income is derived from:

- (1) industrial production in its country of residence;
- (2) another company resident in the same country that carries out industrial production in the same country if the latter company belongs to the same group of companies;
- (3) shipping.

Motive N/A

Publicly traded CFC N/A

De minimis N/A

Relief provisions

Foreign taxes Credit given for foreign taxes paid.

Losses (1) Taxpayer's pro rata share of CFC's losses may be carried forward 5 years and set off against income of the CFC attributable to the taxpayer.

(2) No consolidation.

Subsequent dividends Exempt if paid in the same or subsequent five years.

Subsequent capital gains on sale of shares of CFC No relief.

France

Definition of a CFC

(1) On the last day of the financial year of the CFC (although the level of participation is also checked throughout the year), a French company holds 10% or more, or an investment of Ffr 150 million, whichever is less, of the shares of the CFC;

(2) indirect and constructive ownership provisions;

(3) transitional rule for structures existing on 30 September 1992: instead of an interest equal to the lesser of 10% or Ffr 150 million, the previous 25% ownership threshold applies until 1 January 2003.

Definition of a tax haven

Foreign tax less than 2/3 of French tax (administrative rule; the only statutory provision is that foreign corporation benefits from a “privileged” tax regime. A corporation is considered to benefit from a privileged tax regime if it is exempt from tax or if it is subject to tax rates that are substantially lower than in France on a similar tax base).

— until 1992, unclear whether nominal rate or effective rate; by internal regulation of 6 March 1992, a comparison is made between the foreign tax actually borne by the CFC and the domestic tax that would have been paid had the CFC been resident in France.

— partial administrative list of tax havens.

Attributed income

All income, as calculated under French tax law. So, for example, the participation exemption available to French corporations (under which certain foreign-source dividends are excluded from income) is also applicable to CFCs.

Domestic taxpayers to whom income of CFC is attributed

(1) Any corporation that owns at least 10% of shares or an investment of at least Ffr 150 million in the CFC, directly or indirectly, at end of year (threshold was reduced from 25% effective 30 September 1992; transitional provisions applicable to existing structures until 1 January 2003);

(2) constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity No attribution if CFC's operations do not have the principal effect of “localising” profits in a country where it is subject to a privileged tax regime; test deemed to be satisfied if more than 50% of revenue comes from local

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manufacturing, sales or commercial service activities, or from local purchases of goods or raw materials.

Motive N/A (but see above, under "Industrial and commercial activity").

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Credit allowed against French corporation tax for foreign taxes paid. Withholding tax on distributions of profits previously taxed under CFC regime are deductible.

Losses (1) CFC's losses carried forward for five years;

(2) no consolidation unless French corporation uses consolidation generally (in which case the CFC regime is not applicable).

Subsequent dividends Deductible up to amount of profits previously attributed.

Subsequent capital gains on sale of shares of CFC No relief.

Germany

Definition of a CFC

- (1) At the end of fiscal year of the CFC, German resident shareholders own more than 50% of voting rights or profit distribution rights of the CFC;
- (2) indirect and constructive ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

Foreign tax on attributable income (passive income) less than 30%.

- special rules for determining tax base.
- administrative list of tax havens and other countries.

Attributed income

Passive income and certain base company income (e.g. captive insurance, inter-affiliate sales).

Attributed income, other than income to which the PFIC rules apply, treated as income from capital and for purposes of treaties, treated as a dividend (Germany's treaties generally exempt dividends for corporate shareholders holding at least 10% of shares, although in many treaties the exemption is limited to dividends from subsidiaries engaged in active business operations). Income attributed under the PFIC rules is treated as ordinary income of the German taxpayer to which no treaty exemption can apply.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any German resident shareholder (certain emigrants are treated as resident for 10 years following emigration) at end of year;
- (2) no minimum ownership or constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A, but only passive income and certain base company income attributed.

- special rules for a company that holds directly at least 25% of the shares of subsidiary companies, and subsidiary involved in exempt activities.

Motive N/A

Publicly traded CFC N/A

De minimis No attribution if tainted income less than 10% of gross income of CFC, provided that total amount that is thus exempt with respect to any particular CFC or any particular German taxpayer (i.e. in respect of all CFCs in which the German taxpayer owns shares) shall not exceed DM120,000.

Relief provisions

Foreign taxes Deductible or creditable at shareholder's option; if credit, attributed income must be grossed up by foreign taxes.

Losses (1) CFC's losses carried forward for 5 years;

(2) no consolidation.

Subsequent dividends German tax on previously taxed attributed income refunded if dividend paid in following 4 years.

Subsequent capital gains on sale of shares of CFC German tax on previously taxed attributed income refunded if shares sold in following 4 years.

Hungary***Definition of a CFC***

- (1) A corporation resident in Hungary holds at least 25 per cent of the registered capital of the CFC for at least 30 days and at the end of the year;
- (2) indirect ownership rules;
- (3) no constructive ownership rules.

Definition of a tax haven

A country that does not impose corporate tax on the income of non-residents or does so at an applicable rate that is not more than 10 per cent, unless Hungary has concluded a double tax treaty with the country.

— evidently, the Ministry of Finance intends to publish a black list of countries to which the CFC legislation applies.

Attributed income

Undistributed profits of the CFC determined in accordance with the laws of the CFC's country of residence.

Domestic taxpayers to whom income of CFC is attributed

A corporation resident in Hungary that holds directly or indirectly at least 25 per cent of the registered capital of the CFC for at least 30 days and at the end of the year.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes No specific relief. "Undistributed profits" of the CFC are not defined; however, according to the Ministry of Finance, it means after-tax profits.

Losses No specific relief. However, since the attributed income of the CFC is determined in accordance with foreign laws, it is possible that relief is effectively given if the foreign country's laws provide for the carry-over of losses.

Subsequent dividends No relief. In effect, undistributed profits of the CFC will be taxed twice: in the year they arise, and in the subsequent year when they are distributed.

Subsequent capital gains on sale of shares of CFC No relief.

Hungary's CFC legislation came into effect on 1 January 1997. The provisions are extremely brief and there are numerous gaps and anomalies that will require attention in order for the legislation to function properly.

Indonesia***Definition of a CFC***

- (1) Residents of Indonesia own at least 50% of the shares of the CFC and the shares of the CFC are not traded on a stock exchange;
- (2) no indirect and constructive ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

The legislation contains a black list of 32 jurisdictions.

Attributed income

The after-tax profits of the CFC are deemed to be distributed as dividends in the fourth month after the CFC is obligated to file a tax return, or in the seventh month after the end of the CFC's tax year if there is no obligation or no time limit for filing a return. There are no guidelines on how after-tax profits are determined.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any shareholder who is resident in Indonesia;
- (2) no minimum ownership or constructive ownership provisions.

Exemptions:

Distribution No attribution if [likely to mean "to the extent that"] the CFC has distributed dividends to which resident taxpayers are entitled prior to the end of the four or seven month time period indicated above under "Attributed income".

Industrial and commercial activity N/A

Motive N/A

Publicly traded CFC See "Definition of a CFC", above.

De minimis None.

Relief provisions

Foreign taxes Credit for foreign withholding taxes paid (no credit for underlying tax paid by CFC presumably because only the after-tax profits of the CFC are attributed to resident shareholders).

Losses No relief.

Subsequent dividends Not taxable to the extent of previously attributed income.

Subsequent capital gains on sale of shares of CFC No relief.

The legislation that came into effect on 1 January 1995 is set out primarily in the Decree of the Minister of Finance No. 650/KMK.04/1994 dated 29 December 1994. The decree is silent on a number of significant issues (such as the time when control of the CFC is determined and the manner in which after-tax profits of the CFC are calculated (i.e., under Indonesian law or foreign law)).

Article 7 of the decree states that “[f]urther provisions on the implementation of this decree shall be stipulated by the Director General of Taxation”.

Japan***Definition of a CFC***

- (1) At the end of fiscal year of the CFC, Japanese residents own more than 50% of votes or shares of the CFC;
- (2) indirect and constructive ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

Foreign tax less than 25% (rate set by Cabinet Order promulgated under the Japanese income tax law.

— Until 1 April 1992, there was an official list of tax havens; currently no official or unofficial list of tax havens or non-tax havens.

Attributed income

All income.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any Japanese shareholder who holds, directly or indirectly, 5% or more of the shares of the CFC at the end of the fiscal year (reduced from 10% in 1992);
- (2) constructive ownership rules.

Exemptions:

Distribution No attribution with regard to the distributed portion of the profits of the particular year.

Industrial and commercial activity No attribution for a particular CFC when all of the following four conditions are satisfied:

- (1) main business is not to hold securities, licensing, or lease of vessels or aircraft;
- (2) CFC has fixed facilities that are necessary to conduct its business in the tax haven;
- (3) CFC manages and controls its business in the tax haven as an independent operating unit; and
- (4) if main business of CFC is wholesale, banking, trust, securities, insurance, shipping or air transport, more than 50% of business income must come from

unrelated persons; if main business other than above, it must be mainly (more than 50%) carried out in tax haven.

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Corporate shareholders entitled to tax credit for foreign taxes payable (attributed income grossed up by proportionate share of foreign taxes). Individual shareholders may only deduct foreign taxes payable.

Losses (1) CFC's losses carried forward five years;

(2) no consolidation.

Subsequent dividends Deductible if paid out of profits previously attributed and if paid within five years of attribution, in case of corporate shareholders, and three years, in the case of individuals.

Subsequent capital gains on sale of shares of CFC No relief.

Korea, Republic of***Definition of a CFC***

- (1) The CFC is related to a resident of Korea;
- (2) indirect ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

- (1) A country or a region in which 50% or more of the income of the CFC is exempt from tax because of the corporation's business, corporate form or source of income; or
- (2) a country or a region in which the effective rate of foreign tax on the income of the CFC is less than 15%.

— the Commissioner of NTA has the authority to create a white list of countries (countries to which the CFC regime does not apply, or does not apply if certain conditions are met). No such list has been created. The International Tax Department of the Ministry of Finance and Economics published a list of tax havens, in four categories, in an introduction booklet of the CFC provisions; however, it is unclear whether the NTA will follow this list.

Attributed income

Essentially, all income. "Distributable retained earnings", defined as the amount by which the aggregate of the earned surplus and distributable earned surplus of the CFC (determined in accordance with generally accepted accounting principles in the resident country of the CFC, unless significantly different from those principles generally accepted in South Korea) exceeds the aggregate of:

1. dividends or distributions from retained earnings;
2. bonus, severance pay or outlays paid from retained earnings;
3. statutory reserves under the laws of resident country of CFC; and
4. aggregate surplus deemed to have been paid under CFC rules in previous years.

Distributable retained earnings are deemed to be paid on the 60th day after the end of the taxation year of the CFC.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any resident who owns, directly or indirectly, 20% or more of the outstanding shares or investment amount of the CFC; for the purposes of indirect ownership, if a person or corporation

owns 50% or more of the stock of another corporation, such person is considered to own indirectly all of the stock of the CFC owned by the other corporation;

(2) no constructive ownership rules.

Exemptions:

Distribution No attribution to the extent of dividends or distributed portion of the profits of the particular year.

Industrial and commercial activity No attribution for a particular CFC if the CFC maintains a fixed place of business, including an office, sales outlet or factory, and actually engages in business in the tax haven, and:

(1) if the CFC is engaged in the business of wholesaling, retailing, consumer goods repairing, transportation, warehousing, communications, banking, insurance, real estate leasing or services, not more than 50% of the total revenue from the business and not more than 50% of the purchases of the business are derived from related party transactions;

(2) the CFC does not derive more than 50% of its total revenue from holding stocks or debentures, rendering intellectual property rights, leasing vessels, aircraft or equipment or investing in investment trusts or funds.

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes No relief. Prior to 1 January 1997, corporate taxes of the CFC were a fifth item deductible in determining the attributed income (see "Attributed income", above).

Losses No specific relief. However, since the attributed income is determined in accordance with generally accepted accounting principles in the CFC's resident country, it is possible that loss relief under those rules may be available (so long as such rules do not differ significantly from Korea's loss carry-over provisions). The legislation and Presidential Enforcement Decree provide no clear guidance on this issue.

Subsequent dividends Not included in income (up to amount of previously attributed income) if paid within 5 years.

Subsequent capital gains on sale of shares of CFC No relief.

Mexico

Definition of a CFC

- (1) A CFC is any entity (corporation, branch, trust, joint venture, investment fund or any other similar legal entity created or established in accordance with foreign law) in a listed tax haven;
- (2) The following are not considered to be CFCs:
 - (a) investments made through legal entities whose shares are traded on a recognized stock exchange; and
 - (b) investments made indirectly through other entities if the taxpayer does not participate in the control of the other entity and the taxpayer cannot possibly know that an investment is being made by the other entity in a tax haven; there is a rebuttable presumption that the taxpayer has influence over the management or control of the other entity and is aware of the investments made by such entities in tax havens;
- (3) Limited indirect ownership rules—Mexican investor is considered to have a direct interest in a CFC if two conditions are met: (i) an intermediary corporation resident in another jurisdiction is interposed between the Mexican taxpayer and the CFC; and (ii) the sole purpose of the intermediary corporation is to avoid the CFC rules. It is assumed that the second condition is met if more than 80% of the intermediary corporation's income is from dividends, interest, royalties or capital gains from the transfer of shares of tax haven entities.
- (4) No constructive ownership rules.

Definition of a tax haven

A black list of 65 jurisdictions.

Attributed income

As a general rule, the gross income of the CFC before deduction of expenses. If the accounting records of the CFC are maintained by the taxpayer and available to the Mexican tax authorities, attributed income is based on the net income of the CFC, determined in accordance with Mexican tax law.

Domestic taxpayers to whom income of CFC is attributed

Any resident who has a participation in the CFC.

Exemptions:

Distribution N/A

Industrial and commercial activity No attribution if two conditions are met:

- (1) more than 50% of the CFC's assets (based on their value as determined under the Mexican Assets Tax Law) comprise fixed assets, land or inventory; and
- (2) not more than 20% of the income of the CFC is from dividends, interest, rent or royalties.

Motive N/A

Publicly traded CFC See "Definition of a CFC", above.

De minimis None.

Relief provisions

[It is assumed for the purposes of the relief provisions that the accounting records of the CFC are maintained and available to the Mexican tax authorities.]

Foreign taxes Credit for foreign taxes paid.

Losses (1) CFC's losses may be carried forward five years;

(2) no consolidation.

Subsequent dividends Tax credit given for tax paid on previously attributed income.

Subsequent capital gains on sale of shares of CFC Relief by way of tax credit for tax paid on previously attributed income.

New Zealand

Definition of a CFC

- (1) Strict control test: at any time during an accounting period, five or fewer New Zealand residents control more than 50% (changed from 50% or more, 1992) of the CFC (based on any of total paid-up capital, total nominal capital, entitlement to income, entitlement to value of net assets, or total rights to vote in specified decisions);
- (2) *de facto* control tests (added 1992): if at any time during the accounting period, one person controls 40% or more of the CFC, and no other single person controls at least as large a holding (objective *de facto* control); or if there is a group of five or fewer residents who have the power to control the exercise of the shareholder decision-making rights (subjective *de facto* control);
- (3) indirect and constructive ownership rules;
- (4) to simplify matters, control interests calculated on specified measurement dates (last day of each calendar quarter), and if control established under above rules on any measurement date, then a CFC for entire year.

Definition of a tax haven

Both a grey and black list (applicable since 1 April 1988) was initially published; since 1 April 1993, only grey list (essentially a white list) applicable. In principle, everywhere is caught although grey list exempts certain high-tax countries where, due to high source tax and application of New Zealand tax credits, there is no point in applying CFC rules.

Attributed income

- (1) Where CFC resident in a grey list country receiving a specified tax preference, all income of the CFC (calculated in accordance with foreign tax law) upwardly adjusted by the amount of the tax preference, and ignoring any prior year losses;
- (2) where CFC not resident not in a grey list country, all income of the CFC, calculated on a branch equivalent basis (i.e. as if CFC resident in New Zealand);
- (3) New Zealand does not currently impose any tax on capital gains (apart from certain quasi capital gains on financial transactions and those gains on sales of property that would be recognized as business income).

Domestic taxpayers to whom income of CFC is attributed

- (1) Any taxpayer who holds, directly or indirectly, at least 10% of income interests during the year. Where under 10%, a separate regime (foreign investment fund provisions) may apply;
- (2) no constructive ownership provisions;

(3) income interest calculated on specified measurement dates (similar to control interests: see above, under "Definition of a CFC") and averaged.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Foreign income taxes paid or payable are allowed as a credit against New Zealand tax liability, first against domestic tax on attributed foreign income from that CFC, and second, against domestic tax payable on attributed foreign income of another company resident in the same jurisdiction as the CFC; any unused credits can be carried forward in the same manner. Unused credits can also be used by another New Zealand company in same corporate group in respect of a CFC in the same jurisdiction.

Losses (1) Losses of CFCs may be consolidated with profits of CFCs resident in the same jurisdiction;

(2) excess losses of a CFC may be carried forward indefinitely and set off against profits of the CFC or another CFC resident in the same jurisdiction;

(3) certain consolidation permitted between losses and profits of CFCs of New Zealand group of companies (66% common ownership among the New Zealand companies).

Subsequent dividends If recipient a New Zealand company that owns at least 10% of the CFC, credit given for New Zealand tax previously paid under CFC regime (as well as tax paid by the CFC and any withholding taxes levied in respect of the dividend).

Subsequent capital gains on sale of shares of CFC New Zealand does not currently tax capital gains.

Norway

Definition of a CFC

- (1) At the end of the year, Norwegian residents control at least 50% of shares or capital of the CFC;
- (2) indirect ownership rules;
- (3) no minimum shareholding requirements.

Definition of a tax haven

Foreign tax less than 2/3 of tax that entity would have paid had it been resident in Norway.

— government currently not intending to publish an applicable list of countries.

Attributed income

All income.

Domestic taxpayers to whom income of CFC is attributed

Any Norwegian resident taxpayer with an interest in the CFC at end of the year.

Exemptions:

Distribution N/A

Industrial and commercial activity If the CFC is resident in a country with which Norway has concluded a tax treaty, no income is attributed unless the income of the CFC is mainly of a passive character.

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Credit given for foreign taxes paid, subject to approval of Ministry of Finance; otherwise, foreign taxes deductible.

Losses Losses attributed to a Norwegian taxpayer and can be consolidated with profits of taxpayer up to ceiling of taxpayer's taxed net capital of the CFC (i.e. can only deduct amount equal to the amount that Norwegian taxpayer could "lose" on investment in a limited liability company).

Subsequent dividends Not taxable up to amount of profits already attributed to shareholders. 28

Subsequent capital gains on sale of shares of CFC Relief by way of adjustment to cost of shares.

Portugal***Definition of a CFC***

(1) Two alternate tests:

(a) at the end of the financial year of the CFC, a resident of Portugal owns more than 25% of the shares or capital of the CFC; or

(b) at the end of the financial year of the CFC, residents of Portugal own more than 50% of the shares or capital of the CFC;

(2) indirect ownership rules;

(3) no constructive ownership rules.

Definition of a tax haven

Foreign tax less than 20% (nominal rate).

—no official or unofficial lists.

Attributed income

All income, as calculated under the tax rules of the tax haven, less the income tax paid or payable on that profit in accordance with the tax legislation of the tax haven.

Domestic taxpayers to whom income of CFC is attributed

(1) Any resident of Portugal who controls, directly or indirectly, 25% or more of the shares or capital of the CFC on the last day of the financial year of the CFC;

(2) where more than 50% of the shares or capital of the CFC is owned by residents of Portugal, any resident shareholder holding, directly or indirectly, 10% or more of the shares or capital of the CFC;

(3) no constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity No attribution if two conditions are met:

(1) at least 75% of the profits of the CFC are derived from agricultural or industrial activity carried on in the tax haven or from a commercial activity not involving residents of Portugal, or if it does involve residents of Portugal, the activity is predominantly directed to the tax haven market;

(2) the CFC's main business is not: banking and similar activities; insurance activity carried on predominantly outside the tax haven; dealing in securities; dealing in intellectual property or industrial property or the provision of know-how or technical assistance; or leasing, except the lease of immovable property located in the tax haven.

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Foreign income tax paid or payable by the CFC in the tax haven is deducted in determining attributed income: see "Attributed income", above.

Losses (1) No specific provisions, although presumably the CFC's losses may be carried forward in accordance with the loss relief provisions of the domestic law of the tax haven: see "Attributed income", above;

(2) no consolidation.

Subsequent dividends Credit against corporate income tax equal to corporate income tax previously paid on attributed income. Any unused credit may be carried forward five years.

Subsequent capital gains on sale of shares of CFC No relief.

Spain***Definition of a CFC***

- (1) On the last day of the account period of the CFC, a resident of Spain controls 50% or more of the capital, equity, profits, or voting rights of the CFC;
- (2) indirect and constructive ownership provisions.

Definition of a tax haven

Foreign tax less than 75% of tax that would have been paid had CFC been resident in Spain.

— regulations include a “grey” list of 48 countries or territories presumed to be tax havens (designated tax havens).

Attributed income

- (1) Where the CFC is resident in a tax haven, only passive income and certain base company income of the CFC computed in accordance with Spanish corporate tax law, including income from the following sources:
 - (a) income from real property, unless the real property is used in a business activity or is leased to a non-resident entity that is an affiliate of the CFC;
 - (b) income from financial assets (shares in other companies or loans to third parties), including interest and dividends;
 - (c) income from finance, credit and insurance facilities or services that give rise to deductible expenses of Spanish residents related to the CFC; and
 - (d) capital gains from dispositions of real property and financial assets.
- (2) income under (b) above is not considered “passive” (and therefore not subject to attribution) if the income is from financial assets that:
 - are held to meet legal requirements imposed as a result of the special type of business activities carried on by the CFC;
 - represent debt-claims related to contractual relationships entered into in the course of business activities;
 - are held in the course of a business activity such as a brokerage in official stock markets; or
 - are held by finance or insurance entities in the course of their business activities;

(3) income under (c) above is not subject to attribution if more than 50% of such income is linked to transactions conducted with non-related parties;

(4) income under (a), (b) or (d) received from companies in which the CFC has more than a 5% interest is excluded if the payer carries on an active business effectively managed by it and it derives at least 85% of its total turnover from active business activities;

(5) *De minimis* rule: income only considered passive if amount is greater than 15% of the CFC's total income or 4% of the CFC's total turnover; if the CFC forms part of a group, the 15% and 4% thresholds refer to the total income or total turnover of all CFCs belonging to that group;

(6) Where the CFC is resident in a designated tax haven, a rebuttable presumption that all income of the CFC is passive, and that attributable income is equal to 15% of the acquisition cost of the shareholder's participation in the CFC.

Domestic taxpayers to whom income of CFC is attributed

(1) Any resident of Spain who controls, directly or indirectly, 50% or more of the capital, funds, profits or voting rights of the CFC on the last day of the financial year of the CFC;

(2) constructive ownership provisions.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A, but "Attributed income", above.

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes Credit given for foreign taxes paid; for corporate shareholders, the credit extends to taxes paid by subsidiaries (both direct and indirect) of the CFC.

Losses (1) CFC's losses may be carried forward for 5 years;

(2) no consolidation.

Subsequent dividends Exempt up to amount of profits previously attributed to shareholders.

Subsequent capital gains on sale of shares of CFC Relief by way of adjustment to cost of shares.

Sweden***Definition of a CFC***

- (1) At the end of the year, Swedish residents control at least 50% of the capital or voting power of the CFC;
- (2) indirect and constructive ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

Until end of 1993, any non-treaty country, unless the corporation was subject to a domestic tax regime similar to that imposed in Sweden ("similar" not defined, but taken to include both level and structure of taxation). Since 1994, only specified treaty countries are excluded. The new rules work as follows:

- (1) a foreign company resident in a treaty country is excluded from the CFC rules if the country appears on the statutory white list and the treaty provisions afford treaty protection to the company in question;
- (2) a foreign company resident in:
 - (a) a non-treaty country;
 - (b) a treaty country not on the white list; or
 - (c) a treaty country on the white list but in which the company is explicitly or implicitly excluded from treaty protection,

must satisfy the comparable tax requirement (similarity to Swedish corporate taxation, both in level and structure).

Attributed income

All income.

Domestic taxpayers to whom income of CFC is attributed

- (1) Any taxpayer who holds at least 10% of the capital or voting power of the CFC at end of the year;
- (2) constructive ownership rules.

Exemptions:

Distribution N/A

Industrial and commercial activity N/A

Motive N/A

Publicly traded CFC N/A

De minimis None.

Relief provisions

Foreign taxes N/A

Losses (1) CFC's losses may be carried forward indefinitely;

(2) no consolidation.

Subsequent dividends Not taxable up to amount of profits already attributed to shareholders.

Subsequent capital gains on sale of shares of CFC No relief.

United Kingdom

Definition of a CFC

- (1) At any time during the year, UK residents hold more than 50% of votes, distributable income, or value of assets on liquidation of the CFC;
- (2) indirect and constructive ownership rules;
- (3) no minimum ownership requirements.

Definition of a tax haven

Foreign tax less than 3/4 (increased from 1/2 by Finance Act 1993) of UK tax payable had the CFC been resident in the UK.

— white list and grey list published.

Attributed income

All income other than capital gains.

Domestic taxpayers to whom income of CFC is attributed

Corporations to which, at any time, 10% or more of the CFC's income is apportioned.

The Board of Inland Revenue has the power to attribute income to a domestic taxpayer other than a shareholder (for example, a loan creditor).

Exemptions:

Distribution No attribution if the CFC distributes 90% of its taxable profits (determined under UK tax rules) less capital gains and foreign tax within 18 months after the end of the CFC's accounting period. For accounting periods ending prior to 28 November 1995, trading CFCs met the exemption if 50% of their accounting profits were distributed.

Industrial and commercial activity Must meet three conditions:

- (1) throughout accounting period must be effectively managed and have a business establishment in the tax haven;
- (2) main business of CFC not comprised of certain specified activities, including: holding securities, patents or copyrights; dealing in securities; leasing; investment of funds; dealing in goods for delivery to or from the UK or to or from connected persons (not including goods actually delivered into the country of residence of the CFC);

(3) where the CFC engaged in wholesale, distributive or financial business, less than 50% of its gross trading receipts from that business must be derived from connected or associated persons.

— special rules for holding companies: must meet condition (1) above, and derive at least 90% of gross revenue from controlled exempt holding companies with exempt subsidiaries in the same tax haven or from other exempt operating companies (wherever located).

Motive Two conditions:

- (1) where transactions have achieved reduction in UK tax either reduction is minimal or not a main purpose; and
- (2) reduction in UK tax by a diversion of profits from the UK not a main reason for the company's existence.

Publicly traded CFC Three conditions:

- (1) at least 35% of voting power unconditionally allotted to the public;
- (2) within 12 months preceding accounting period there have been dealings in the shares on a recognized stock exchange in tax haven, and shares are on official list of such exchange; and
- (3) at no time during that period have CFC's principal shareholders (those with more than 5%, or if more than five, the five largest shareholders) held more than 85% of voting power of CFC.

De minimis Less than £20,000 per 12 month accounting period, apportioned if necessary.

Relief provisions

Foreign taxes Credit allowed against UK tax for foreign tax paid.

Losses (1) CFC's trading losses can be carried forward indefinitely; in addition, if claimed on a timely basis, the losses of the CFC in the 6 accounting periods preceding the first accounting period in which the Board makes a direction may be carried forward;

(2) no consolidation.

Subsequent dividends Tax paid on attributed income treated as deductible foreign tax credit against subsequent dividends.

Subsequent capital gains on sale of shares of CFC Capital gain on sale reduced by UK tax on attributed income, to the extent not relieved by previous dividends.

United States

Definition of a CFC

- (1) On any day in the corporate tax year, "US shareholders" (US citizens, residents or corporations each owning at least 10% of voting power of CFC) own more than 50% of the voting interest or total value of the CFC;
- (2) indirect and constructive ownership rules;
- (3) with effect from 1 January 1997, "check-the-box" regulations allow foreign entities to choose whether to be classified as a corporation for US tax purposes. Eighty types of non-US business entities are not eligible to make the election. Assuming that a foreign entity is eligible, its election not to be classified as a corporation means that it cannot be a CFC.

Definition of a tax haven

None.

Attributed income

- (1) Subpart F income:
 - (a) income from insurance (other than of risks arising in country in which the CFC is resident);
 - (b) foreign base company income:
 - passive income;
 - sales and service income from related party transactions outside CFC's country of residence;
 - income from shipping, air transport, space, or ocean activity, and distribution and sale of oil and gas;
 - (c) income attributable to international boycotts;
 - (d) income from bribes and kickbacks paid by the CFC to foreign government officials.
- (2) Exemption for items of income under (1)(a) and (b) (excluding foreign base company oil-related income) that were subject to an effective rate of foreign tax of at least 90% of the maximum US corporate tax rate.
- (3) *de maximis* rule: if the sum of (1)(a) and (b) above exceeds 70% of the CFC's gross income, then all of its income is deemed to be foreign base company income or insurance income (as appropriate) and all CFC's income is attributed accordingly.

(4) CFC's earnings invested in US property are taxed as attributed income.

Domestic taxpayers to whom income of CFC is attributed

(1) Any US taxpayer holding, directly or indirectly, at least 10% of the voting power of the CFC at any time in the year, and who owns shares directly or indirectly in the CFC at the end of the year;

(2) constructive ownership rules.

Exemptions:

Distribution N/A (repealed in 1975).

Industrial and commercial activity N/A (but see "Attributed income" above)

Motive N/A (replaced in 1986 with the objective test set out at (2) under "Attributed Income")

Publicly traded CFC N/A

De minimis No attribution if the sum of foreign base company income and insurance income is less than the lesser of 5% of gross income and US\$1 million.

Relief provisions

Foreign taxes (1) Indirect foreign tax credit for corporations (or individuals electing to be taxed as corporations) with respect to foreign taxes paid by first-, second-, third-, fourth-, fifth-, and sixth-tier subsidiaries; if credit, attributed income must be grossed up by foreign taxes;

(2) individuals entitled to deduct foreign taxes unless elect to be treated as corporations.

Losses (1) CFC's current losses reduce its earnings and profits; losses carried forward indefinitely;

(2) no consolidation.

Subsequent dividends Excluded from income.

Subsequent capital gains on sale of shares of CFC Relief by way of adjustments to cost of shares.

NOTES TO APPENDIX

Australia: The May 1997 budget proposed some amendments to the CFC rules. Briefly, the number of listed countries will be reduced from 61 to 7. The previous list will be retained and updated as a "repatriation list", so that non-portfolio dividends and branch profits will be exempt from Australian tax so long as the foreign corporation or branch earns active income in a repatriation list country. Australia enacted a regime dealing with foreign investment funds (FIFs), applicable with effect from 1 January 1993. Under the FIF regime, where an Australian taxpayer has an interest in an offshore fund that holds mainly passive assets, the income earned by the fund is attributed to the Australian taxpayer having an interest in the fund at the end of the year in proportion to the taxpayer's interest in the fund at that time. There is no minimum ownership requirement, although there is a *de minimis* exemption where the taxpayer's interests in all FIFs do not exceed AUS\$50,000 in the aggregate.

Canada: Canada added offshore investment fund provisions in 1984: ITA s. 94.1. Under these provisions, if a taxpayer has an interest in a non-resident entity (non-resident corporation, partnership, organization, fund or entity that is not resident in Canada) that derives its value primarily from portfolio investments, and one of the main reasons for the taxpayer holding such investment was to pay significantly less tax than would be paid if the investments were owned directly, the taxpayer is subject to tax on an amount of income determined by multiplying his or her designated cost in the fund by the prescribed rate of interest (calculated monthly) less the income actually received from the offshore investment.

Germany: Although not discussed under "Relief provisions" in the Appendix, s. 10(5) of the AStG may have a significant impact on the application of the CFC provisions. Section 10(5) provides that treaty provisions applicable to distributed dividends apply to deemed dividends under the CFC legislation. As a result, German corporate taxpayers could benefit from the participation exemption found in many German tax treaties, so long as the exemption does not contain an "activity proviso". In order to counteract the perceived abuse of the participation exemption, Germany adopted passive foreign investment company rules on 14 February 1992, and later amended these rules in 1994 to make them stricter. The PFIC rules are described in Chapter 2 under the heading "Germany".

New Zealand: In 1988, New Zealand introduced a FIF regime at the same time as the CFC regime, although it was subsequently repealed retroactively. The current FIF regime became effective in 1993 and has objectives similar to New Zealand's CFC legislation. The two regimes are kept separate primarily for administrative reasons. If resident shareholders do not control the foreign entity (i.e., it is not a CFC), then it may be very difficult for New Zealand shareholders to obtain the necessary information to calculate the exact income of the foreign entity (applying New Zealand tax rules). There are a number of alternative, simpler methods available for resident taxpayers to calculate attributed income under the FIF regime. An exemption from the FIF regime was added in 1993 for any individual whose aggregate FIF investments cost NZ\$20,000 or less.

Sweden: In 1933, Sweden introduced a rule (the "Luxembourg rule", formerly s. 2(12) of the National Income Tax Act), under which a foreign holding company controlled mainly by Swedish citizens and effectively managed by individuals resident in Sweden was subject to domestic taxation on the same basis as a Swedish economic association. The Luxembourg rule was abolished in 1993 when the CFC legislation was introduced.

United Kingdom: A regime somewhat similar to the CFC legislation but applicable to capital gains is found in the Taxation of Chargeable Gains Act 1992 (TCGA 1992) s. 13. In addition, the United Kingdom has a number of anti-avoidance provisions aimed at precluding individuals from using tax havens to avoid or reduce taxes. Significant among provisions are TA 1988 s. 739 (first enacted in 1936) and s. 740. These two provisions deal with income derived from assets transferred to non-resident persons for the benefit of resident individuals. Similar provisions applicable to capital gains of non-resident trusts are contained in TCGA 1992 ss. 86 and 87.

United States: In addition to the CFC provisions, the United States also has (often overlapping) provisions dealing with foreign personal holding companies (enacted in 1937) and passive foreign investment companies (enacted in 1986). The former provisions apply to corporations controlled by five or fewer United States citizens, more than 60% (50% after the first taxation year) of whose gross income is passive income; the latter provisions apply to any residents who have an interest in certain foreign (not necessarily US controlled) corporations more than 75% of whose gross income is passive, or at least 50% of the fair market value of whose assets are held for the production of passive income. A CFC is not treated as a PFIC with respect to 10% US shareholders who are subject to the CFC regime. The PFIC provisions apply to shareholders not subject to the CFC regime and for periods during which a shareholder's ownership is less than 10%.

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Specify who is suing whom for what and the subject of this appeal, i.e., identify (1) the nature of the action; (2) the parties to this appeal; (3) the amount in controversy or other relief involved; and (4) the judgment or other action in the district court or agency from which this appeal is taken:

This action is an appeal pursuant to 28 U.S.C. § 158(d) from the final order of the District Court for the District of New Jersey (Hon. William G. Bassler), entered in this case on June 27, 2003, affirming the Bankruptcy Court's decision to deny a motion for appointment of a chapter 11 trustee pursuant to 11 U.S.C. § 1104.

The appellant herein is the Official Committee of Asbestos Claimants, appointed by the United States Trustee under 11 U.S.C. § 1102(a) on January 22, 2001. The Committee is the principal creditor of the Debtor, and is made up of persons who assert tort claims against G-I, as successor in interest, alleging personal injuries or wrongful death caused by asbestos-containing products.

The appellee herein is G-I Holdings, Inc., a holding company that filed a chapter 11 petition for reorganization on January 5, 2001. G-I has no business operations, no employees, and only a few officers — all of whom are legal and financial professionals. It is controlled by Samuel Heyman, who owns, directly or indirectly, substantially all of its stock. G-I's "source of value" is its indirect subsidiary, BMCA, which is known to the world as GAF Materials.

Provide a short statement of the factual and procedural background which you consider important to this appeal:

On January 5, 2001, G-I filed a chapter 11 petition for bankruptcy. Its petition was precipitated by massive liability to individuals suffering from asbestos-related disease as a consequence of their exposure to asbestos-containing products manufactured and distributed by G-I's predecessors in interest. G-I acknowledges its own succession to these liabilities. Pursuant to 11 U.S.C. § 1107, G-I currently acts as debtor-in-possession.

Asbestos claimants are by far the Debtor's largest creditor constituency. The controlling stockholder of G-I, Sam Heyman, has orchestrated a long series of corporate maneuvers aimed at isolating asbestos liabilities in a holding-company shell, while moving valuable assets into operating entities under Heyman's control. At the same time, Heyman's equity has depreciated drastically under the weight of these asbestos liabilities and has been erased entirely if, as the Committee believes, the Debtor is insolvent. Manifesting Heyman's resentment, the Debtor has used its resources to pursue an agenda that is bitterly and inveterately hostile to its principal creditors, and therefore at odds with G-I's fiduciary duty as a debtor-in-possession. The result is a bankruptcy mired in litigation, with no end in sight.

To facilitate the creation of a confirmable plan of reorganization, the Committee made a motion for the appointment of a trustee in the Bankruptcy Court. The Bankruptcy Court (C.B.J. Rosemary Gambardella) denied the motion in an order dated January 16, 2003. The Committee timely filed an appeal with the District Court. In an order dated June 27, 2003, the District Court

affirmed the Bankruptcy Court's decision. The Committee timely filed its Notice of Appeal dated July 25, 2003 to the United States Court of Appeals for the Third Circuit.

Identify the issues to be raised on appeal:

The issue raised on appeal is whether the Bankruptcy Court erred in adopting, as its basis for rejecting the Committee's motion for a trustee, a "strong presumption" favoring the Debtor's current management.

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

Controlled Foreign Company (CFC) Rules

Policy objectives

3.1 The Treasurer's Press Release of 22 August 2002 identified a high-level aim of improving Australia's attractiveness as a location for internationally focused companies to operate global and regional businesses. Reform of the CFC rules will contribute to this.

3.2 The Treasurer's Press Release of 2 May 2002 specifically outlined the aim of the review in relation to CFCs. The review's task is to examine claims that the rules:

- are complex and impose significant compliance costs on business;
- are out of step with modern business practice; and
- negatively affect decisions to locate in Australia as against countries with less stringent rules or no such rules.

Current law

3.3 The aim of the CFC regime is to prevent residents accumulating 'tainted income' taxed at low or zero rates in foreign companies controlled by Australian residents. A variety of methods and concepts have been developed over time to achieve this aim. They include:

- *Active income test:* If a CFC passes an active income test (that is, the large majority of its income is not tainted income), its income is generally not taxed on a current basis. If it fails the active income test, Australian owners may be taxed on tainted income on a current basis.
- *Tainted income:* This is foreign passive income and certain (mainly related party) sales and services income. Broadly, it arises from investments and arrangements that could be significantly influenced by taxation considerations in the source country.

- *Listed countries:* In the original regime, countries were divided into two categories: 'comparable tax countries' and 'tax havens'. In 1997, the comparable tax countries were subdivided into two lists: broad-exemption listed countries (BELCs), whose tax regimes were closely comparable to the Australian tax system; and limited-exemption listed countries (LELCs), whose regimes were less comparable to Australia, but were not tax havens. There are currently seven BELCs: Canada, France, Germany, Japan, New Zealand (NZ), United Kingdom (UK), and the United States (US).
- *Eligible Designated Concession Income (EDCI):* This is tainted income that is concessionally taxed in a BELC and therefore subject to tax in Australia. Types of EDCI are listed in the Income Tax Regulations. There are two categories — generic and specific. In the generic category are capital gains not subject to tax. In the specific category are usually 'types of entities' which are concessionally taxed in specific jurisdictions.

3.4 These are only a few examples of the tests and definitions within the CFC rules. There is significant complexity and compliance costs for business in applying these rules.

Problem

3.5 The submissions made to the Board supported the basic underlying policy of the CFC rules. Submissions agreed that rules are necessary to prevent Australian-controlled companies from deliberately accumulating passive income in a low tax jurisdiction. However, there are two major problems with the current CFC regime:

- the complexity of the rules leads to high compliance costs; and
- the operation of the rules often impedes genuine business transactions and decisions.

3.6 Specific problems include:

- restructuring is difficult because of insufficient rollover relief for capital gains tax (CGT);
- the interaction of Australia's transfer pricing rules and the CFC regime leads to duplication;
- under the tainted services income rules, Australian-owned businesses providing services into Australia from overseas pay Australian levels of tax on that income. Foreign-owned competitors providing the same services do not. Further, foreign subsidiaries of Australian companies are discouraged from providing services

among themselves, as the income produced is usually attributed to the Australian parent; and

- a long list of technical and policy options produced by the foreign-source income (FSI) subcommittee of the Australian Taxation Office (ATO) National Tax Liaison Group has remained virtually unactioned.

3.7 The following case studies are representative of the views echoed in numerous submissions about the impediments that Australian companies face when dealing with Australia's international tax regime. They also provide indicators of further behavioural effects that might arise from reforms — namely, that Australia might see an increased volume of inbound employment-creating investment into headquarter activities which are currently being located in Europe or Asian countries.

Box 3.1: Case Study — Malaysia preferred to Australia as headquarters

Company Y has been in negotiations with an European Union (EU) company to establish a 50/50 joint venture in Malaysia, China and Thailand. It may expand to other countries in the future.

Company Y has operations in China, Thailand and Malaysia. The EU company has operations in Malaysia.

Company Y and the EU company would prefer that one joint venture (JV) company holds all these interests, rather than owning companies in each individual jurisdiction. This would provide a focal point for proper management of the joint operations. The EU company rejected the use of a partnership or an unincorporated joint venture. The issue is where the JV company should be domiciled for tax purposes. The following two options have been canvassed.

Option 1 — Malaysia as a hub

Dividends from China would flow tax-free to Malaysia, and then again tax-free from Malaysia to Australia and the Netherlands (EU company intermediate holding company jurisdiction). Company Y and the EU company would be no worse off than if they had received dividends directly from China, as there is no Chinese dividend withholding tax (DWT).

Dividends from Thailand would flow to Malaysia after a 10 per cent DWT and then those same dividends could flow out of Malaysia free of DWT to Australia and the Netherlands. Company Y and the EU company would be no worse off, given that Thai dividends to Australia and the Netherlands also suffer a 10 per cent DWT.

Option 2 — Australia as a hub

Dividends from China and Malaysia would flow free of DWT to the Australian joint venture company. The Thai dividends would attract 10 per cent DWT, the same as if Malaysia were the hub.

The dividends received by the joint venture Australian company would be exempt from Australian tax. These dividends could be paid on to the Netherlands free of DWT by utilising the foreign dividend account (FDA). However, Company Y would have to pay Australian tax on the unfranked dividends received from the joint venture Australian company.

Australian CGT would be payable in respect of any gain on disposal of the foreign subsidiaries.

If the three subsidiaries offshore earned any 'attributable income' (as defined under Australia's CFC laws), then the JV Australian company would pay tax in Australia to the extent the Australian rate exceeds the foreign rate on that income.

Conclusion

Owing to Australia's tax on unfranked dividends (albeit sourced from previously taxed foreign income and which was previously tax exempt in Australia), its capital gains tax on sales of foreign subsidiaries, and its CFC laws that top-up taxes to the Australian rate on passive and tainted income, a hub in Malaysia is recommended.

Box 3.2: Case Study — Observation of a multinational

Company Z has provided this background based on its own observations as a multinational. The comments are focused on the tax considerations of holding/owning assets. They do not purport to address other investment considerations such as sovereign risk, nor do they address the question of where headquarters should ultimately reside. (Headquarters can reside separately from the location where assets are held or owned.)

¹ Case Study provided in a supplementary submission by BCA/CTA/ABA.

A key question for Company Z, when new businesses are acquired or to be established, is the ongoing ownership structure. A related and important issue is the implications of any ultimate disposal of the investment. The taxation implications of these matters may influence a decision one way or another when weighing up country ownership comparisons. Both these issues bring into sharp focus the extent of DWT and the implications of any CFC regime relating to holding/ownership, and the extent of CGT on exit.

Company Z notes that offshore multinationals have a structuring choice. This potentially allows access to more favourable international tax regimes than in Australia — for example, UK where there is no CGT on the sale of foreign businesses (that is, disposals of shares or assets).

Although Australia has an excellent record of economic growth, its taxes on foreign profits and on the sale of foreign assets make it unattractive as a regional holding centre, and largely isolated in the eyes of global investors. As a result, Australia is generally unattractive for 'flow through' investment, which of itself generates positive economic outcomes from service-related activity and Australian-bound personnel transfers. Company Z is aware that in the UK and the US, Australia's taxation regime is a key reason why companies seeking to conduct businesses in the Asia/Pacific region are advised not to consider Australia as a location for the regional holding company. As a result, business and multiplier effects flow instead to places such as Singapore and Hong Kong. Australia is not considered to be a suitable base from which to establish regional headquarters; for the most part it tends to attract only Australian-focused subsidiaries of multinationals.

Company Z is concerned that the international tax debate has focused on outbound investment. Perhaps this is not surprising, from the perspective of Australian companies attempting to grow globally. However, Australia's international tax regime should also be viewed from the perspective of inbound investors, including multinational companies seeking to invest offshore through Australian-based holding companies. While it would be impossible to quantify the amount of international investment that by-passes Australia, Company Z remains concerned that unless Australia makes its international tax regime more attractive, multinational companies in similar positions will continue to locate their regional service businesses (and consequently, their regional holding companies) outside Australia. This will be due, in part, to other countries' competitive on-going tax regimes on annual profits, combined with their minimal exit tax on foreign investments.

Company Z disagrees with arguments that there is no need for reform in this area. It disagrees that other structures (including the dual listed company structure) deal adequately with the tax problems. Those structures do not benefit Australia in the sense of attracting inbound or 'flow-through' investment. Moreover, Australian companies with outbound investments may have no choice but to adhere to an uncompetitive regime.

Inbound multinationals have a choice concerning ownership of offshore assets. With the current Australian tax regime, they are likely (in all but exceptional circumstances) to favour establishing ownership structures under more attractive regimes outside Australia — places such as the UK. (It seems that the US Administration is likely to propose substantial changes to its CFC and foreign tax credit regimes precisely because of a perception that the nature of its international tax rules makes the US (much like Australia) not a preferred tax regime. This compares with the situation in the UK, which recently sought to relax its rules to attract companies holding foreign assets.)

Therefore, Company Z considers it is crucial that reforms be considered not only to encourage companies to locate their headquarters/regional headquarters in Australia, but also to assure them that Australia will not seek to tax gains on investments held through Australia.

Evidence of the problem

3.8 Australian multinationals often wish to restructure, for various reasons. The lack of CGT rollover relief can make this difficult. Australia has a number of rollover rules for capital gains, and many are incorporated into the CFC regime. However, the CFC provisions sometimes modify the rules. For instance, rollover relief is denied for certain transfers between BELCs (for example, from the US to the UK) and from non-comparably taxed jurisdictions to comparably taxed jurisdictions (for example, Hong Kong to US), and vice versa.

3.9 Submissions noted that the general business environment has changed since the introduction of the tainted sales and services rules. The ATO's enforcement of Australia's transfer pricing rules has improved dramatically. This has led to overlap between the transfer pricing rules and the CFC regime. Originally, taxation under the CFC regime of services provided by CFCs to unrelated parties in Australia was originally on the view that such activity should be discouraged. But the effect in the modern economy is to impede Australian businesses from providing services to Australia in the most economic way. This gives a competitive advantage to foreign-owned business providing the same services.

² Case Study provided in a supplementary submission by BCA/CTA/ABA.

3.10 Submissions proffered the National Tax Liaison Group's list of issues as strong evidence that the CFC regime is overly complex. The list of issues is extensive. In the Board's view, the list highlights technical and policy issues which have arisen since the introduction of the CFC regime, and which remain unresolved.

Policy issues arising from the problem

3.11 A central concept in the CFC rules is the active income test. It is aimed at ensuring that only passive and certain sales and services income is affected by the CFC rules. This reflects the general policy that an Australian company's foreign subsidiaries should be subject only to the same tax as their local competitors. Australia does not wish to impose additional tax on active income, regardless of whether the foreign country is a high or low taxing country. This policy is generally referred to as 'capital import neutrality' (CIN), meaning that Australian capital deployed overseas should be subject to the same tax burden as foreign capital.

3.12 Under this principle, the CFC regime is applied in two circumstances only:

- to highly mobile income that can be shifted out of Australia more or less at the taxpayer's choice without involving the movement of real activities (passive and services income); and
- to passive sales and services income which is subject to transfer pricing.

3.13 The CFC provisions define notional assessable income. In some areas, particularly tainted services, perceived risk of abuse leads to a broad inclusion of income. This results in high compliance costs, as the regime attempts to pick up all forms of untaxed or lightly taxed income.

3.14 Important changes have occurred in the world economy since the CFC regime was introduced. Relevantly, they include the following:

- many Australian firms have reached the limits of possible growth in Australia. Expansion overseas is driven by business considerations, not merely to find a more favourable tax regime;
- the Organisation for Economic Cooperation and Development (OECD) Tax Competition project is identifying harmful tax practices in some countries and taking steps to remove their harmful features. This facilitates making judgments based on countries' systems overall rather than dissecting all the features of their tax regimes;
- international trade has increased between related parties compared to unrelated parties. This has led to coordinated international action against, and a much higher profile for, transfer pricing. (The OECD produced its Guidelines on Transfer Pricing in 1995 and has updated them several times.) The CFC regime

means that Australian-owned companies (but generally not foreign-owned companies) must deal with two sets of rules, involving high compliance costs in the transfer pricing area; and

- international trade in services is growing much faster than international trade in goods. This has led to international coordination of policy on the taxation of services. The general policy response is to tax services on the same principles as goods; in contrast, the CFC regime treats services significantly differently from goods.
- 3.15 Submissions universally concluded that the complexity and compliance costs involved in applying the CFC rules, as well as the changes in the international environment, demonstrate the need for urgent reform. Considerations relevant to reforming the CFC rules include:

- developing criteria to assess whether another jurisdiction has a reliable tax system, and then relying on the foreign system rather than trying to assess all its features in detail. Specifically, where a country has a rigorous tax system with features similar to Australia's, then it should be possible to rely on that country's tax system to deal with tax problems, without overlaying Australia's CFC rules;
- identifying changes in international business practices that affect the operation of the CFC rules, and their implications;
- identifying specific situations that constitute genuine and significant risks to revenue to be dealt with by the CFC regime, rather than excluding the regime only where there is no risk to revenue; and
- removing the bias inherent in current tax arrangements so that globally-focused Australian companies maintain corporate structures and select headquarter location on the basis of commercial considerations rather than taxation considerations.

Potential solutions

Exemption for BELCs

3.16 The Treasury Paper proposes a number of options aimed at simplifying the CFC regime and reducing compliance costs. However, many submissions went further and raised the possibility of exempting BELCs from the CFC regime, given that BELCs are countries with broadly similar tax regimes. They argued that the CFC provisions add an unnecessary complex layer of tax compliance. It should be possible to rely on a comparably taxing country without enforcing the CFC rules. Other attributable income not dealt with by the BELC's CFC regime (for example, foreign investment fund (FIF) income) could possibly be included in passive income. In specific situations it may be necessary to list features of a BELC system that should be subject to attribution. For

example, NZ does not have a CGT regime; untaxed capital gains of defined types arising in NZ could be a listed feature. These situations would be specific and much narrower than the current listing.

3.17 The logic that Australia should 'trust' comparably taxed countries applies to income of the CFC sourced in the relevant BELC, or in any BELC. However, a CFC may have income that is sourced outside the BELC, in a jurisdiction that is not comparably taxing. This creates issues that need to be addressed. Possibilities include:

- limiting the BELC exclusion to income sourced in the BELC or otherwise included in its tax base (or sourced in or otherwise included in the tax base of any other BELC); and
- limiting the BELC exemption to CFCs deriving income mainly from a BELC. For example, a *de minimis* rule could allow a small percentage of income sourced outside the BELC.

Advantages and disadvantages

3.18 The majority of Australia's outbound investment is with BELCs. A virtual exemption for BELCs would substantially reduce overall CFC compliance costs for business.

3.19 A possible disadvantage is that Australia would become more dependent on the tax administration and laws of other jurisdictions, as the CFC rules would no longer provide a backstop to BELCs. Overseas regimes would need to be regularly monitored. The behavioural response of business would also need to be monitored, to ensure that the CFC rules are not undermined by the general exemption. On the other hand, the changes in 1997-1998, which were partly driven by the problem of monitoring overseas systems, have resulted in substantial CFC compliance costs in the private sector, far exceeding the monitoring costs for the public sector.

3.20 While the above comments relate to income and gains derived by the CFC resident in the BELC, a residual issue is the treatment of income and gains of a subsidiary of that BELC where that subsidiary is resident in a non-BELC (including for these purposes, subsidiaries not resident in any jurisdiction).

3.21 An approach would be to rely on the CFC regime of the BELC to prevent diversion of passive income to low tax jurisdictions. The effect would be to exclude from Australia's CFC measures a CFC resident in a BELC and all its subsidiaries wherever resident. Conceptually this option is attractive and would limit the compliance burden of dealing with more than one CFC regime. Some submissions emphasised this existing compliance burden and favoured this approach to limiting the CFC measures.

3.22 The practical problems with this approach are similar to those discussed above. As pointed out in the Treasury Paper, even where a country has a CFC system policies vary regarding the type of income to be attributed. Therefore, there is a risk that exempting from Australia's CFC measures all subsidiaries held by a CFC resident of a BELC may leave scope for BELC 'shopping'.

3.23 Also, once a country is listed as a BELC, that BELC's CFC measures would need to be monitored. There is increased potential for countries to be taken off the BELC list depending on changes to their CFC rules.

3.24 On balance, although the compliance saving is attractive, it would inevitably lead to a restriction of the number of countries that could be listed as BELCs.

3.25 In the Board's view, it is important to balance minimising the overall compliance burden of the CFC measures with maximising the number of countries treated as BELCs. For this reason, the Board considers that subsidiaries in non-BELCs should be exempted from the CFC regime only where the BELC has a comprehensive CFC regime broadly equivalent to that of Australia.

Recommendation 3:

The Board recommends that where an attributable taxpayer holds an interest in a controlled foreign company that is resident in a broad-exemption listed country, the following income should not be attributed to the Australian resident:

- (a) the income of the controlled foreign company (which would include its subsidiaries) that is sourced in that broad-exemption listed country or another broad-exemption listed country or is otherwise included in the tax base of a broad exemption listed country;
- (b) the income of any subsidiaries of the broad-exemption listed country controlled foreign company where the subsidiaries are not resident in a broad-exemption listed country provided the broad-exemption listed country has a broadly comparable controlled foreign company regime to Australia's controlled foreign company regime.

In limited cases, income arising from specific features of a broad exemption listed country's tax system may be listed as subject to attribution.

This recommendation should be seen in conjunction with the Board's recommendations in 3.1(1) and (2), 3.2, 3.3, 3.4 and 3.10(1), (2) and (3) (below).

Option 3.1: To consider options to expand rollover relief under the controlled foreign company rules, while maintaining the integrity of those rules

3.26 The Treasury Paper suggests the extension of rollover relief under the CFC rules. Suggestions in submissions include extending relief to:

- all forms of corporate reorganisations available under the domestic CGT provisions;
- any rollover relief available under the laws of the relevant foreign jurisdiction;
- any rollover in a BELC;
- any gain of a CFC on disposal of a non-portfolio interest in a non-resident company with underlying active assets (for corporate reorganisations, merger or demerger);
- any rollover between 100 per cent commonly-owned companies; and
- transfer of shares from one CFC to another in exchange for shares.

3.27 Another suggestion is to allow the use of Australian capital losses to offset attributable capital gains of CFCs.

Advantages and disadvantages

3.28 Submissions emphasised that any extension of CGT rollover relief would facilitate corporate reorganisations and other business decisions in relation to foreign jurisdictions-matters, which are currently impeded or prevented by the CFC regime.

3.29 Although extension of Australian rollover relief will solve some problems, it will not meet all the cases where there is no clear policy against rollover. This is because of the wide variety of overseas tax systems to which the rules would have to relate.

3.30 A more targeted overall strategy would involve less complexity and deal with virtually all cases. The strategy would involve three elements, two of which arise from other recommendations of the Board. The first is to virtually exempt BELCs from the CFC rules (see Exemption for BELCs, above). Many submissions suggested this kind of approach as a possible alternative to extending CGT rollover relief. Of course, this will solve problems for BELCs only. For non-BELCS, a second and similar approach is possible — namely, permitting restructures which are specifically permitted under the law of the non-BELC concerned. Thirdly, the Board's recommendations in relation to Option 3.10(2) would effectively permit many corporate restructures in non-BELCs where the restructure involves the transfer of certain non-portfolio shareholdings in CFCs.

3.31 This still leaves some residual restrictions for the restructure of foreign subsidiaries, mainly in non-BELCs. For instance, rollover relief would not be allowed under the CFC measures where the foreign jurisdiction does not generally impose CGT and therefore does not have rollover relief. Therefore, additional rollover relief for companies may be necessary (in certain cases, scrip for scrip rollover relief may be appropriate). Moreover, if recommendation 3.10(2) were not accepted, such additional rollover relief would be critical for both BELC and non-BELC cases. For example, this extended rollover relief would also need to cover the disposal of assets by a CFC resident of a jurisdiction that did not have a CGT regime. Another example would be countries with capital gains and rollover provisions, where the rollover relief was narrow.

3.32 It is arguable this additional rollover relief should be restricted to relief available in Australia. That is, the relief should be restricted to transfers between 100 per cent owned group companies, scrip for scrip rollover, and de-merger relief. This would ensure neutrality between restructures onshore and offshore.

3.33 However, the argument against this restriction is that rollover relief is intended to place the Australian multinational on a consistent footing with the foreign multinational competitor. Since the foreign competitor may not be subject to any tax impediment or restructuring in the country of residence of the CFC, rollover relief should be as broad as possible while maintaining the integrity of the CFC measures.

3.34 The Board prefers the second approach because it gives an Australian multinational greater ability to restructure its business offshore for maximum efficiency. However, this measure will inevitably take some time to design and implement. In the meantime, the existing constraints on the restructure of an Australian multinational's offshore operations would remain. However, in the interim, the Board recommends that in addition to the relief recommended above, rollover relief be provided for transfers between 100 per cent owned group companies and for scrip for scrip and de-merger transactions.

Option 3.1: Extending CGT rollover relief**Recommendation 3.1(1):**

The Board recommends that rollover relief should be available for corporate restructuring of controlled foreign companies not resident in a broad-exemption listed country, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned.

Recommendation 3.1(2):

The Board recommends that rollover relief be extended to cover transfers of assets or interests between 100 per cent owned group companies, scrip for scrip transactions and demerger transactions in cases where relief would not otherwise be available as a result of recommendations 3, 3.1(1) and 3.10(2).

Option 3.2: To consider options to appropriately target the tainted services income rules, while maintaining the integrity of the controlled foreign company rules

3.35 There is general agreement that the tainted services income rules need to be reformed. While many submissions suggested the need to narrow the scope of both the tainted sales and services income rules, services were the main focus. Suggestions included that:

- provision of services between CFCs on an 'arms length basis' should be outside the scope of the CFC rules;
- consistent with the tainted sales income rules, provision of services that do not have a direct connection with Australia should be excluded;
- the scope of the rules should be confined to genuinely passive income;
- the scope of the rules should be confined to services which CFCs provide to resident associates; and
- CFCs undertaking an active business of providing services should be excluded.

Advantages and disadvantages

3.36 The Board accepts the need to reform the tainted-income rules. A number of submissions suggested handling the problem by distinguishing between active and passive businesses of providing services. However, rapid developments in the high-value services area make enduring definitions difficult. Further tinkering with the

definitions of tainted sales and tainted services income is likely to add to complexity and compliance costs without fully solving the problems. Where the concern is transfer pricing out of Australia, the Board considers that Australia's transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.

3.37 An overall strategy to deal with concerns is to remove altogether the concepts of tainted services and tainted sales income. However, the Board recognises that there may be a narrow range of services the location of which are generally accepted as more likely to be motivated by tax minimisation than by commercial considerations. Captive insurance companies may fall into this category; they can be dealt with expressly in the passive income rules.

3.38 A concern remains about the use of tax havens, particularly in view of other changes recommended in this report. For example, those other changes create the potential to more easily establish the residence of a company offshore (Recommendation 3.12), including in tax havens, to generate tainted services or tainted sales income and take advantage of nil or low tax rates to distribute dividends to an Australian parent in a tax-free form (Recommendation 3.9) and to entitle the shareholders of the Australian parent to a 20 per cent tax credit (Recommendation 2.1(1)).

3.39 Accordingly, the Board's recommendation in relation to this option does not extend to tainted services income or tainted sales income derived in designated tax havens unless, consistent with Recommendation 3, the income is subject to tax under the tax regime of a BELC (including its CFC regime). In other words, unless the income is subject to tax in a BELC it will continue to be subject to Australia's CFC measures. Care needs to be taken in determining what is a designated tax haven for this purpose, and the Board suggests using the criteria adopted by the OECD to identify tax havens.³

Option 3.2: Reforming the tainted services income rules

Recommendation 3.2:

The Board recommends that the tainted sales and services income rules be abandoned (except in relation to income or gains derived in designated tax havens that are not otherwise subject to tax in a broad-exemption listed country), and that services that are considered to raise particular integrity issues be dealt with expressly in the passive income rules under the controlled foreign company regime.

³ Harmful Tax Competition: An Emerging Global Issue — 1998.

Option 3.3: To consider whether additional countries should be included on the broad exemption country list, and to clarify the criteria for inclusion (or exclusion)

3.40 Many submissions called for clear criteria to determine BELC status. Developing such criteria will become crucial if the Board's recommendation to exempt BELCs from the CFC regime is adopted. This is because:

- Australia will be relying more heavily on the tax laws and administration of the BELC; and
- the favourable treatment will result in more pressure to expand the list.

3.41 Submissions suggested including the Scandinavian countries, and some southern European and Asian countries on the BELC list. This would double the current list to approximately 15 members. Until criteria are developed, the Board does not support specific recommendations on countries for inclusion.

Option 3.3: Adding to the list of BELCs, and clarifying criteria for inclusion

Recommendation 3.3:

The Board recommends that criteria for declaring further countries as broad exemption listed countries be developed and published as soon as practicable. Any further declarations of broad-exemption listed countries should be made on the basis of those published criteria. Existing broad-exemption listed countries should remain broad-exemption listed countries.

Option 3.4: To identify technical and other remaining policy issues regarding the controlled foreign company rules, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite of the provision

3.42 The current CFC rules are lengthy, highly technical and complex. There are many compliance problems and unintended consequences (even though, when enacted in 1990, the rules had been subject to very extensive consultation).

3.43 The FSI Subcommittee of the National Tax Liaison Group has maintained a list of CFC issues (CFC issues register) for a decade. A large number of submissions referred to this list, and called for immediate action. The submissions pointed out that

the issues have remained unresolved for many years, even though CFC issues had been raised in two major reviews (the 1997 CFC review⁴ and the RBT).

3.44 The Board commissioned a report to examine the issues and to prioritise them: see Attachment 1. On the basis of this report and the submissions, the Board considers that these issues should be resolved as a matter of urgency.

3.45 Many issues may be resolved if other recommendations of the Board in this report are adopted. For example, the issues relating to EDCI will not be relevant if BELCs are exempted from the CFC rules. As noted in the Treasury Paper, one issue in particular is already the subject of consideration and should be resolved swiftly — namely, the treatment of hybrid entities such as limited partnerships and US limited liability companies.

3.46 The Treasury Paper also raised the possibility of a complete rewrite of the CFC provisions. Submissions were divided on whether a rewrite is the best solution. There is concern that a complete rewrite would:

- take some years to complete;
- create other unintended consequences and compliance problems; and
- impose considerable costs of re-learning the rules and re-engineering compliance systems in an environment where tax reform fatigue is already a significant problem.

3.47 Conversely, there is concern that marginal tinkering:

- would deal only with some of the problems and not address systemic issues;
- would receive only a low priority in government business and be drawn-out over time; and
- may lead to greater complexity by merely modifying or qualifying existing rules, not removing them.

Advantages and disadvantages

3.48 As the benefits of a complete rewrite are difficult to demonstrate, a more targeted strategy is likely to be more effective, at least in the short-term. The Board is satisfied that the major CFC recommendations in this report will substantially improve the operation of the CFC provisions and significantly reduce compliance costs. It recognises, however, the need also to work on other technical issues.

⁴ *Information Paper: Proposed changes to the taxation of foreign source income*, December 1996.

Option 3.4: Identify technical and remaining policy issues, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite

Recommendation 3.4:

The Board recommends that the policy position on the following issues in the controlled foreign company regime should be resolved by 31 December 2003:

- (a) currency exchange fluctuations;
- (b) limited liability companies and limited partnerships;
- (c) all issues classified as urgent in the consultancy report commissioned by the Board not covered by other recommendations (see Attachment 1); and
- (d) an ongoing speedy decision-making process to resolve other issues on the Controlled Foreign Company National Issues Register (see Attachment 2).

Tax Treaties

Policy objectives

3.49 A policy objective of the current Review is to promote Australia as a location for internationally-focused companies. Double tax agreements (DTAs) are a significant element in international tax arrangements and need to be considered alongside domestic tax law. As DTAs are the result of detailed negotiations based on the tax systems of the two countries concerned, general DTA policy necessarily must be concerned with high-level issues and processes. A major policy question is the balance between residence and source taxation, and whether the balance struck in the recent Protocol to the US treaty should be the basis of future policy.

Current position

3.50 DTAs allocate taxing rights between Australia and other countries. They ensure that the same income or capital gain is not subject to double taxation, or to double non-taxation (or exemption). Until recently, Australia's DTAs have generally given greater emphasis to source taxation than to residence taxation. This is reflected in a number of features, such as:

- a wide definition of permanent establishment (PE), which increases Australia's taxing rights over non-residents' business operations in Australia; and
- relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia.

Option 3.8: Improving consultation arrangements**Recommendation 3.8:**

The Board recommends that the consultation processes on negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation.

Conduit income**Policy objectives**

3.84 Conduit income raises two related policy issues:

- whether the CFC and foreign tax credit/exemption rules are too complex and impose unduly onerous compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia; and
- the adequacy of the current conduit rules and their impact on the establishment of regional holding companies in Australia.

Current law

3.85 The current treatment of dividends from foreign companies is very complex, depending on the following factors:

- whether the dividends are portfolio or non-portfolio;
- whether the dividends are received by a company or other taxpayer;
- whether the dividends are received from a company resident in an unlisted country or a listed country;
- whether the dividends are paid out of income that has been attributed under the CFC regime; and
- whether the dividends are subject to withholding tax in the foreign country.

3.86 Depending on these factors, the dividends may be exempt, partially exempt, subject to a foreign tax credit in whole or part (and relating to underlying corporate tax, or dividend withholding tax, or both), or simply taxable. Most dividends paid to Australia are received by Australian companies from non-portfolio interests in foreign companies. They are generally exempt from tax if they are paid by companies resident

in either BELCs or LELCs. The exemption does not generally apply to dividends received directly (or in some cases indirectly) from unlisted countries.

3.87 On the inbound side into Australia, unfranked dividends paid to non-resident owners are generally subject to DWT (usually reduced by treaty to 15 per cent). Some recent treaties adopt lower rates of tax on non-portfolio dividends paid to companies, most notably zero in certain cases under the US Protocol. The withholding tax on unfranked dividends is not payable if the dividend can be traced through an accounting mechanism contained in the tax legislation — foreign dividend account (FDA) — to non-portfolio dividends received by the Australian company from offshore. The FDA currently records only non-portfolio dividends. The purpose of the account is to allow an Australian company to pay unfranked dividends to non-resident shareholders without the imposition of withholding tax, subject to rules which prevent streaming of the account only to such shareholders.

3.88 Capital gains derived by resident companies from disposal of non-portfolio interests in foreign companies are subject to tax; so are gains by non-residents on non-portfolio interests in Australian companies.

3.89 In a broad sense, these treatments of dividends and capital gains are replicated offshore under Australia's CFC regime.

Problems

3.90 The complexity of the current rules for dividends from foreign companies is obvious even from this brief description. Where possible, companies respond by paying dividends which are exempt in Australia from countries which do not levy withholding tax on the dividends; otherwise, dividends are unlikely to be paid to Australia. Where a company's financial position forces it to pay substantial amounts of dividends to Australia from foreign subsidiaries which are subject to significant levels of withholding tax, then it may consider moving offshore. This is because the withholding tax generally operates as an additional tax impost on the company and ultimately on shareholders arising simply from residence in Australia. For similar reasons, companies may be reluctant to locate in Australia.

3.91 Because Australia potentially taxes incoming and outgoing dividends, Australian tax may be levied on conduit income passing from offshore through an Australian company to a non-resident. Interposing the Australian conduit affects the tax outcome. For some dividends, this problem is overcome through the exemption for non-portfolio dividends and the FDA. However, this is not the result in some potentially common cases. For example, if a US company were to set up a JV company in Australia with an Australian company for investing in the Asia-Pacific region, dividends from a Hong Kong subsidiary of the JV would be subject to corporate tax in Australia. Dividends paid by the Australian JV company which were franked would not be subject to withholding tax, and would give rise to franking credits for the

Australian participant in the JV company. Dividends paid out of the FDA would also not be subject to withholding tax, but would be unfranked dividends for the Australian participant and subject to corporate tax at that level. Other dividends paid by the JV company (for example, out of profits of a branch in Hong Kong) would be subject to dividend withholding tax in the hands of the US joint venturer.

3.92 For capital gains on shares in either an offshore subsidiary of an Australian company, or an Australian subsidiary of a foreign parent, there is no attempt to provide any tax relief. Capital gains on shares in controlled companies often represent retained income. To the extent that the profits are paid out as dividends from a foreign company resident in a listed country, or by an Australian subsidiary to a US parent, the profits would not be subject to tax in Australia. This differential treatment of dividends and capital gains is difficult to justify.

3.93 As a result of the treatment of dividends and capital gains on non-portfolio interests in companies into or out of Australia, Australia has not developed as a favoured conduit or headquarter location.

3.94 While the dividend situation is to a degree dealt with in the tax law, conduit treatment does not apply to exit from investments (either offshore subsidiaries of the Australian conduit, or the foreign parent from the Australian conduit).

3.95 In the CFC regime, the complexity of the treatment of dividends and capital gains was considered necessary to prevent movement of profits from companies resident in unlisted countries to companies resident in listed countries.

Evidence of the problems

3.96 The LELC category was created in 1997 when listed countries were separated into BELCs and LELCs. Approximately 88 percent of non-portfolio dividends currently paid to Australia are from BELCs, 9 percent from LELCs, and 3 percent from unlisted countries.

3.97 Very little revenue is thus collected on dividends repatriated to Australia from unlisted countries. In addition, the amount of dividend income from LELCs is small — even though it is exempt. Yet Australian companies and their offshore CFCs incur large compliance costs in tracking the various kinds of dividends and in making deduction allocation and foreign tax credit calculations.

3.98 Many large companies with significant amounts of foreign income have examined their dividend position under the system for relief of double taxation in combination with their imputation position. The prevalence of exempt dividends indicates how they approach dividend policy. The result is a considerable constraint on capital management by Australian-based companies. In extreme cases, companies may move out of Australia.

3.99 Australia has had little success in attracting holding companies and regional headquarters. In the late 1980s and early 1990s, the private sector made a concerted push to make Australia an attractive location. The government gave some ground to the push and introduced a number of tax measures, including some relating to offshore banking units, regional headquarters, and the FDA. However, the private sector regarded the measures as inadequate.

Policy issues arising from the problems

3.100 In common with most countries, Australia levies tax on a source and residence basis. This is relatively easy to apply in the case of individuals. However, in the case of entities such as companies the application becomes complex, for two reasons. The first is the problem of double taxation of dividends. The second is that determining the residence of companies is not as simple as for individuals. For the first problem, mechanisms are put in place such as imputation, and the exemption of dividends from foreign subsidiaries, or underlying tax credit for such dividends. For the second problem, the appropriate policy would be to base the residence of a company on that of its ultimate owners; but to trace ownership through many tiers of entities is not practical, and in any event the ultimate owners will often be resident in several countries.

3.101 Hence, it is common to use a 'management' or 'place of incorporation test'. As these tests can be manipulated, they are backed up by measures such as CFC and FIF regimes. Where FSI is derived by a company resident in Australia under these tests, but the owners of the company are non-residents, Australia is generally considered to have no real tax claim.

3.102 Partly for this reason, the OECD Model tax treaty ensures that little or no tax is levied on dividends or capital gains on non-portfolio interests in companies held by non-residents.

3.103 In addition, many countries in their tax law or treaties provide an exemption for the foreign-source dividends and capital gains received by their residents. The purpose is to avoid international double taxation (given that the underlying profits will have been subject to corporate tax). These measures are supported on the policy basis of CIN — that is, that the company should be subject to the same tax level as its competitors in the countries where it operates, either through branches or subsidiaries. As noted previously, this is the general policy basis underlying Australia's CFC regime.

3.104 The combination of these policies also produces a conduit situation — that is, foreign income passes through a country to non-resident owners without tax in a direct investment situation. Unless appropriate policies are adopted, it becomes necessary to create special rules to deal with conduit situations. The FDA serves this purpose in current law for outgoing dividends (there is no relief for capital gains). But the FDA

covers only incoming dividends; it does not cover other FSI. The RBT recommended that other income be covered by the account, so that conduit treatment is also possible for other types of foreign income such as foreign branches.

Potential solutions

Option 3.9: To consider abolishing the limited exemption country list and provide a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) for foreign branch profits

3.105 Clearly, any simplification of the current maze regulating the taxation of foreign dividends will be an advantage. In view of the small amount of tax collected on dividends from companies resident in unlisted countries, and the small amount of dividends received from LELCs, there is a strong case on compliance grounds alone for exempting all non-portfolio dividends received by Australian companies. In policy terms, such a change would also produce greater consistency for foreign income. Active income would be subject to CIN at the corporate level — that is, it would be taxed only in the country of source. Low taxed passive income would be subject to attribution under the CFC regime.

3.106 This policy and compliance approach could greatly simplify the system. Non-portfolio dividends received by Australian companies from foreign companies would be exempt from tax in all cases, with no credit for DWT. All other dividends would be subject to tax, with credit for foreign DWT only.

3.107 This change would also greatly simplify the CFC regime. It would lead to abolition of the LELCs, the only listed countries would be BELCs. Complex rules dealing with disguised distributions from CFCs resident in unlisted countries would no longer be necessary. Further, the exemption would be extended to offshore dividends under the CFC regime, as concerns about moving profits from unlisted to listed countries would no longer arise. Non-portfolio dividends received by CFCs would also be exempt from attribution. Finally, it would no longer be necessary to record and track (through tiers of companies) dividends that are paid out of attributed income under the CFC regime.

3.108 As the treatment of foreign branch profits largely parallels the treatment of CFC income, all foreign branch income would similarly become exempt, except for low taxed passive income.

Option 3.9: General exemption for non-portfolio dividends**Recommendation 3.9:**

The Board recommends providing a general exemption for foreign non-portfolio dividends received by Australian companies and their controlled foreign companies and (subject to some existing exceptions) foreign branch profits.

Option 3.10: To consider options to provide conduit relief for Australian regional holding and joint venture companies, including considering the benefits and costs of introducing a general conduit regime providing an exemption from the sale of non-portfolio interests in a foreign company with an underlying active business; and providing conduit restructure relief

3.109 Constructing a targeted conduit regime is fraught with difficulties:

- if not limited to wholly-owned situations, there are significant problems of complexity and risks of leakage;
- if limited to wholly-owned situations, not all the necessary cases will be covered; and
- in either event, there may be problems in meeting forthcoming OECD guidelines on harmful tax practices for what is an acceptable conduit or headquarter regime.

3.110 Also, conduit restructure relief represents a complex and backdoor solution to the problem of conduit income. It would require parties to enter into additional transactions which, though effective under Australian domestic law (as amended under this proposal), may create tax problems under foreign law.

3.111 A systemic solution is therefore to be preferred. Such a solution is possible, consistent with policy developments discussed elsewhere in this report. The solution would also significantly simplify the CFC and related rules.

3.112 The following measures, for example, would in essence achieve a conduit regime without undue complexity:

- exempting certain dividends paid into Australia — see Recommendation 3.9 and exemption available under section 23AJ;
- exempting dividends paid out of Australia — DWT and foreign income account (FIA);

- CGT exemption for sale by an Australian resident of a non-portfolio interest in a foreign company that has an underlying active business — see Recommendation 3.10(2);
- simplifying the CFC regime (exemption for CFCs in relation to income from BELC) — see Recommendation 3; and
- exempting non-portfolio gains on shares in Australian companies — see Recommendation 3.11(2).

3.113 On the CGT side, the solution involves exempting capital gains on direct investment in foreign companies, whether in listed countries or not. Along with this, any capital gain so exempted would then qualify for FIA treatment. This change would parallel the solution in relation to the previous option of exempting all non-portfolio dividends received from foreign companies. The potential simplifying power of these two changes is very significant. They would allow the removal of a significant part of the CFC and associated legislation: potentially sections 23AI, 23AJ, 47A, 422, 423, 457, 458, 459, 459A, Part X Divisions 4, 5, 6, 10 of the 1936 Act. Exemptions would also need to be inserted for capital gains offshore between CFCs in a similar way for dividends. Simplification would flow into the underlying foreign tax credit (FTC) provisions and other parts of the legislation.

3.114 The Treasury paper canvasses whether the CGT exemption should be limited to shares in companies which pass the active income test. The Board considers that this is necessary, but that it should be done on a time-apportionment basis. That is, shares would be regarded as active assets so long as the CFCs effectively disposed of in the sale passed the active income test for at least half of the time they were held by the taxpayer or its associates. This limitation should not prevent the removal of the provisions above (which at the moment do contribute to the CGT calculation where companies do not pass the active income test). Rather, a provision should be inserted that, if the capital gain is taxable, CGT applies only to the extent that it reasonably reflects gains on the assets producing the income which caused failure of the active income test, and reduced by any foreign tax liability in respect of those assets. The interaction of Recommendation 3.10(2) and other recommendations contained in this report, for example Recommendation 2.1, will need to be further considered.

Option 3.10: Conduit relief for Australian regional holding and joint venture companies**Recommendation 3.10(1):**

In view of the taxation relief available on certain dividends passing through Australia, and of the Board's recommendations in 3, 3.9, 3.10(2) and 3.11(2), the Board recommends that a separate conduit regime not be developed at this stage.

Recommendation 3.10(2):

The Board recommends that there should be a capital gains tax exemption for the sale by an Australian resident company or its controlled foreign companies of a non-portfolio interest in a foreign company that has an underlying active business.

Recommendation 3.10(3):

The Board recommends that any capital gain by an Australian resident company exempted as a result of Recommendation 3.10(2) would incur no withholding tax if passed to non-residents consistent with the policy intent of the Board's other recommendations on conduits.

Option 3.11: To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1

3.115 The discussion of this option has to be considered in the light of Recommendations 3.9 and 3.10(1) to (3). The nature of a FDA or FIA will depend on the purpose or purposes to which it is being put. Chapter 2 recommended that a 20 per cent tax credit be attached to dividends paid out of foreign income and that companies be allowed to stream dividends out of foreign income to foreign shareholders. So far as the FIA is used to support a credit for Australian resident shareholders, it is not appropriate to include such types of income as royalties or interest received from unrelated parties. This is because the account deals with income from direct investment.

3.116 The FDA currently is part of limited conduit arrangements. In the form of an FIA, it will still be used for conduit type treatment of dividends under the streaming proposal in Chapter 2 (see paragraph 2.45). However, Australia is moving to a treaty policy of exempting non-portfolio dividends from Australian withholding tax, as in the recent US Protocol. This treatment goes beyond conduit relief (as it also covers dividends out of Australian source profits). But the adoption of the previous two recommendations will effectively provide conduit relief for non-portfolio dividends

from foreign companies (Recommendation 3.9) and capital gains on non-portfolio interests in foreign companies conducting an active business (Recommendations 3.10(2) and 3.10(3)). Again, the Board considers that broader systemic measures of this kind are more effective than a specific regime to achieve conduit relief. Therefore, it was not considered necessary to include any other form of foreign income in this recommendation. With respect to allowing the tax free flow through of foreign income amounts along a chain of Australian companies, the Board has had insufficient evidence put to it on whether the benefits outweigh the revenue cost and other integrity issues for it to determine whether it should make a recommendation. The Board believes that further work should be undertaken to establish the viability of such a proposal.

3.117 Consistent with the principle underlying conduit income flows, consideration of conduit capital gains is also necessary. There is a strong argument supportive of an exemption of the capital gains on direct investments. This is in fact the international standard under tax treaties. It recognises that any income generated by non-resident investment in Australia should be taxed here, being the country of source, as and when the income is derived. However, any capital gain accruing to the investor reflective of possible future income flows, more appropriately falls to be taxed in the investor's home country. A consequence of such a policy avoids imposing local tax impediments to both the initial investment commitment as well as to future ownership changes that may in fact prove favourable from a local efficiency, technology and management perspective.

3.118 There are questions about how such treatment should be achieved. One possibility is through future tax treaties. The treatment would be available only for treaty partners, and only on condition that Australian companies receive reciprocal treatment in the foreign country. As it would take some time for the treaty network to cover the main countries from which conduit investment into Australia is sourced, in the short term the treatment could be legislated into domestic law for investors resident in BELCs. The purpose would be to ensure that Australia is not used as a conduit to lend respectability to pure tax haven activities. The CFC regime and other features of the tax system of the BELC would be relied upon to ensure continuing integrity in the system.

3.119 While this solution in relation to non-resident investors achieves conduit treatment, it also goes further. It exempts the investor for capital gains generated by the Australian activities of the Australian company. As noted above, it is already possible to achieve this by disposing of shares in a foreign company which holds the Australian assets directly or indirectly. The Board recommends on practical grounds against extending the CGT to such cases. Viewed from this broader perspective, Australia would be relying on its corporate tax system to ensure that Australian activities of the direct investor are appropriately taxed, just as it relies on the tainted income rules in the CFC system to ensure that low taxed passive foreign income does not escape Australian taxation.

3.120 The interaction between the consolidation regime and this option may need further consideration in order to ensure that any capital gain on the Australian assets is ultimately taxed on disposal of the assets (as compared to the company in which the shares are held).

3.121 In addition, the exemption of sales of shares in CFCs held by residents and sales of shares in Australian companies held by non-residents would require measures to prevent Australian residents acquiring Australian companies through CFCs (that is, by looping the investment through a foreign company). This can be achieved by denying the exemption for sales of shares in CFCs operating active businesses in Australia (where the Australian assets form a significant part of the CFC's assets). Further, if a CFC sold directly or indirectly a non-portfolio interest in an Australian resident company, the profit or gain on the sale would be subject to tax in the hands of the Australian controllers, provided the Australian assets form a significant part of the value of the shares sold.

Option 3.11: Adoption of a foreign income account as recommended by the Ralph Review

Recommendation 3.11(1):

The Board recommends proceeding with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment flows (such as non-portfolio dividends and branch profits but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties).

Recommendation 3.11(2):

The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Company residence

Policy objectives

3.122 To assist in establishing Australia as a centre for internationally-focused companies, it is necessary to have clear, practical and internationally-acceptable rules for company residence. It is also necessary to resolve issues that arise when a company is a dual resident, that is, treated as a resident in two or more countries under the respective countries' tax laws.

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**FROM THE BOTTOM UP: TAXING THE INCOME
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H. David Rosenbloom



**PANEL III: U.S. MULTINATIONAL
AND INTERNATIONAL
COMPETITIVENESS**

PRINCIPAL PAPER

**FROM THE BOTTOM UP: TAXING THE
INCOME OF FOREIGN CONTROLLED
CORPORATIONS**

H. David Rosenbloom

I. INTRODUCTION

From time to time I have occasion to offer advice in regard to other countries' income tax systems, and therefore to think about income taxation in general, but very practical, terms. For the most part these assignments concern developing countries with so-called emerging economies. I never have sufficient time to understand fully the context in which the tax system must operate in these countries, but I do my best to learn about the problems and issues that others more familiar with the territory have identified, and I attempt to tailor my comments to the circumstances as I come to understand them. Clearly there is no single income tax system that fits the needs of all jurisdictions. The principal supports of the local economy, the country's history with taxation, the question whether the

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country is, or could eventually become, a capital exporter as well as an importer, its tax and general economic relationships with other countries, all enter into the calculus of what might be appropriate in any given case.

There do seem to be some constants, however. Any country that has a government must find a means of paying for that government and that means, however implemented in rules and actions, usually will require some form of mandatory contribution from the public. It is not necessary that any such concept as tax law, or even law, exist for this purpose. A country that borrows, or that prints money to pay expenses, or some combination of these options, would still impose a "tax" in a broad sense of that term, because the effects of these actions would have a cost that the populace of the country would be required to bear. In this sense, running large deficits, tolerating inflation, paying interest out of public resources—all of these involve taxation. Thus, a "tax reduction" that contributes to deficits or inflation merely shifts the burden from one set of "taxpayers" to another.

If there is to be a formal tax system in a country—and most countries clearly believe (though not always for clearly articulated reasons) that they should have such a system—there are additional constants irrespective of where in the world the question is posed. For one thing, the system should have as little adverse effect as possible on other interests deserving of government encouragement or protection. Taxes are, by definition, undesirable insofar as the person called upon to pay them is concerned. It is obvious that the incidence of taxation—the combination of circumstances that give rise to an obligation to pay tax—is burdened by the tax, and to that extent disadvantaged, discouraged. Since most countries impose taxes upon some form of economic activity, and since a rational nation has an interest in supporting economic activity of persons subject to its taxing jurisdiction, the nation generally will wish to impose its tax with as much care as possible to preserve maximum room for that activity, given the necessity of the tax. This may be difficult in particular situations, but the general directive is clear: As between two taxes having the same effect, the one that interferes less with economic freedom is to be preferred. More broadly, it could be argued that general freedom of decision-making is a "good" meriting government protection, and taxes therefore should be

imposed with as much leeway as possible for such freedom. Such considerations are commonly referred to as "efficiency."¹ Professor Gergen invokes instead, and probably more fittingly, "the natural law of the parasite: Do the least damage to the host in extracting sustenance from it."²

A second desirable feature in a tax system, no less important than efficiency, is what some refer to as "equity." This condition obtains when persons who stand in the same place insofar as the relevant target of tax is concerned are treated similarly by the tax regime. The point is important because tax systems in countries that are not totalitarian ultimately depend, to a large extent, upon the (sometimes grudging) consent of the taxed. If the system does not operate in an equitable way, that consent is difficult to acquire and more difficult to retain, with the result that those subject to the system will devote greater energy to frustrating, avoiding, or evading it. Such actions, in turn, render the system more difficult to administer and enforce in an equitable way which, in turn, only will add to the frustration of persons subject to the regime. For this reason, equity is needed in a tax system for the most pragmatic of reasons, to permit the system to function.

The term "equity" is sometimes also used to describe a progressive system of taxation, in which persons who have more resources from which to contribute to government revenues, or perhaps who have benefited more from government actions supported by such revenues (often the same folks), should contribute more than others by paying a higher amount. I do not disagree with this view, but it seems a different matter from the proposition that those persons standing relevantly in the same place should be treated (more or less) the same by the tax regime. One could envision a tax system without progressivity, a debatable subject in its own right. That subject may not be intrinsic to thinking about the "fundamentals" of taxation, and I propose to leave the matter

1. See, e.g., DAVID F. BRADFORD, AND THE U.S. TREASURY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 1-3, 2 (Tax Analysts 2d ed. 1984).

2. Mark Gergen, The Common Knowledge of Tax Abuse, Paper presented to the Ernst & Young Tax Policy Seminar at Georgetown University (Sept. 22, 2000) (on file with author). This recalls Colbert's "art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing." GEORGE ARMITAGE-SMITH, PRINCIPLES AND METHODS OF TAXATION 36 (John Murray ed., 1907).

here—and, as explained in more detail below, take no detailed position (for the moment) on the topic of corporate integration, which could be viewed as an element of progressivity.

The third fundamental characteristic of a sound tax system is “simplicity,” which means favoring the less complex over the more complex to the extent a choice is available. Simplicity, like efficiency but perhaps not quite like equity, is a general goal, not capable of being attained in anything resembling a pure state. It is valuable in its own right and also because it contributes to other aspects of a well-functioning tax system: Administrability (the capability of government officials themselves to understand the relevant rules and see to their implementation in practice); and transparency (the ability of the public to understand the rules, so that obligations are clear and the companion goals of efficiency and equity can be evaluated and intelligently discussed). If the tax system cannot be understood and administered, then in actual practice it may become something very different from what its authors envisioned. And while they go on finely spinning rules, some other regime for raising taxes comes to operate in practice.³

Perhaps it is years of working with and under the U.S. tax system that leads me to place a special premium on simplicity in matters of taxation. There are too many rules in that system, and the complexity of those rules impedes assessment of their merits on other grounds. Furthermore, there is all too little consideration by the creators of U.S. tax legislation of what and who will be involved in translating tax laws into working reality. For these reasons, simplicity and administrability of rules hold a special place for me. Efficiency, equity, and simplicity are all virtues in matters of taxation, but the greatest of these virtues is simplicity.

Advising other countries on tax matters, I try to take all of these factors into account. This is, of course, no easy task, since not only are efficiency, equity, and simplicity all abstract concepts subject to considerable doubt and interpretation when applied in the evaluation of specific provisions, but the factors

3. This long has been the case in the United States, where, in my experience, there are in force two parallel systems of taxation having at best only a resemblance—one, enacted in Washington and the other as applied by the Internal Revenue Service in the “field,” in (for example) San Jose, Des Moines, and Cleveland.

actually conflict with one another when any of them is pursued with a single mind. Clearly, the goal of simplicity is best served by rules that do "rough justice" in the sense of assimilating different inputs into categories—persons, circumstances, amounts, etc.—even though it is known, indeed obvious, that there are differences within the categories and that item A is not at all the same as item B, but only similar to item B in a particular way. The call of equity may be strong in these circumstances. Does not each item deserve its own rule, or sub-rule, or exception? An affirmative response translates into discarding a key element of simplicity.

The same conflicts are present with respect to efficiency, though they may be more subtle. There are circumstances where a simpler rule or one that responds more closely to considerations of equity pulls in a direction that may not be the most efficient. Thus, in weighing the implications of efficiency, equity, and simplicity, it is necessary to engage in a constant process of judgment, revision, and compromise. The overall system will be an amalgamation of the disparate results of this process.

Recently, I had occasion to think about all this in a context that was unusual for me. The country in question had not only agricultural and mineral sectors, but a substantial manufacturing base. It was not only a capital importer, but a nation of real wealth, with substantial capital exports and possibilities for more. It was relatively modern, with a reasonable number of highly educated residents. Yet, its tax system was underdeveloped as a result of historical factors which, perhaps, were on the wane. In other words, here was a country with a need for a modern tax system. There were certain unusual factors that might impede movement from the existing—quite old, quite odd—system to one that appeared capable of working better in the future. The transition might be painful, and there were problems stemming from a large indigent population and substantial disparities in the distribution of wealth. Nevertheless, here was a chance to concentrate upon sensible taxation in a complex country, and to develop proposals that might not be weighted down by years of politics, inattention, habit, or ignorance.

A. *Explanations, Disclaimers, Excuses, Apologies, Etc., Etc.*

By now even the inattentive reader may have realized that the author is neither an economist nor someone who approaches taxation from the perch of high theory in any other discipline. I am interested in what works, in practice, on the ground. My only qualification to be writing at all is that I have worked on tax matters for nearly 35 years in the private sector, government, and the classroom, and have witnessed at close quarters the operation of many of the world's tax systems. Some of my notions may function better in practice than in theory.

The starting point for this paper is a hunch that a good deal of the current U.S. debate about subpart F is misplaced: It is either focused upon what happened in the distant past (1961-1962, to be precise), or about what occurred to produce the numerous *ad hoc* adjustments over the years to the original understanding, or about anecdotal evidence of the difficulties U.S. companies face in operating under the strictures of U.S. law, particularly in competing against companies from other countries that are not subject to similar regimes, or about the implications of banalities such as "capital export neutrality" and "capital import neutrality." The debate has been heating up (again) in recent years.⁴ It seems to me, however, that debating on the basis of what originally was contemplated or not contemplated is not likely to be fruitful, since we are not speaking of a constitution but a set of tax laws, a quite different proposition. Tax laws (not subpart F in particular, thank goodness) are probably the most important laws in the United States as a practical matter, but there is no obvious reason why, in revising them, we should be saddled today with the "intention of the framers." Anything is possible and worthy of consideration. It would be foolish to operate on the assumption that what may or may not have been right in the early

4. See, e.g., NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME TAX PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY (1999). Largely as a result of the strong public and congressional reaction to Notice 98-11, 1998-1 C.B. 433, involving "hybrid branches," and its aftermath, the U.S. Treasury announced on December 11, 1998, that it would study "the extent to which changes in our anti-deferral rules are warranted." *Id.* The Treasury's report, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," was issued in December 2000.

1960s should have substantial force in the new century. Lengthy reports are not needed to demonstrate that the world has changed since 1962.

Reasoning from practical application of present-day rules is even worse. The "truth" about competitive and other effects of the rules is elusive, changing, unverifiable, and unknowable. Something of interest probably can be gleaned from the decibel level of corporate complaints at any given time, but that something is not likely to tell us that today's rules should be any better than what some congressman thought in 1962. Moreover, the evident self-interest of participants in the debate renders it difficult to credit the complaints without independent and objective evaluation.

Perhaps it would make sense to consider the subject from a different perspective. Instead of thinking about how the past is apt to resemble the future, perhaps it would be useful to begin with a blank page and ask what would constitute sound and appropriate treatment of the income of foreign controlled corporations as a matter of general tax policy. In other words, maybe the United States should be viewed as a candidate for true tax reform.⁵

Approaching the topic from this vantage point, I mean no disrespect for the substantial scholarship that has been devoted over the years to the question whether, and how, the United States should tax income earned by foreign corporations controlled by U.S. persons.⁶ That scholarship is formidable, and offers numerous insights into both the ways in which the stat-

5. The term "true tax reform" is employed in contradiction to the "tax reform" label that Congress routinely slaps on tax legislation, as in 1969, 1976, 1982, and 1986.

6. The past few years have witnessed an array of substantial and thoughtful legal writings devoted to this topic. See, e.g., Melvin S. Address et al., *The Erosion of Deferral After the 1993 Act*, 47 TAX LAW 933 (1994); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975 (1997); Stuart Leblang, *Deferred Gratification: A More Rational Approach for Taxing U.S. Multinationals*, 27 TAX MGMT INT'L J. 78 (1998); J. Clifton Fleming et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Roseanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255 (2000); J. Clifton Fleming et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 937 (2000); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, U. TEX. L. REV. (forthcoming 2001).

ute developed and the alternatives that have been considered and rejected (sometimes by repeal, after enactment) along the way. It is interesting to consider the relevance of arguments made forty years ago for the world of the twenty-first century. Further, I can not categorically reject the methodology of attempting to determine "how should subpart F be altered to fit the needs of today?" My approach, however, is different. I propose to think about constructing a tax system, using building blocks, experimenting and rejecting, in much the same process I would employ (have employed) in counseling other countries. This methodology offers the possibility of opening for discussion propositions that might be viewed as too certain or immutable to merit comment in the context of the existing system. That, in and of itself, has to be salutary.

Of course, the economic system of the United States is complex, and rethinking the enterprise is a Herculean proposition. Many adjustments are doubtless needed in attempting to transfer rules developed for other jurisdictions to the U.S. context. Moreover, there is no way of "unlearning" our experiences with the present statute and every reason to believe that the forces that shaped it will continue to operate on whatever might stand in its stead. Nevertheless, it seems possible that we are unduly intimidated by the monster that lies before us. It may not have to look like that.

I approach the subject with few illusions. Ultimately, how U.S. income tax will apply to income of foreign corporations controlled by U.S. persons will be subject to the same political forces that have always determined the outcome of the discussion (though that outcome varies from time to time, as the political forces themselves mutate). However, it even may be useful to note that the debate *is* political, that subpart F is neither going to be expanded into a complete repeal of deferral nor itself repealed on the basis of which view is "right." The question is who has the votes, not which side is "right." In these circumstances the notion of "starting over" as a basis for considering changes in this important body of law may seem ludicrous. On the other hand, there are few things more risible than the rules presently on U.S. books.

II. RESIDENCE-BASIS TAXATION AND ITS CONTENTS

There are two well-recognized and internationally accepted "jurisdictional" bases for an income tax: source and residence. Source-basis taxation depends, more or less, on the proposition that the country where income originates has a legitimate claim to tax that income. Residence-basis taxation relies on the notion that the country where the taxpayer resides legitimately may impose tax in order to support the normal government activities that residents enjoy.

Most countries rely on both source taxation and residence taxation for their income tax base, and there is really no need to choose between these two jurisdictional grounds. A "mixed" system is common, justifiable, and reasonable. What is more important, for this paper, is that residence-basis taxation is hard to quarrel with as a matter of tax policy. Such taxation certainly is equitable, since it treats equally taxpayers having similar amounts of income, irrespective of where that income was derived. In contrast, a system that relied exclusively on source-basis taxation would favor residents benefiting from foreign-source income, a benefit that modern technology and communications make much easier to achieve than in years past.

From the standpoint of efficiency, there is no obvious gain in an exclusively source-based system because a government's interest in favoring foreign-source income is difficult to rationalize. Most countries may be thought to have the converse interest—favoring domestic income over foreign, so that the domestic use of capital may work to produce non-tax benefits in the form of economic activity and employment. And, from the standpoint of simplicity, there is nothing inherently complex in defining who is a resident, although there are competing definitions from which to choose and it would be easy to devise others.⁷

In short, it is possible, without much effort, to defend the residence basis as a jurisdictional ground for income taxation.

7. The United States, idiosyncratically but understandably in light of twentieth century events, views citizens as enjoying many of the same government-funded benefits as residents and, therefore, effectively treats U.S. citizens the same as residents for purposes of jurisdiction to tax. That is a fine point for present purposes.

It fits nicely within all criteria of a good and proper income tax, does no violence to international understandings, and probably should be used by any country that has a formal income tax. The most common objection—that the worldwide taxation implied by residence basis jurisdiction creates difficult problems for tax administration because income sources outside the country cannot be easily verified—has validity. But the desirable features of residence taxation and the undesirable implications of an exclusively source-based system argue strongly in favor of making the attempt. The results of not doing so will be distortions in the patterns of income-producing activity and dramatic inequality among taxpayers having similar amounts of economic income.

Taxing on a residence basis does, however, definitely imply taxation of global income, “from whatever source derived” in the resounding words of section 61 of the U.S. Internal Revenue Code. If less than all worldwide income is taxed to residents—or, more specifically, if residents are taxed only on some geographically limited slice of that income—the result is something less than true residence-basis taxation but rather (depending on how the slice is defined, though it generally would be limited to some version of domestic source) an expanded version of source taxation. Residence-basis taxation ultimately is based on the proposition that geographic distinctions among income flows are irrelevant.

There is nothing inherent in the concept of residence-basis taxation that speaks clearly to the question of how to tax income of foreign controlled corporations. However, two attributes of such corporations are more eloquent. First, corporations are a complicating factor. Their presence in a tax system requires rules of many different sorts—not least troublesome of which is identifying exactly what a corporation is.⁸ Respect for the corporation as an entity separate from its controlling shareholders leads to difficult questions about when income enters or leaves corporate solution, the need to police inter-corporate dealings, and inevitable ambiguities in assessing the

8. The United States virtually has thrown in the towel on the point, having adopted rules that generally permit corporate status to be elected by merely “checking the box.” See Treas. Reg. § 301.7701-2, -3 (as amended in 1999). The prior rules based the definition on a weighing of “factors” that, over time, became increasingly arcane, abstract, and ephemeral.

relationship between the corporation and those who control it.

Second, the only persons a country has available to tax are, in the final analysis, individuals. Corporations, trusts, and more exotic types of entities are all pieces of paper—legal constructs, adopted at one time or another for one purpose or another. Without disparaging those purposes or those times, the results need not be accepted for all purposes. The existence of the constructs holds many legal implications, but those implications exist exclusively at the sufferance of laws and lawmakers and, in that sense, the constructs are not “real.” Insofar as taxation in particular is concerned, there is no compelling reason why those implications must be respected. It is possible to make a reasoned and independent judgment whether to accept and respect the legal constructs *in tax matters*.

This paper is focused on taxation of the income of foreign corporations controlled by resident taxpayers. One of the building blocks I would propose for such taxation is disregard of the corporate form, because the benefits of accepting that form in a control situation—treating it as an entity separate from those who control it and potentially representing a taxpayer in its own right—do not seem compelling. The corporate form is easily obtained and insubstantial. Especially in today’s world, there are few inhibitions to adopting or discarding it in any geographic location. The costs of maintaining the form in existence are insignificant. There is no difference in substance between a single controlled corporation and twenty such corporations. In the United States, as a result of the check-the-box regime, the form easily can be made transparent (non-existent) in one jurisdiction but opaque in another. The decision whether to operate in corporate form is, for the controlling shareholder, simply an election.⁹

9. The point was made clearly and irrefutably by Sidney I. Roberts, *From the Thoughtful Tax Man*, 40 TAXES 355 (1962):

If a taxpayer had foreign income and decided he did not want to pay tax on that income, he went to the Wizard of Og to secure a Talisman.

Now you would have thought that the road to Og was long or difficult or expensive. Not so! You would draw your Charter pretty much as if you were forming the ordinary garden-variety corporation, say, in Delaware or New York. Then you would mail it to counsel in Og and for \$500 he would arrange to have affixed the Talisman, which was merely a red seal symbolizing that you were incorporated under the laws of Og. In other respects, this corporation could operate in much the same places

Without being absolute on the subject, I think elections in tax matters are suspect. They arguably promote efficiency through the element of taxpayer choice, and in some cases may do no serious violence to the goal of equity. But they are not simple. By definition elections require the development of at least two sets of rules where, but for them, one would have served. Moreover, elections may become a threat to equity because, although they begin by allowing different results for situations that taxpayers, at their option, deem different, they commonly end up distinguishing between situations that are similar.

A foreign corporation represents an election by controlling shareholders in the residence country not to recognize income and loss, or credits, currently. The shareholder facing positive income and relatively low credits may be expected to make the election and thus not recognize the income or claim the credits. A shareholder anticipating losses usually will make the contrary election, because losses have a current value that the taxpayer will not wish to defer. But the situation may change. The foreign corporation that suffered losses begins to earn income; the one that anticipated income endures difficult years. Residents now in similar situations continue to be treated differently. If the tax system opts to address this inequity, it will adopt rules, invariably complex, for permitting the election to be reversed.

Nor is the election limited to recognition versus non-recognition, current taxation versus deferral. That is merely a starting point. When a resident shareholder chooses to earn income through a foreign controlled corporation, the election to defer income opens up a panoply of further elections because non-recognition of current income of a foreign corporation historically has implied an optional regime for when and how much recognition will occur at subsequent times. Since income is apt to be a driving force under other provisions of the tax regime—for example, the limitation on certain deductions or

and with much the same people as if it were a Delaware or a New York corporation. But because of the Talisman affixed to its Charter—which nobody but the lawyers ever so much as looked at or noticed—the laws of this Kingdom specified that a corporation with this Talisman paid no tax on its foreign income.

Id. at 355.

certain credits, including the foreign tax credit—these other provisions also become elective in substantial part. The result is additional rules to govern or restrict these secondary elections.¹⁰

This is not to condemn elections in all instances—there are few such black letter postulates in the business of developing a tax system. But tax choices having no non-tax consequences are problematic. Taxes are, and are meant to be, compulsory. To the extent elections introduce elements subject to the taxpayer's control, they tend to undermine the compulsory nature of the system and produce unfairness and inequity, in the basic sense of treating similar persons differently.

The notion of residence-basis taxation without respect for the corporate form is not radical in situations involving foreign corporations and control. The U.S. rules relating to the "deemed paid foreign tax credit" long have applied to corporate residents owning 10 percent or more of the voting stock of a foreign corporation.¹¹ These "indirect credit" provisions, which apply at ownership levels much lower than control, are at odds with the concept that the foreign corporation is separate from its shareholders. If the corporation is in fact separate, why is a credit allowed to the shareholder for taxes paid by the separate entity? In fact, the indirect credit provisions recognize that the foreign corporation is separate only in a formal or legal sense. In the context of a regime for avoiding international double taxation, it has seemed appropriate to cut through such formalities and allow a credit for taxes incurred by *the enterprise* on foreign income-producing activities. The gross-up of section 78, which prevents *the enterprise* from simultaneously benefiting from a credit and a deduction for foreign taxes paid completes the picture: The shareholder is called upon to recognize the income out of which the foreign tax was paid, making clear that both income and tax "really" belonged to the shareholder in the first place.¹²

10. Thus, the deferral regime in the United States fueled elections under the allocation and apportionment rules of Treasury Regulation section 1.861-8, which depended on the amount of current income recognition. These secondary elections came to be seen as excessively generous, and were eventually circumscribed (in part) by additional rules and limitations.

11. See I.R.C. §§ 902, 960 (1988).

12. The United States restricts the indirect credit to *corporate* shareholders, a restriction that derives from the classical system of taxation of corporate earnings.

There are two important offshoots of the suggestion of corporate transparency, each representing something of a diversion, but each worthy of note. First, the suggestion pertains to control situations, not necessarily to other instances of income earned through foreign corporations. This is because control situations are fundamentally different from situations in which the shareholder lacks control. The proposed rationale for disregarding the corporate form for controlling shareholders is that, taxes aside, the corporate form amounts to a simple election. In a world where limited liability companies are common, it is no longer necessary to adopt the corporate form even for the purpose of limiting liability. But it is only in situations involving control that the election is without non-tax consequences; in other circumstances the corporate form represents a structural choice having potentially important effects beyond taxation. In a case of control, the shareholder elects whether to operate directly or in a form that the tax laws may view as separate from him. In the absence of control, the shareholder may or may not engage in income-earning activities through a corporate vehicle, but the decision to employ that vehicle involves a surrender of decision-making authority to other persons, or at least a sharing of such authority. For this reason, the suggestion that the corporate form be disregarded or viewed as transparent in a control situation does not necessarily imply disregard of that form in other situations. Of course, an underlying assumption here is that it is possible through suitable definitions to distinguish control from non-control. Except at the margin, where all cats are grey, that assumption does not seem unreasonable.

Second, disregarding the corporate form when that form is foreign need not hold implications for corporate integration within the residence country. The so-called classical system involves taxation at the corporate level and again at the shareholder level. That system does not have to depend upon the "person-hood" of the corporation; it can be defended as an imperfect element of progressivity, without holding any implications for the separateness of corporation from shareholder except in the practical sense that a corporate-level tax requires some understanding of what a corporation, and the corporate tax base, are. On this view, the corporation is simply a convenient place to situate a second tax on certain earnings. Although the classical system doubtless has underlain at least

some thinking about taxing the income of foreign corporations, questioning the substantiality of such corporations does not necessarily imply dispensing with the corporate tax at home. Corporate residents represent a well-known and long-understood type of taxpayer, and on these grounds alone a very different matter than foreign corporations. The U.S. check-the-box regime, with its distinctions between U.S. and foreign corporations, appears to make a distinction of precisely this sort.

In sum, viewing the foreign control situation as an insubstantial election, or series of elections, says nothing compelling about corporations in other contexts, where they do not function as an election and hold substantially different consequences for the residence country tax base. A tax system could function without accepting the separateness of the foreign controlled corporation from its controlling resident shareholders while continuing to view both non-controlled foreign corporations and domestic corporations as independent and separate taxpayers or potential taxpayers.

The proposition that there may be no difference between income earned by a resident through a foreign controlled corporation and income earned by the resident directly is not the end of the matter, however. That proposition serves to simplify and may induce clear thinking about taxing the income of foreign controlled corporations, but it does not dictate the tax rules to be adopted. Residence-basis taxation implies taxation of worldwide income, but there are considerations of international comity and double taxation that also bear importantly on the subject. Those considerations are important without regard to the separateness of the corporate form, and quite apart from notions of global neutrality or competitiveness, the main linchpins of the arguments that have been advanced in the United States against, and for, deferral.¹³ Comity and double taxation draw the debate away from these abstract and elusive subjects, and into the distinct area of how best to deal with impediments to international commerce. The topic is integral to the taxation of foreign controlled corporations and, as a practical matter, cannot be shunted aside for separate consideration.

13. See Engel, *supra* note 6.

III. THE PROBLEM OF INTERNATIONAL DOUBLE TAXATION

It may be a basic tenet of residence-basis taxation that the tax base should include all income irrespective of source, but it also is indisputable that source-basis taxation exists commonly in the world; indeed, most countries have such taxation in their laws. The residence country may conclude—as countries around the world decades ago similarly concluded—that it is excessive for two taxing jurisdictions to impose the same type of tax (income) simultaneously on the same base; one because it sees itself as the origin of that base and the other by reason of its claim on the person of the taxpayer.¹⁴ Traditionally, the claim of the source country comes first, with the residence country assuming the responsibility of alleviating double taxation because it is in the best position of any country to do so. This responsibility may be discharged by a system allowing credit for income tax imposed by the source country, by exempting income earned in the source country, or by some combination of these methods. The United States, of course, has a well-developed foreign tax credit system.

In an industrialized and tax-sophisticated country the inherent logic of such a system threatens to engulf it. This leads to a regime that is either terribly naïve or terribly complex—and neither attribute is, ultimately, tolerable. A theoretically proper foreign tax credit system would allow credits for qualifying foreign (source country) tax on each item of income subject to tax in both the source country and the residence country, and prevent foreign taxes in excess of the residence country tax on any item to be used to offset the residence country tax on other items. There appears to be no principled justification for mitigating double taxation through cross-crediting, allowing the foreign country's "excess" tax on certain income to reduce residence country tax on other income. And yet, the "per item" approach, clearly, is impractical. Multinational enterprises cannot be expected to subdivide income into bite-sized pieces for the purpose of determining whether a credit is available. Even if they could, tax administrations cannot be expect-

14. This is distinguishable from a revenue-sharing situation, in which similar taxes are imposed at national and subnational levels within a single jurisdiction. There are various reasons born of history and practice why the same concern for "double taxation" need not apply with equal force in both situations.

ed to police the resulting determinations. There also lurk questions about the meaning of an "item," the problem of taxes imposed on the same "item" in different years, and the difficulty of determining how much foreign tax has been applied to each item (since foreign countries will not itemize their taxes so that items perceived as separate by the residence country are taxed separately by the country of source). These problems are overwhelming. For good reason, the per item approach has never been employed by any country.

The next best solutions, like most next best solutions in tax matters, carry far from the optimum. They all involve compromises and limited cross-crediting: Allowing excess source country foreign tax on certain items as a credit against residence tax on other items. The cross-crediting may be geographically general (worldwide) or specific (country-by-country). It may involve various categories of items, which in turn may be grouped on a worldwide basis or according to some other geographical or other delineation. The possibilities are numerous. The results will be a series of limitations on the credit in a way, and to an extent, that policy-makers conclude (for the moment) is reasonable.

Taxpayers, of course, will wish to have as few categories as possible apply to themselves, irrespective of what categories may be created. The important thing for a resident taxpayer is that, in its particular situation, foreign taxes giving rise to potential credits not be disassociated from income categories on the basis of which the credit limitation is computed. The fewer the applicable categories of taxes and income, the better the taxpayer will fare.

In such a regime, it is clear that accepting foreign corporations as entities separate from shareholders constitutes a complicating factor of enormous proportions. When foreign corporations are viewed as separate from shareholders and credits are allowed for foreign taxes imposed on the corporations and "deemed paid" by resident shareholders, logic and integrity suggest that the limitation be refined. An item of income must be assigned a category for purposes of the limitation regime when it enters into the tax return of the resident shareholder. The same holds true for foreign taxes eligible for credit. If the residence country wants to forestall manipulation of its system, taxpayers must be precluded from altering limitation categories by transactions with themselves (that is, transac-

tions involving related, commonly controlled, foreign corporations) after the income has been earned by a foreign affiliate, but prior to the time when it becomes taxable, and credits available, in the residence country. If each corporate form represents a person for tax purposes and no tax applies to the current income of foreign corporations, separate corporations are relatively free to transact business with each other and, potentially, adjust credit limitation categories to their benefit. It is, therefore, necessary to establish rules to "trace" income and credits back from the time when they are reported on the resident's tax return to the moment when they first became available to the enterprise, that is, when they were first taken into account for tax purposes by a foreign corporation that constitutes part of the enterprise.

As current U.S. law amply demonstrates, a regime for "basketing" income and foreign taxes is complicated enough. However, complications are turbo-charged by the elaborate rules needed to "look through" transactions between and among foreign corporations.¹⁵ Additional rules are necessary for handling losses and deficits within categories, both during the period when income and credits remain in foreign corporate solution before reaching the resident's return and as of the moment when one or more of the categories on the return are themselves negative. Losses in a category may be provisionally applied to reduce other categories,¹⁶ without actually moving into those other categories, or they actually may shift over, "borrowed" by other categories, subject to rules for eventual repayment to the category whence they came.¹⁷ It is a separate question whether foreign taxes associated with the loss category should move as well.¹⁸

To determine the amounts, positive or negative, in the categories, it is necessary to provide for the allocation and apportionment of deductible expenses, both while income remains in foreign corporate solution and when income and credits arrive on the residence country tax return.¹⁹ Conceptually and logically (if not politically) unassailable, this detailed,

15. See I.R.C. § 904(d) (1989).

16. See I.R.S. Notice 88-71, 1988-2 C.B. 374, 375.

17. See I.R.C. § 904(f)(5) (1989).

18. See Treas. Reg. § 1.904-6 (1989).

19. See Treas. Reg. § 1.861-8 (1989).

judgment-laden process results in “stealth” deductions assigned to limitation categories but which may be totally unknown in the foreign jurisdiction that imposes tax. The effect is a regime for avoiding international double taxation that floats free, with only a tenuous connection to what is occurring in the source country.²⁰

The problem is not simply that this tangle of rules is complex, much less that it is illogical or unnecessary. The rules fit together nicely in a rational unfolding of the basic notion that the foreign tax credit should be limited so as to preclude “excessive” cross-crediting or the use of credits to offset tax on income from within the residence country. It is certainly unclear where in this unfolding the proponents of the rules strayed from the necessary and rational. Nor is the problem simply that the limitation may have been spun too fine for its own good. The more serious point is that the complexity is bound to engender inequality of treatment among taxpayers. A great deal clearly escapes audit attention, and the odd case that becomes a discussion with tax authorities tends to produce (in me, at least) a nagging feeling that many others, indistinguishable, must surely pass without drawing attention.

Treating foreign-controlled corporations as transparent is no panacea. This step would not dispense with the need to deal with cross-crediting and determining net income in individual credit categories. Further, the “deemed paid” credit rules—and all they require in the name of defending purity of the limitation categories—still would have room for operation in noncontrol situations. Respecting the separateness of foreign corporations magnifies the conundrum of limitation, but the origins of that conundrum lie in the foreign tax credit regime itself.

The tax policy choices that have been the object of the obsessively intricate U.S. rules are inherent in the laws of any nation that employs a credit as the means of alleviating international double taxation. Those choices seem to lead to any of three conceivable results: large dollops of electivity; rules so generous on the issue of cross-crediting as to make elections virtually unnecessary; or a fiendishly complex, ultimately self-

20. For a particularized example, see *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989).

defeating, series of provisions designed to police the limitation categories and the rest of the regime.

Exemption may offer a better alternative. In considering that possibility it is worth taking note that most substantial business activities occur in countries with formal and serious tax systems. The amount of "residual" residence country tax to be derived after a foreign tax credit is allowed with respect to income from such activities is small. A credit system in these circumstances operates prophylactically, to protect the residence country tax base. Viewed from that perspective, however, the system may be extravagant. It costs the residence country a great deal in terms of compliance, tax administration, efficacy and honesty of the rules. Weighing such costs, a residence country might conclude that an exemption carefully trained upon the principal sources of international double taxation would be an improvement.

The residence country might also note that all taxing jurisdictions in the world are not equal, and there is no reason to treat them as if they were. Even as a political matter, it is unclear that equality should be the norm. If France and the Cayman Islands are viewed *in pari passu* insofar as residence-country taxation is concerned, it inevitably will be necessary to adopt rules not needed for France because the same rules must contend with the Caymans. For such reasons, tax policy addressing foreign income earned by residents can and should contain means of distinguishing between jurisdictions anticipated to impose substantial income tax and those that will not. The aim is not necessarily to find a match for residence country rules but, more modestly, to identify jurisdictions that have comprehensive rules of income taxation. The possibility of exemption should be reserved for such jurisdictions.

It is not, of course, enough for the residence country to make a distinction among countries and leave the matter there. That country would have to remain vigilant and adopt a dynamic method for distinguishing between the Frances of the world and the Caymans. Any jurisdiction may find it necessary/expedient/profitable to convert to low-tax status, either in whole or in substantial part. Countries that previously have been oblivious in matters of taxation suddenly may perceive gold in haven status and embark on programs intended to attract investment from residence countries. Or, more subtly, France may decide for any number of reasons that Alsace (for

example) should become a special enterprise zone, with privileged tax rules. Without proceeding so far as a new view of the national tax system, and perhaps for reasons other than those that induce a nation to turn itself into a fiscal paradise, geographical or industrial or other distinctions may be adopted that have the result of precluding application of "normal" tax rules. This, too, would be problematic from the standpoint of the residence country.

For such reasons, the residence country will not want simply to prepare a list, include France (or, conversely, the Caymans), and rely on the list for operation of its rules. The subject requires periodic revisitation, and current information about both actual practices and new developments.

The best tool for this purpose is the residence country's tax treaty network. A sensible country will use this network, in combination with its internal law, to advance its national tax policy goals. If an element serving those goals is distinguishing between France and the Cayman Islands on a dynamic basis, and perhaps making distinctions within France as well, the treaties readily lend themselves to the task. They can be used with precision, changed rapidly, offer the possibility of ascertaining current information, and ought to be the instrument of choice for identifying, on an ongoing basis, those jurisdictions where an exemption system could apply.

There are some risks, particularly in the discretion that must be vested in government officials charged with tending the treaty network, but they do not seem so huge as to be unbearable. The suggestion is not that compiling a list of countries qualifying for exemption be left entirely to the treaty program, but that the program be employed to prepare, review and, if necessary, change the list. Nor is reliance on the treaties inconsistent with oversight and correction by the legislature. The treaties are not the only means of establishing and reviewing the sort of list that has been described, but some means of distinguishing among jurisdictions is indispensable.

Normal business income in countries appearing on the list of exemption jurisdictions does not appear to require a foreign tax credit system. If exemption was instead employed for the core case—business income attributable to a substantial presence within such countries—there is a potential for real improvement in the tax system, judged in terms of efficiency, equity, and simplicity.

Under the proposal, manufacturing income earned in France would not be taxable in the residence country, either when earned or when repatriated. Sales income in France, even from sales into Germany, similarly would be exempt, provided the income was linked with activities carried on in France. The so-called "base company" concept should not be controlling in this context, as the "high tax exception" of subpart F recognizes in a different way.²¹ That exception, however, mechanical and static, is not equivalent to exempting income in the first instance. The exemption would apply not only to income earned directly by the resident taxpayer but, since foreign controlled corporations would be transparent, to all foreign corporations subject to the taxpayer's control, wherever organized and wherever managed and controlled, at whatever tier in the chain of ownership.

Would some income escape taxation? Certainly. In some instances income would qualify for exemption under the proposal yet not be taxed by the source country. In others, the source country's tax rate would be low enough that potential residual taxation in the residence country would be foregone. Would there be tax planning opportunities for professionals and tax directors in the residence country's businesses? Surely. Exemption is a powerful magnet and residence country taxpayers would pay close attention to it. The question, however, is not whether the proposal places a hermetic seal on income that might, in the abstract, be subject to tax in the residence country, but whether costs of the described nature will be so large as to result in assaults on the goals of efficiency, equity, and simplicity, particularly by comparison with the system presently in force in the residence country. Seepage exists in the most detailed tax system, and no approach to taxing the income of foreign controlled corporations is capable of preventing it. Aiming for perfection will, inevitably, fall short of the mark with respect to persons determined to avoid tax while (at best) inconveniencing everyone else.

To be sure, the proposal (like any other dealing with this subject) calls for important definitions, such as what is control, what is business income, and when is such income to be viewed as earned through a substantial presence in a listed

21. See I.R.C. § 954(b)(4) (1989).

foreign country? Each of these crucial concepts merits careful consideration, but it is relatively easy to identify starting points.

For "control," it is tempting to recur to the definition used in the transfer pricing area—"any kind of control, direct or indirect, whether legally enforceable or not, and however exercised or exercisable."²² The vagueness of the phrase may rule it out as a sole test, however. The "safe harbor" that lies at hand is direct or indirect holding of a majority of either vote or value.²³ Shareholders not within the control group,²⁴ even if substantial, should be treated separately, since notwithstanding the size of their holdings it cannot be said that the foreign corporation represents, for them, merely an election.

For "business income" the leading definition is probably the treaty concept of business profits. This would include passive income recharacterized in accordance with the circumstances in which it is earned. The residence country would have to make a judgment, in developing its exemption list, whether such income likely would be subject to tax in foreign countries. Incidental income is going to be the focus of planning activity, and in jurisdictions where such income is apt to escape tax, adjustments to the list would be indicated.

To determine when income is earned through a substantial presence in a foreign country, the concepts of permanent establishment and attribution seem appropriate. These concepts are used around the world as a result of the international web of tax treaties and therefore, in most jurisdictions, offer the hope that they truly will identify cases in which the source country will tax. Although the precise contours of the permanent establishment concept are not crisp and a number of fact patterns (more numerous, no doubt, by reason of the e-commerce phenomenon) are bound to require interpretation, any competing concepts (for example, the "trade or business" and "effectively connected" standards employed for inbound taxation in the United States)²⁵ are unlikely to achieve wide acceptance and could be idiosyncratic in application. The notion of business

22. Treas. Reg. § 1.482-1(i)(4) (1989).

23. See I.R.C. § 957 (1988).

24. Constructive ownership rules would, of course, be used for this purpose, though the rules of I.R.C. Code section 958 usefully could be rationalized.

25. See I.R.C. § 864(b), (c) (1989).

profits attributable to a permanent establishment has a clear basic meaning, one that receives endorsement and interpretation through ongoing work of the Organization for Economic Cooperation and Development (OECD). So the suggestion is that business income attributable to a permanent establishment in designated countries would be exempt in the residence country. Permanent establishment would be defined by law in a general way—for example, adopting the OECD concept—though the definition could be adjusted by negotiation with individual treaty partners.

The residence country would be the arbiter of these definitions, since the rules would represent its domestic law, even though the terms are borrowed from the treaties. There might, of course, be instances where the law of the residence country would pose a question not asked by the source country for purposes of its own taxation, for example whether a controlled corporation considered by France to be a resident had a permanent establishment in France. France, taxing corporations on a residence basis, might not have any interest in the inquiry. There also might be jurisdictions, even designated jurisdictions, that do not tax at source all income that, in the eyes of the residence country, is attributable to a permanent establishment in those jurisdictions. If there likely is not to be a source country tax on a clearly envisioned class of income—the operative word here is likely, not certain—adjustments to the list, as suggested above, should be made. In particular, a source country exemption for foreign income attributable to a permanent establishment in that country cannot be accepted in this regime. Systemic holes in a tax system are like the drain in a bathtub; the fact that they are limited in diameter is of little importance.

As for the Caymans, as for income from Alsace, the implications of the proposal are current tax in the residence country and a deduction for foreign taxes imposed on such income. Like the proposed exemption, this rule would apply regardless of whether income was earned directly or in foreign controlled corporate solution, and irrespective of how many layers of foreign controlled corporations were interposed between the resident and the income. The taxpayer that finds itself in a position in which it does not derive maximum benefit from the tax regime can obtain that benefit by removing itself from that position. Relieving international double taxation is a worthy

goal for a residence country, but that goal need not be pursued in exactly the same way in every country in the world.

My inclination would be to favor a similar approach to passive income, not qualifying as business profits. It has never been clear why a foreign tax credit should be made available for such income. The earning of income from portfolio investments in a source country is clearly in the economic interests of that country, which finds itself in a conflict. It wants and needs the investments, but the earnings are a natural part of its tax base. The result is likely to be a modest regime of taxation, with exemption perhaps for particularly favored investment forms. The residence country does not have a strong interest in wading into this conflict and making life easier for the source country by shouldering the burden of whatever tax the latter country chooses to impose. (The existence of a foreign tax credit regime that is likely to be misunderstood in the source country probably contributes to a higher level of source country tax than would otherwise be the case.) A deduction for foreign taxes imposed on income not qualifying as business profits attributable to a permanent establishment would treat such income in the same manner as if it was earned in the residence country and subject to taxation at the sub-national level.

It is true that not every residence country will be prepared to contemplate this binary view of the world, with an "exemption zone" carved out from a general rule of current taxation and no foreign tax credit. Much will depend upon the extent of the foreign activities carried on by residents of the particular country. Especially if those activities are likely to be widely dispersed, it may be necessary to interject a direct foreign tax credit, subject to some form of limitation to control cross-crediting, for certain situations. Ideally, this "third way" would be limited to business profits and activated solely by means of negotiated treaties. There would, of course, be a cost in terms of complexity. But if the residence country could achieve at least elimination of the deemed paid credit, gains for the cause of simplicity still could be substantial.

Even with neither foreign tax credit nor exemption for income earned in the Cayman Islands or (on the previous hypothetical) Alsace, a deduction would be allowed since there is no reason to treat such income more harshly than income earned within the borders of the residence country. The same

rule would apply to business profits from a listed country but not attributable to a permanent establishment. Source rules still would be needed, if only to govern source-basis taxation in the residence country. But the focus on income attributable to a permanent establishment would diminish the importance of such rules in the case of residence-basis taxation.

Income earned by foreign corporations in a non-control situation—either the corporation is not controlled by any one shareholder or controlling group of shareholders or the residence country taxpayer is not part of the control group—presents a different question. The proposal relating to control situations does not indicate how best to deal with the problem of international double taxation when control is lacking, and that subject is not the focus of this paper. Nevertheless, the subject is so closely related to the case of foreign control that a few observations are warranted.

The case for non-transparency of the corporate form finds support here in an eminently practical consideration—the residence country will not wish to place taxpayers in a position where they may be without sufficient information to comply with the law. That is probably a sufficient basis for general acceptance of the separateness of the non-controlled foreign corporation from its shareholders. On the other hand, if income earned through a non-controlled foreign corporation is not taxed currently to resident shareholders, there will be avoidance possibilities that would justify a regime akin to the U.S. rules relating to passive foreign investment companies.²⁶

A greater problem pertains to business profits attributable to permanent establishments. Suppose a residence country taxpayer enters into a joint venture with an independent party from another country to carry on business in corporate form in an exemption jurisdiction that imposes a substantial income tax on earnings of the venture. It might be reasonable to provide for exemption of dividends from such foreign corporations, at least (in a classical system), insofar as *corporate* recipients in the residence country are concerned. Further, there is no obvious justification for a minimum threshold of ownership,

26. See I.R.C. §§ 1291-1298 (1989). The word "akin" is used advisedly. It is hard to imagine a rational residence country intentionally replicating the passive foreign investment rules (PFIC), but there are doubtless simpler ways of targeting non-business income earned through foreign entities.

like ten percent of voting stock as employed in the United States to govern the deemed paid foreign tax credit.²⁷ In the case of income that would qualify for exemption if earned directly by the resident or through a foreign controlled corporation, the circumstance of non-control is not a reasonable basis for withholding double taxation relief. Nevertheless, exemption would have to be conditioned on availability of sufficient information to allow residence country tax authorities to verify the nature of the income; in the absence of such information, taxation would attach to the dividends received, with a deduction for foreign taxes imposed on the dividends. A direct credit might be considered, but in no event would a deemed paid credit be available; a foreign corporation would not be both separate from its shareholders and not separate at the same time.

To the extent of exemption, whether in a control or non-control situation, expenses incurred by the resident would be denied deductibility based on an appropriate allocation and apportionment to exempt foreign income. This would not be simple, but the allocation and apportionment rules presently in place in the United States, for example, serve an essentially similar purpose.

IV. PRESSURE POINTS

When the building blocks are assembled, the resulting system relieves foreign business income from residence-basis taxation, but in the name of alleviating international double taxation, not protecting import neutrality or promoting competitiveness. The system is precise, subject to the scrutiny and control of residence country tax authorities, and flexible. Exemption is afforded to income earned through substantial activities in designated jurisdictions. Other income—passive income not constituting business profits, business profits not attributable to a permanent establishment, income from jurisdictions not designated on the list—is taxed currently, whether earned directly by a resident or through foreign controlled corporations. A direct foreign tax credit for taxes imposed on the resident might be allowed in some of these instances, but the general rule would be deduction only.

27. See I.R.C. § 902 (1989).

In such a regime, the foreign tax credit would have relatively little scope for application. The rules relating to transfer pricing also would have reduced importance, particularly if the definition of control is borrowed from the transfer pricing area, though similar rules would be needed to govern the concept of attribution to a permanent establishment. More prominent would be the determination of what is a permanent establishment and what income is business profits. These are concepts that must be applied by countries around the globe in their role as source-basis taxing jurisdictions, and that are relatively familiar from decades of application in an international context.

The result would favor business investment and business earnings in major trading partners of the residence country. There would be no concept of "base companies," and no traps for the unwary in the rules relating to international double taxation. On the other hand, it would be more difficult to use foreign corporations to squirrel away passive income without tax, and there would be no special incentive to retain earnings in foreign corporate solution.

Without doubt there are many fault lines in the proposal, and experience would surely bring these to the attention of tax authorities. Several important issues, however, do not require such experience and can be identified now.

As suggested, rules similar to those that govern transfer pricing would be required to regulate the issue of what income is attributable to a permanent establishment. There does not appear to be any reason, however, why those rules need be any more complex than a transfer pricing regime. In addition, since the system is based on the notion of avoiding international double taxation, it may be possible to build upon the views of the source country, at least to some extent. This should not go so far as a "subject to tax" test, which would tend to embroil residence country tax administrators in the unhappy task of understanding laws of the source country as applied on a case-by-case basis. A lesser standard—for example, a requirement that the taxpayer demonstrate consistency of factual representations in both countries—might not be nearly so difficult to administer. The test would not conclusively establish attribution, but might be a necessary condition for such a claim.

The residence country also would have to address transfers of appreciated property to a permanent establishment in a

country qualifying for exemption. Such transfers should give rise to immediate taxable gain, regardless of whether the asset in question is "purchased" by the permanent establishment. There thus would be a "price" for entering the exemption zone with assets that had acquired value outside it. Alternative approaches would place too much pressure on the question of what is, and what is not, attributable to the permanent establishment. Other conceivable responses to the "transfer in" issue likely would prove dauntingly complex in practice.

The proposal would result in a "misallocation" of tax revenue in some instances, particularly when deductible expenses have been incurred outside the exemption zone and a not yet highly appreciated asset is transferred into that zone. The proposal accepts the resulting misallocation as a fact of life, given the concept of an annual accounting period. Similar mismatches inhere in any system that allows current deductions for expenses, like research and development costs, that produce future value. My inclination would be not to attempt to police the mismatch through detailed rules governing the transfer to the exemption jurisdiction,²⁸ but instead to rely upon a combination of an immediate tax upon gain and the expected tax in the source country to inhibit transfers having little business purpose.

Finally, perhaps most importantly, the proposal draws a sharp line between designated jurisdictions where exemption could apply and everywhere else. The resulting difference in treatment would place continual pressure upon the residence country to expand its list of exemption jurisdictions. Clearly, not every jurisdiction is either a France or a Cayman Islands. How is the residence country to treat Morocco or Brazil? Hungary? Gabon? Nations have different views about taxation, different capabilities for implementing a tax system, different economic attractions for the resident. Some pressure would be relieved if it was determined to allow a direct foreign tax credit in specific situations, preferably through treaty negotiations. But with every agency in the residence country doubtless viewing itself as a custodian of tax policy, it may be difficult to keep the exemption list to its intended purpose. Nevertheless, there are substantial dangers in loosening the grip. *In concept*

28. See I.R.C. § 367 (1988).

the list should include only foreign countries that have full-blown, purposively administered, income tax systems, and which can be trusted, in most cases, to impose tax on persons having a substantial nexus with their soil. That does not necessarily imply a restriction to OECD members (or, for that matter, inclusion of all OECD members), but the criteria for inclusion should be high. It would be strange indeed for a residence country, dubious of its ability to administer such criteria, to opt instead to place all foreign taxing jurisdictions on the same plane and structure its rules for foreign income accordingly.

V. CONCLUSION

There is no way to drain complexity from the regime of a modern capital-exporting country for taxing income of foreign corporations controlled by residents. The history of this subject contains many lessons. But, the lessons are themselves in conflict and ultimately unclear; some do not find concrete expression in existing rules of law. Considerations of economic encouragement or discouragement do not point clearly to any particular solution; and, in any event, the *tendency* of a given rule to induce or discourage certain behavior is often a weak foundation on which to create a superstructure of more detailed rules. What is left, at the end of the day, is the need to deal with international double taxation and to protect the residence country's tax base. The proposals sketched above, involving a limited exemption for business profits attributable to permanent establishments in certain specific foreign countries, aims at these objectives.

Any country—the United States, for instance—having a different set of rules presently in place for taxing the income of foreign controlled corporations would have to address many transitional issues in passing to the proposed regime. The treaty network would have to be studied with a view, eventually, to reworking it to accommodate the proposal. All that is no doubt of great technical and political complexity. But it is a separate subject.

PREPARED STATEMENT OF STEPHEN E. SHAY

Mr. Chairman and Members of the Committee:

My name is Stephen Shay. I am a partner in the law firm Ropes & Gray in Boston. I specialize in U.S. international income taxation and was formerly an International Tax Counsel for the Department of the Treasury in the Reagan Administration. I was invited last Friday by the Committee to be a witness to discuss the

effects of U.S. tax policy on the international competitiveness of U.S.-owned foreign corporations.¹

With the Chairman's permission, I would like to submit my testimony for the record and summarize my principal observations in oral remarks. Because I learned of my invitation to be a witness three days ago, I will necessarily keep my remarks limited to a few aspects of this topic.

Overview

My first observations relate to the objectives of U.S. tax policy—of which international tax policy is only a part. The primary focus of U.S. income tax policy should be to improve the lives and living standards of American citizens and residents.² The question raised by the topic of this hearing is in what circumstances, if any, improving the “taxcompetitiveness” of U.S.-owned foreign corporations (meaning reduced U.S. tax on their U.S. shareholders) improves the standards of living of American citizens and residents more than alternative uses of those tax dollars.

My second set of observations address the question whether U.S.-owned multinational corporations are “tax-disadvantaged” in relation to foreign-owned corporations conducting business operations outside the United States. Although aspects of the U.S. tax rules excessively burden international commerce, to the detriment of a particular U.S. company or even industry, I have not seen compelling evidence that the U.S. tax rules taken as a whole are more onerous than the rules of other countries, even including countries that employ a traditional exemption system. Indeed, there is legitimate debate as to whether adoption of a exemption system by the United States would actually raise rather than lose revenue.

I encourage the Committee to consider international tax changes in the context of the overall U.S. tax system. I suggest that the tax savings from the repeal of ETI not be earmarked for international corporate taxation reforms, but instead be devoted to changes that are likely to improve the living standards of all Americans. If a proposal to modify an international tax rule is superior to all other proposals under that standard, then I would support it. I am not yet persuaded that the current international tax reform proposals meet that mark.

United States International Competitiveness

The objectives of the United States international income tax rules are to provide for the interaction between the United States Federal income tax system and the income tax systems (or absence of income tax systems) of other countries in a manner that achieves overall objectives of the United States. The international tax rules are a subset of the overall U.S. income tax system, the principal objective of which should be to collect revenue in the amount needed to fund the needs determined by the political branches of government to improve over some reasonable period the standard of living of U.S. citizens and residents.

The tax policy decisions before this Committee should be evaluated against a simple standard of U.S. competitiveness: will it improve over some reasonable period the standard of living of individual U.S. citizens and residents? The fact that a policy increases the after-tax profitability of U.S. owners of foreign business entities in relation to foreign owned business entities carrying on non-U.S. business should be relevant only to the extent it may be demonstrated that U.S. citizens and residents will realize a benefit commensurate with the cost of the policy.³

Although not directly the topic of this hearing, the ETI does not appear to have been tested against this or any other measurement standard. The effect of the ETI regime is to reduce the tax rate on certain export income by approximately 15%.⁴ In the initial rush to find fault with the WTO decision finding the ETI to be an illegal export subsidy,⁵ and then to adopt some form of substitute benefit, I have not

¹I have attached a copy of my biography to this testimony. The views I am expressing are my personal views and do not represent the views of either my clients or my law firm.

²See Michael J. Graetz, *The David Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 *Tax Law Rev.* 261, 284 (2001).

³Tax policy proposals are traditionally tested against the following criteria: tax rules should (i) be efficient in that they should distort economic decisions and allocation of resources as little as possible (unless the rule has an explicit subsidy or deterrent objective), (ii) be consistent with U.S. fairness or welfare objectives as determined by the political branches of government, and (iii) raise the intended revenue at a reasonable cost to the taxpayer and the government. See U.S. Treasury Department, 3 *Tax Reform for Fairness, Simplicity and Economic Growth* 13–19 (1984).

⁴A domestic corporation subject to a 35% Federal corporate tax rate will pay a 29.75% rate on its net income subject to the ETI regime.

⁵On January 14, 2002, the WTO Appellate Body issued a report upholding a dispute resolution panel finding that the ETI is a prohibited export subsidy. Subsequent appeals have been

seen discussed the question: Does the ETI improve the overall living standards of American citizens and residents?

It is questionable whether the ETI (and its predecessors the FSC and DISC) does in fact improve the living standards of Americans by comparison with alternative ways that the foregone revenues (or tax benefits) could have been employed. There appears to be support for the position that the impact of the ETI on net exports (the increase in exports reduced by the corresponding increase in demand for imports) is modest at best and likely does not exceed the tax revenue lost as a result of the tax incentive.⁶ In addition to the obvious questions that should be asked about any proposal that would perpetuate ETI benefits for old users (but apparently not new ones) and continue a benefit already found illegal, it should be asked whether an inefficient tax subsidy is good policy.

I turn next to the question whether U.S.-owned foreign corporations (or their U.S. parent companies) are disadvantaged in relation to foreign-owned corporations carrying on business outside the United States.

Evaluating the U.S. Worldwide Tax System with Deferral in Relation to A Territorial Tax System

The major approaches by which the tax system of a country (the “residence country”) accounts for income earned by its residents in a foreign country (“foreign-source income”) are a worldwide system and an exemption, or territorial, system. Although a number of major trading partners employ some form of territorial system, none of the international competitiveness or simplification tax proposals currently under discussion would adopt an exemption system.⁷

One question implied by a claim that the U.S. tax rules are anti-competitive is whether U.S. companies would be better off under a territorial tax system? If the United States were to adopt a territorial system comparable to the systems adopted in other countries, the United States (i) would not tax its own residents’ foreign-source business income that is subject to taxation in another country,⁸ (ii) would disallow deduction of foreign business losses,⁹ and (iii) would tax currently portfolio dividends and all foreign source interest and royalties.¹⁰ In other words, only foreign-source business income would be exempt from U.S. tax and this income would bear the tax only in the foreign country where the income was produced (the “source country”).¹¹

rejected and the United States has committed to repeal the ETI. The ETI was the successor to the Foreign Sales Corporation (“FSC”), enacted by the Congress in 1984 and found by a WTO Appellate Body in February, 2000, to be a prohibited export subsidy. The FSC was the successor to the Domestic International Sales Corporation (“DISC”) enacted in 1971, and found to be an export subsidy in a panel report adopted by the GATT Council in 1981. I do not discuss here the substance of the U.S. position nor its merits as a matter of trade law. Suffice it to say, the WTO has twice rejected the U.S. efforts to further perpetuate the export benefits that commenced in 1971.

⁶A 2000 Report on the FSC by the Congressional Research Service cites a 1992 Treasury Department analysis that repealing the FSC would have reduced net exports by 140 million. If the impact of the ETI on net exports was in fact less than the tax expenditure, it would be ironic that the United States now is faced with having to arbitrate EU claims for compensatory damages that are based on U.S. tax expenditure estimates. The CRS Report also observed that under traditional economic analysis the FSC by definition reduces U.S. economic welfare (as opposed to the welfare of the firms benefited by the subsidy and their shareholders) because at least some portion of the benefit is presumed to be passed on to foreign consumers in the form of lower prices.

⁷The approach proposed by House Ways and Means Committee Chairman Thomas last year would substantially expand the scope of permitted deferral of U.S. tax on foreign business income earned through a foreign corporation and address provisions limiting the foreign tax credit (but would not restrict provisions that permit foreign taxes to offset U.S. income).

⁸For this purpose, foreign business income includes foreign dividends or gains from substantial shareholdings.

⁹In some cases, foreign losses are allowed, but are recaptured as domestic income when the taxpayer next realizes positive foreign net income.

¹⁰See Michael J. Graetz and Paul Oosterhuis, Structuring an Exemption System for Foreign Income of U.S. Corporations, 54 Nat’l Tax J. 771, 774 (2002).

¹¹The traditional justification for exempting U.S. multinationals’ foreign-source business income is based principally on a competitiveness argument that is usually stated as follows: foreign corporations operating businesses in low-tax foreign countries owned by residents of countries with a territorial tax system, as well as local businesses in the low-tax foreign countries, pay only the low local income tax on their in-country profits. Without exemption, U.S. multinationals are unduly disadvantaged when competing against these foreigners in low-tax foreign countries because in addition to the foreign tax, a U.S. multinational will pay a U.S. residual tax on its foreign profits, while the foreigners would pay only the low foreign tax. Therefore a U.S. multinational should be given a countervailing exemption from the U.S. residual tax.

Note that adoption of the form of exemption system just described would result in heavier taxation than under current U.S. rules in at least three respects: Foreign income generally is not exempt unless it is subject to some level of foreign tax, whereas the United States allows deferral from U.S. tax for income that is not taxed at all. Foreign source royalty income would be subject to full U.S. tax, whereas the United States allows U.S. tax on foreign royalty income to be offset by excess foreign tax credits on other income. Finally, foreign losses are not allowed as deductions, whereas the United States permits losses to be deducted (subject to possible recapture which in any event would result in a timing benefit). One response to these observations might be that taxpayers can be expected to adjust their behavior so as to obtain the full benefit of the exemption system, i.e., by paying less royalties and so on.

Although a territorial system provides no direct benefit for foreign operations in countries with effective tax rates equal to or higher than the U.S. rate, it does offer greater potential for a U.S. multinational to reduce high foreign taxes through tax planning techniques that shift income from a high tax to a lower-tax foreign country. If there is lower taxation of foreign income, taxpayers with foreign operations have an incentive to shift higher taxed U.S. (and foreign) income to lower taxed foreign operations.¹² Significantly, an exemption system also permits repatriation of future exempted foreign business earnings without further U.S. tax.¹³

Notwithstanding the potential advantages of an exemption system and the assertion that companies from other countries have a competitive tax advantage, U.S. companies apparently do not support a shift to an exemption system. In this context, the Committee should view assertions that foreign tax systems are better for taxpayers with skepticism.¹⁴

It is not my purpose to defend the current U.S. rules; they can and should be improved. It simply has not been proven that the direction of policy should be to decrease as opposed to increase the tax on foreign income. Proponents of reduced taxation of foreign income should be required to go further than making generalized competitiveness arguments, and should link the tax benefits of a proposal to increased American living standards.¹⁵

Reform of the Current U.S. Tax System of Worldwide Taxation with Deferral

In practice the current U.S. system of worldwide taxation with deferral of U.S. tax on foreign corporate business income operates in much the same manner as a territorial system. If U.S. multinationals earn income through active business operations carried on by foreign corporations in low-tax source countries, the U.S. multinationals generally pay no residual U.S. tax until they either receive dividends or sell their shares. This phenomenon is referred to as "deferral." Deferral obviously decreases the present value of the U.S. residual tax. When this value reduction is combined with certain other features of the U.S. international tax regime (i.e., cross-crediting foreign taxes and certain source rules that overstate foreign-source income), well-advised U.S. multinationals can frequently reduce the U.S. residual tax on their repatriated foreign-source income to zero. Stated differently, the U.S. worldwide system, with deferral, frequently provides the same result as a territorial system (exemption from U.S. tax on foreign-source income). In a high-tax environment, the ability to credit excess foreign taxes against royalty income and export sales income makes the U.S. system more generous than an exemption system.

The original proponents of the DISC argued for the export subsidy in part on the grounds that exporters were disadvantaged relative to taxpayers that could locate their operations abroad and take advantage of deferral. In other words, an original

¹²The principal objection to a territorial system is that it creates a bias in favor of investment in foreign operations. In the worst case, this bias causes a foreign investment to be preferred even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.

¹³None of the current international proposals (including Chairman Thomas's) would provide for tax-free repatriation of future earnings eligible for deferral. The Homeland Reinvestment Act would allow a reduced tax on currently deferred income—much in the nature of a tax amnesty.

¹⁴In none of the corporate inversions that attracted so much attention in the last two years did companies re-domicile their parent company in a major trading partner, such as United Kingdom, Canada, France, Germany or Japan.

¹⁵It may be anticipated that the proponents will argue that benefits for operations in lower tax foreign countries will generate greater purchases of U.S. goods because U.S. multinationals will buy from their U.S. affiliates and suppliers. Although this is a claim that deserves some scrutiny, at best this is an assertion that reduced taxation of the operations of U.S. multinationals in low-taxed foreign countries indirectly encourages U.S. exports and economic activity. It is unclear how much support there is for this claim, but no proposal to expand deferral would limit its scope to businesses with foreign operations that purchase goods from the United States.

rationale for the DISC predecessor of the ETI was to equalize for exporters the advantages realized by U.S. multinationals from deferral.¹⁶

If the ETI is repealed, as a logical matter the Committee also should consider decreasing the tax advantages to earning low taxed foreign income through foreign corporations.¹⁷ One would not have to repeal deferral to make substantial improvements in the current international tax rules without increasing the current incentives to locate investment outside the United States. It would be helpful to rationalize the current antideferral rules in a manner that would limit use of tax havens, but would impose less of a burden on normal business operations.

The current foreign tax credit mechanism could be improved by repeal of the sales source rule and other rationalization of source rules combined with improvements to the interest allocation rules and modification of the domestic loss recapture rules. If there were revenue available, the kinds of changes just described could be combined with revenue neutral reductions in tax for business income generally. This approach would assist U.S. businesses that export from the United States or compete against foreign imports as well as those that operate abroad. Alternatively, any revenue increase from these changes could pay for more favorable depreciation and amortization for investment in productive property, used to improve U.S. education or fund anti-terrorism initiatives.

Whatever the choice, I respectfully encourage the Committee to consider international tax reform proposals that will improve the well-being of all U.S. citizens and residents, including workers, farmers and small business men and women, and not just those in the multinational sector.

I would be pleased to answer any questions the Committee might have.

PREPARED STATEMENT OF HON. GORDON SMITH

I want to thank the Chair for holding this hearing on the different international tax issues that face the Senate Finance Committee. In talking about these issues I believe it is of the utmost importance to consider passing repatriation legislation, similar to the Invest in the USA Act that has been considered before this very committee.

The U.S. tax rate of 35 percent on foreign earnings makes it prohibitively expensive for our U.S.-based companies to bring foreign earnings back for investment in the United States unless the U.S. tax rate is substantially offset with foreign tax credits for taxes paid to foreign governments. As the Joint Committee pamphlet notes, it encourages investment of those earnings outside the United States when better investments can be made here.

The impact of this has accumulated over decades. JP Morgan looked at this issue on behalf of its investors and conservatively estimates that the pool of foreign earnings that current law discourages U.S. companies from reinvesting in the United States is now about \$500 billion—it may be substantially more. A good starting point for any international reform legislation would be to permit those dollars to be reinvested here. We need the stimulus and job creation here.

I am please to see that Senator Ensign, the sponsor of S. 596 (“Invest in the USA Tax Act”), will be testifying along with Senators Allen and Boxer, both cosponsors with me on that bill which the Senate has already passed once this year. It would unlock those dollars for investment in the United States at relatively no cost to the federal government.

For a one-year period, it would open the door to the reinvestment of those dollars in the United States. The 35 percent tax rate on dividends paid by a foreign subsidiary to a U.S. company would be replaced with a tax burden equivalent to the average tax rate at which companies have demonstrated they will bring the dollars back to the United States. Thus it would impose a 5.25 percent toll charge on dividends in excess of the company’s historical average, which is the equivalent of an 85 percent dividends received deduction. No foreign tax credit would be allowed for 85 percent of the foreign taxes associated with dividends qualifying for the 5.25 percent toll charge.

¹⁶See generally, Cohen and Hankin, “A Decade of DISC: Genesis, and Analysis,” 12 Va. Tax Rev. 7 (1982).

¹⁷I and my co-authors, Professors Robert J. Peroni and J. Clifton Fleming, Jr., have outlined a proposal for a broad repeal of deferral. Essentially, our proposal would apply mandatory pass-through treatment to 10% or greater shareholders in foreign corporations. Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 TAX NOTES 837 (2000).

According to JP Morgan's analysis for its investors, it would result in about as much economic stimulus as the portion of the President's tax proposals that were enacted this year—about a one-percent increase in GDP.

These are difficult economic times and enacting S. 596 is one way we can help. I am pleased to see that my colleagues are making the strong bipartisan effort to get it enacted this year.

COMMUNICATIONS

AMERICAN BUSINESS COUNCIL

[SUBMITTED BY JOHN E. PRATT, CHAIRMAN]

Mr. Chairman and members of the committee, the American Business Council of the Gulf Countries (ABCGC) would like to add a written statement to the record of these proceedings. Although these hearings focused on the international competitiveness of U.S. businesses operating abroad, the American Business Council of the Gulf Countries would like to complement the testimony of the distinguished Panel by speaking of the importance of maintaining and increasing Section 911 of the tax code, the Foreign Earned Income Exclusion.

All of the witnesses testified to the benefits of a U.S. tax code that allows American businesses to be competitive with foreign competition. However, the ABCGC believes that an important aspect of this strategy is to assist the U.S. workers employed by these multinationals, live in these foreign countries, and help sell the goods and services that create jobs back home. In the Jobs and Growth Tax Bill that emerged from this Committee in May, the Foreign Earned Income Exclusion was targeted for elimination. Eliminating the Foreign Earned Income Exclusion would cost countless jobs at home in America.

To remain competitive, American Companies are increasingly forced to fire American employees and hire foreign nationals that cost significantly less money to employ. Fewer Americans working abroad means fewer American goods and services sold overseas. Simply put, one billion dollars of exports creates 15,000 jobs for American workers. It is a trade competitiveness issue, not a tax issue. Why should Americans be penalized when competing in the global marketplace?

The American Business Council of the Gulf Countries and the 750 U.S. companies that it represents urges the Senate Finance Committee to help level the playing field for American companies abroad and not favor foreign companies, from every other industrialized nation, who do not tax foreign earned income. Please stand up for U.S. citizens abroad who keep America competitive and risk so much in these dangerous times overseas.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
[SUBMITTED BY EILEEN SHERR, AICPA TECHNICAL MANAGER]

AICPA COMMENTS ON INTERNATIONAL COMPETITIVENESS

The American Institute of Certified Public Accountants (AICPA) appreciates this opportunity to provide a written statement for the record of the Senate Finance Committee hearings on United States tax policy and its effect on the domestic and international competitiveness of U.S.-based operations and the operations of U.S. companies outside the United States. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

The AICPA believes that certain international provisions in the Internal Revenue Code are overly complex and disadvantageous to American businesses operating and competing abroad. For the most part, these provisions became law when the United States faced significantly less competition from its international trading partners than we do today. Unfortunately, these antiquated rules create competitive impediments that threaten American jobs.

It is our understanding that Congress and the Administration have decided to comply with recent World Trade Organization (WTO) decisions by repealing the Extraterritorial Income Exclusion (ETI) regime. The AICPA believes that it is critically important that the revenues gained from ETI repeal be used for reforms that increase the international competitiveness of U.S. companies.

We have attached a summary of the areas of international tax law most in need of immediate attention, followed by copies of documents and testimony on international tax reform that the AICPA has submitted to Congress over the last two years. These attachments are:

- A. Summary of the AICPA's Most Urgent International Tax Concerns.
- B. May 1, 2003, AICPA Comments to the Honorable Amo Houghton, Chairman of the Subcommittee on Oversight of the House Ways and Means Committee, on H.R. 285, the *Fairness, Simplification and Competitiveness for American Business Act of 2003*.
- C. September 30, 2002, AICPA Comments to the Honorable William M. Thomas, Chairman of the House Ways and Means Committee, on the International Tax Provisions in H.R. 5095, the *American Competitiveness and Corporate Accountability Act*.
- D. February 7, 2002, AICPA Comments on *Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System*.
- E. April 26, 2001, AICPA Testimony to the Senate Committee on Finance Holding Hearings on Tax Simplification.

ATTACHMENT A**Summary of the AICPA's Most Urgent International Tax Concerns**

1. Limit the application of Subpart F to truly passive income by repealing the CFC rules on foreign base company sales and services income. (See Attachments C and E.)¹
2. Reduce the number of foreign tax credit "baskets" to three. (See Attachments C and E.)
3. Provide a 10-year foreign tax credit carry-forward. (See Attachment B and C.)
4. Repeal the alternative minimum tax limitation on the utilization of the foreign tax credit. (See Attachments B, C, and E.)
5. Modify the interest expense allocation rules for purposes of computing the foreign tax credit. (See Attachments B and C.)
6. Consolidate, reconcile, modernize, and simplify the various overlapping anti-deferral regimes and provisions (e.g., the passive foreign investment company, foreign personal holding company, and foreign investment company rules in Subpart F).
 - a. Repeal the foreign personal holding company and foreign investment company rules. (See Attachments B and D.)
 - b. Exclude foreign corporations from the personal holding company rules. (See Attachment D.)
 - c. Include certain personal services contract income targeted under the present foreign personal holding company rules as Subpart F foreign personal holding company income. (See Attachment D.)
 - d. Eliminate the application of the passive foreign investment company rules to smaller investments in foreign companies whose stock is not marketable. (See Attachment E.)
 - e. Revise the rules for determining foreign personal holding company income with respect to commodity transactions. (See Attachment C.)
7. Recharacterize overall domestic losses. (See Attachments B and C.)
8. Provide for deemed paid foreign tax credits to be claimed indirectly through partnerships. (See Attachment D.)

¹ We also have previously suggested and continue to support treating the European Union (EU) as one country in order to mitigate the problems raised by the Subpart F rules. (See Attachment C.)

9. Eliminate the reporting requirements for foreign-owned domestic corporations with immaterial cross-border transactions. (See Attachment B.)

Attachment B

May 1, 2003

The Honorable Amo Houghton
Chair, Subcommittee on Oversight
House Ways and Means Committee
1110 Longworth House Office Building
Washington, D.C. 20515

Re: Support for H. R. 285, *Fairness, Simplification and Competitiveness for American Business Act of 2003*

Dear Chairman Houghton:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide our strong support for H.R. 285, the *Fairness, Simplification and Competitiveness for American Business Act of 2003*. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

As global trade increases, legislative changes, such as those in H.R. 285, are needed to allow U.S. businesses to react more nimbly and on a par with foreign competitors having less complex tax systems. H.R. 285 is both timely and a welcome simplification proposal.

Reducing Complexity and Compliance Burdens

In particular, the AICPA supports the following provisions, which would greatly simplify compliance:

- Expanding the Subpart F *de minimis* rule (section 101);
- Deleting overlapping provisions by, for example, repealing the foreign personal holding company and foreign investment company rules (section 104);
- Repealing the CFC rules on foreign base company sales and services income (section 106);
- Reducing the number of foreign tax credit baskets to three (section 108);
- Eliminating the reporting requirements for foreign-owned domestic corporations with immaterial cross-border transactions (section 306);
- Allocating interest on a worldwide basis (section 310); and
- Rationalizing the foreign tax credit rules (Title II).

The current foreign tax credit rules often result in double taxation and leave many taxpayers with excess foreign tax credits. Extending the carryover period, allowing recharacterization of overall

domestic losses, and repealing the alternative minimum tax foreign tax credit limitation would significantly reduce this double tax burden and enhance competitiveness.

* * * * *

The AICPA would be happy to offer our further assistance on this legislation. Please contact me at (202) 414-1705, or robert.zarzar@us.pwcglobal.com; Andrew Mattson, Chair of the International Tax Technical Resource Panel, at (408) 369-2566, or Andy@mohlernixon.com; or Eileen Sherr, AICPA Technical Manager at (202) 434-9256, or esherr@aicpa.org.

Sincerely,

Robert A. Zarzar
Chair, Tax Executive Committee

[cc's omitted]

Attachment C

September 30, 2002

The Honorable William M. Thomas
Chairman, House Ways and Means Committee
1110 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on the International Tax Provisions in H.R. 5095, the American Competitiveness and Corporate Accountability Act

Dear Chairman Thomas:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide our technical comments on the international tax provisions contained in Titles II and III of H.R. 5095, the American Competitiveness and Corporate Accountability Act, as introduced on July 11, 2002, (the Bill). The AICPA is the national professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We realize that in crafting any tax legislation, there are a multitude of economic, policy, and revenue considerations that must be balanced. Our comments focus only on several technical international tax issues in the proposed legislation.²

In general, we support – and are pleased to see – many of the provisions in Title III, which simplify the taxation of U.S. businesses operating abroad. (Please see our comments below on seven specific sections of Title III.) In addition, we have some concerns with Section 201 of Title II, addressing corporate earnings stripping.

A. Title III – Simplification of Rules Relating to the Taxation of United States Businesses Operating Abroad

1. Section 301. Repeal of CFC Rules on Foreign Base Company Sales and Services Income

The AICPA supports Section 301.

The current law Subpart F provisions, originally enacted in 1962, were designed for a world in which foreign trade often comprised commodities and tangible products and in which the U.S.

² For example, this letter does not offer any comment on Section 327 regarding repeal of the exclusion for extraterritorial income (ETI).

was dominant. The U.S. economy is now a major exporter of knowledge and expertise and now faces much stronger international competition. The AICPA commends changes that support U.S. exporters.

As global cross-border trade grows, it is increasingly difficult for U.S.-controlled multinational companies (USCCs) to compete with foreign-controlled multinational companies (FCCs). The current one-country, one-subsidiary model has been rendered inefficient by the ease of transport and the growth of knowledge businesses, such as software companies and consulting firms that are based on intellectual property and human capital rather than based on bricks and mortar.

For example, many engineering, software design and other contracts are now bid on a global or regional basis. To minimize costs, services and sales are provided from a central location for these multi-country contracts. In order to illustrate, assume a U.K. bank contracts for a new financial system. The contract includes consulting, system design, software development, and installation and training at its branches throughout Europe. A USCC service provider develops the system, performs software design, and stages the hardware at its U.K. subsidiary. The U.K. subsidiary then sells the hardware to each local customer branch and a core group of experienced U.K. staff goes to each bank location for the installation and training. For U.S. taxpayers, this creates Subpart F income that increases their income tax burden.

As provided in Section 301, the elimination of foreign base company sales income and foreign base company services income will put USCCs on a par with FCC competitors and will encourage USCCs to streamline their foreign operations for administrative and economic efficiency, rather than duplicate offshore facilities and staff to minimize U.S. Subpart F income. Accordingly, the Bill would significantly simplify the planning required by USCC foreign operations and would help "level the playing field" as compared to their foreign competitors. Further, we note that the repeal of the foreign base company income rules would not permanently allow USCCs to avoid paying U.S. income tax on the earnings of their foreign subsidiaries. Rather, the repeal would result in the normal taxation of foreign earnings -- upon repatriation or upon the disposition of the subsidiary.

2. Section 306. Determination of Foreign Personal Holding Company Income with Respect to Transactions in Commodities

The AICPA supports Section 306, which provides for the exclusion from personal holding company income of the excess of gains over losses from commodity hedging transactions undertaken by controlled foreign corporations (CFCs) with respect to commodities used in their businesses. We note that this same objective appears to be addressed by the proposed regulations [REG-154920-01] released by the IRS on May 10, 2002. This regulatory proposal would also result in commodity hedging transactions by CFCs being excluded from personal holding company income, but it in a slightly different way. It would expand the definition of "producer, processor, merchant, or handler of commodities" to include "a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business." Modifying the Internal Revenue Code (IRC) using this alternative formulation may actually be a simpler approach to accomplishing the same objective.

3. Section 311. Interest Expense Allocation Rules

The AICPA supports the adoption of worldwide fungibility in Section 311 and the Bill's amendments to the interest allocation and apportionment rules of IRC Section 864(e). First proposed by the Senate in 1986 but rejected by the House,³ incorporated in a bill passed by Congress in 1999 but vetoed by the President,⁴ and widely supported by commentators, practitioners, and taxpayers alike,⁵ worldwide fungibility is a necessary first step in rectifying the distorting and anticompetitive nature of the present-law foreign tax credit (FTC) regime.

As is widely recognized, the present-law interest allocation rules do not fully embody the fungibility principle because these rules ignore the assets and interest expense of foreign affiliates. Under the current system, interest expense of the domestic affiliates is treated as funding the activities of the entire worldwide affiliated group, thereby ignoring the practical reality that foreign entities in the group may (and probably do in fact) directly bear interest expense to finance their own activities. A disproportionate amount of the U.S. group's interest expense accordingly is allocated to foreign-source income, which, in turn, artificially reduces the U.S. group's FTC limitation and results in double taxation of foreign earnings. The double tax burdens created by the current regime put many USCCs at a competitive disadvantage and can distort investment decisions by penalizing foreign investment.

Because the interest allocation rules are intended to reflect fungibility and should not create economic distortions, the rules should take into account interest expense and assets of all affiliated corporations, domestic and foreign. The Bill does this by putting the foreign interest expense and assets of a U.S. corporation on par with domestic interest expense and assets by two means. First, the Bill includes assets of certain foreign corporations for purposes of apportioning the worldwide group's interest expense between foreign and U.S. assets.⁶ Second, the Bill includes an allocation method that reduces the amount of interest expense of domestic group members that is allocated to foreign-source income to the extent that foreign group members incur their own interest expense. These mechanisms better reflect fungibility by taking into account both foreign assets and foreign interest expense. Moreover, the proposed rules represent a fairer system through explicitly acknowledging that multinational corporations incur interest expense both domestically and abroad and that domestic indebtedness does not necessarily

³ See S. Rep. No. 99-313, 99th Cong., 2d Sess. at 343-344 (1986); Section 914 of the Tax Reform Bill of 1986, H.R. 3838, 99th Cong. (1986).

⁴ Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. (1999) (passed by Congress Aug. 5, 1999, and vetoed Sept. 23, 1999).

⁵ See, e.g., Emily S. McMahon, "Interest Expense Allocation After the Taxpayer Refund and Relief Act of 1999," *Tax Mgmt Int'l J.* 793 (1999); Steven P. Hannes & James Riedy, "Time to Move to a Worldwide Group Approach for Apportioning Interest," 2001 TNT 98-110 (May 21, 2001); Harrison Cohen, et. al., "New ETI Repeal Measure Seeks to Preserve U.S. Businesses' Competitiveness," 2002 WTD 137-14 (July 17, 2002); Marty A. Sullivan, "Interest Allocation Reform: Time to Talk or Time to Act?" 1999 TNT 167-1 (Aug. 30, 1999).

⁶ The AICPA agrees that the 80-percent ownership threshold proposed for both domestic and foreign corporations ensures that the corporations included in a worldwide affiliated group are sufficiently economically related to justify single-entity treatment.

support foreign activity, at least to the extent that foreign indebtedness also has been incurred. The reforms of the interest allocation regime proposed in the Bill would result in a more economically sensible apportionment of interest expense of USCCs, moderating the double tax burdens created by the present-law rules.

Additionally, the AICPA endorses the one-time election to expand and otherwise update the financial subgroup. Present law allows certain banks and similar corporations to be treated as a separate affiliated group recognizing that the debt structures of such entities are very different than other corporations. The Bill provides an election for a common parent to treat a broader range of corporations, including those engaged in the insurance business and other financing activities, to be includible in the financial subgroup. The financial subgroup is thus expanded and updated to include any entities whose income is at least 80 percent “financial services income” as defined in IRC Section 904(d)(2)(C)(i). This definition recognizes that a company with such income is likely to have a debt structure that is significantly different than most other corporations (such as manufacturing entities, for example) and more akin to those currently included in the definition of “financial corporation.” The AICPA thus concurs that it is proper to allow an election for all corporations engaged in analogous financial services businesses to be included in the financial subgroup.

4. Section 312. Recharacterization of Overall Domestic Loss

The AICPA supports Section 312, dealing with the recharacterization of an overall domestic loss and providing symmetry with IRC Section 904(f) dealing with recapture of an overall foreign loss. We believe that current law raises serious tax policy concerns.

For example, current law actually places USCCs in cyclical industries at a competitive disadvantage when compared to their FCC competitors with respect to *operations in the U.S.* This is because a USCC experiencing a tax loss must offset foreign-source income (which has often been fully taxed) by the loss and must then pay full U.S. tax on future income, while the FCC experiencing the same loss can carry it forward against future U.S. income since its foreign income is not subject to U.S. tax. As a result, there is an inherent bias for a USCC to pay higher total taxes than an FCC, thus providing a competitive advantage *in the United States* to the FCC.

Current law also creates an impediment to funding pension and other post-employment benefit plans (e.g. retiree medical) by U.S. companies. This is because the tax deductions for funding these plans can create losses that offset foreign-source income (which has often been fully taxed), rather than carrying forward to offset U.S.-source income. In an effort to mitigate this problem, U.S. companies may delay funding these plans when doing so would result in a tax loss.

U.S. corporations experiencing a domestic loss (as many have in the recent economic downturn), also try to mitigate the adverse impact of current law in other ways. For example, they may avoid remitting dividends to the United States and, instead, invest the funds in foreign operations. This is because current law requires that these dividends (which are foreign-source income) be offset by domestic losses before the use of FTCs. The foreign-source income has in many cases been fully taxed in the country of operations and the U.S. tax on such dividends

normally would be offset by FTCs. Application of current law has the result of leaving the company with excess FTCs (for which it may not be able to record a deferred tax asset under generally accepted accounting principles) while reducing the net operating loss carryforward of the company (for which it would be more likely to be able to record a deferred tax asset under generally accepted accounting principles). Thus, the decision to pay dividends while in a net operating loss position often results in a reduction of reported financial results under generally accepted accounting principles. Accordingly, companies generally avoid remitting dividends in such a situation. Instead, they invest the funds in foreign operations. This has the dysfunctional and counterintuitive result of reducing investment in the U.S. economy during an economic downturn. Modifying current law to remove this impediment to the repatriation of foreign earnings would seem likely to increase investment in U.S. operations, thus raising the level of U.S. economic activity and potentially increasing tax revenues.

5. Section 313. Reduction to 3 Foreign Tax Credit Baskets

Taxpayers currently determine their FTC for nine or more separate limitations or “baskets.”⁷ The AICPA supports Section 313, which would reduce the number of FTC baskets to three. The new baskets would be:

- Passive income and other passive category income.
- Financial services income.
- All other income.

We believe that this provision furthers the Bill’s objectives of meaningful simplification of the FTC regime, and that this reduction in the FTC baskets would make the changes to the interest allocation rules and overall domestic loss rules more meaningful. In many cases, the income earned by an FCC investing in the same third country as a USCC would be exempt from home country tax under a variety of exemption methods. In no other country that taxes foreign income is an investor subject to such complex basketing requirements, which – along with the current interest allocation rules and the overall foreign loss rules – dramatically increase the likelihood of double taxation. The simplification offered by this provision would reduce the competitive disadvantages that are imposed on USCCs by the current tax system and make it less likely that excess credits will expire unused, thereby preventing double taxation. The Technical Explanation of the Bill provides that taxes from pre-effective date tax years would be carried over to the appropriate new basket. Excess credits in the shipping basket, for example, would be carried over to the general basket. The Technical Explanation does not, however, discuss the potential recapture of either separate limitation or overall foreign losses from pre-effective date years. For example, if an overall foreign loss was generated before 2003 in the shipping basket,

⁷ Separate foreign tax credit limitation categories are currently provided for the following items of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from a noncontrolled section 902 foreign corporation (a “10/50 company”), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called “general limitation” income).

then after 2002 either the overall foreign loss would have to be recaptured out of the general basket or the potential for recapture would be eliminated because no additional shipping income could ever be earned. If it is determined that recapture is appropriate, the AICPA would like to see the recapture occurring over a multi-year period.

The AICPA also respectfully requests that Section 313 (Reduction to three foreign tax credit baskets) and Section 301 (Repeal of CFC rules on foreign base company sales and services income) be enhanced to eliminate interest income derived in leasing operations from the definitions of passive income contained in IRC Section 904(d)(2)(A) and IRC Section 954(c). Currently, U.S. exporters who are not in the active conduct of a banking, financing or similar business may assist their customers with lease financing. This promotes the sales of U.S.-manufactured products abroad. However, interest income generated by leases held by their foreign marketing subsidiaries triggers Subpart F income and falls into the passive basket rather than the general basket. Transactions such as these are distinguishable in intent from the maintenance of offshore funds to reduce U.S. taxation, and should not be characterized as passive income because they relate intrinsically to the CFC's trade or business.

6. Section 314. 10-Year Foreign Tax Credit Carryforward

The 10-year FTC carryforward period proposed in Section 314 would be a significant improvement for taxpayers, as compared to the five-year carryforward period permitted under current law. We are pleased that the provision would allow for varying FTC situations over a longer period of time. We note, however, that unless Congress provides an unlimited carryforward, USCCs may still not repatriate foreign earnings unless they can be reasonably certain FTCs will not expire. We encourage Congress to consider expanding the FTC to an unlimited carryforward.

As a matter of policy, FTCs should be treated in a similar fashion as minimum tax credits (credits arising from the application of the alternative minimum tax (AMT)). Minimum tax credits do not have an expiration date since that could ultimately lead to double taxation of the same income.

The IRC places numerous restrictions on the usage of FTCs, making full utilization of such credits difficult. Congress should grant an unlimited carryover period so that U.S. corporations and individuals avoid double taxation of earnings.

7. Section 315. Repeal of Limitation of Foreign Tax Credit Under Alternative Minimum Tax

Under present law, for AMT purposes, the FTC may only offset 90 percent of a corporate taxpayer's tentative minimum tax. Section 315 repeals this limitation. The AICPA strongly supports this simplification provision.

The AMT is highly complex and requires a separate, second set of calculations of income tax. Successive National Taxpayer Advocates have called for the repeal of the AMT. The present law 90 percent limitation further complicates both complying with, and planning for, the AMT.

The current 90-percent limitation serves to increase the U.S. income tax costs to certain U.S. companies that are both subject to the AMT and export goods and services outside the U.S. Such taxpayers are prevented by the 90-percent limitation from claiming the full recovery of foreign taxes paid on income that is taxed both in the United States (under the AMT) and the foreign jurisdiction. Accordingly, the current limitation results in double taxation.

The 90-percent limitation became a component of the U.S. tax code in 1986. At that time, as stated in the Conference Report, the 90-percent limitation was “designed to prevent U.S. taxpayers with substantial income from using the FTC to avoid all U.S. tax liability.” We believe that the current tax policy objectives of simplification, neutrality, and elimination of double taxation are more compelling and override the prior policy objectives of 1986.

Therefore, the AICPA believes there is limited tax policy benefit from the 90-percent limitation and views the double taxation problem for exporters as a significant issue that requires rectification

B. Title II, Section 201. Reduction in Potential for Earnings Stripping by Further Limiting Deduction for Interest on Certain Indebtedness

In our letter of June 28, 2002, to The Honorable Jim McCrery, Chairman of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, the AICPA provided comments for the record of the June 25, 2002, House Ways and Means Committee Select Revenue Measures Subcommittee hearing on corporate inversions. We will not repeat comments on that issue here. We do, however, have significant concerns about the Bill’s “earnings stripping” provisions found in Section 201 – Reduction in potential for earnings stripping by further limiting deduction for interest on certain indebtedness. Our comments on that section follow.

For foreign-owned U.S. companies, the Bill would significantly modify the current U.S. earnings stripping rules under IRC Section 163(j). The Bill would:

- Eliminate the existing 1.5 to 1 debt/equity safe harbor.
- Disallow interest expense that is the greater of: (1) net interest expense over 35 percent of adjusted taxable income, or (2) the corporation’s excess domestic disqualified interest (EDDI). EDDI measures the amount of excess related party debt in the U.S. by comparing actual U.S. debt to the amount of worldwide group debt that is attributable to the United States, based on a comparison of U.S. and worldwide assets. An excess of EDDI exists if the U.S. debt/asset ratio exceeds the worldwide ratio.
- In general, reduce disallowed interest expense carryforward from an indefinite period to five years. In the case of EDDI, however, the carryforward is eliminated altogether and deductibility completely denied. In addition, an unused limitation from one year could not be carried over at all.

These changes would generally take effect for tax years beginning after December 31, 2003; however, they would apply to debt incurred in years ending after July 10, 2002, including refinanced debt. In addition, the rules would apply as of March 20, 2002, in the case of certain former U.S. companies that "inverted" after 1996.

This proposal raises serious tax policy concerns. Taxpayers should be able to determine, based on business and tax considerations, the legal entity that will incur debt, as long as the entity has the capacity to bear that debt. Existing laws – both statutory and case law – prevent foreign parent companies from overloading their U.S. subsidiaries with related party debt. If these laws are breached, interest deductions may be disallowed under certain circumstances, and debt may be recast as equity. However, imposition of the formulary limitation contemplated in this proposal, based on the debt/equity ratio of a parent corporation and its worldwide affiliated group as compared to its U.S. subsidiary, in effect imposes an arbitrary limitation with no nexus to economic substance. This may chill inbound investment and would treat similarly situated taxpayers in a dissimilar manner, to the detriment of the U.S. economy.

For example, consider two foreign multinational affiliated groups, one with a low level of debt and the other with a high level of debt. Each is considering expanding into the U.S. by establishing a subsidiary operation. The new operations will be financed in part by a contribution to capital and in part by a loan to a newly incorporated entity. Under these facts, the U.S. businesses will have exactly the same level of debt, but their ability to deduct interest paid to their foreign parent will be very different. In essence, a more than adequately capitalized U.S. subsidiary will be penalized due to the attributes of its foreign parent. Such a result is hard to reconcile with sound tax policy and is inconsistent with arm's length standards and international norms. Accordingly, we recommend that a U.S. taxpayer's ability to deduct interest not be linked to its parent's debt level, and that a debt/equity safe harbor of some type be retained.

In addition, it appears that this proposal will generate conflicts under many existing tax treaties. The "Associated Enterprise" article of most treaties allocates profits between related entities based on the profits that would have accrued if the conditions made between the two enterprises had been those that would have been made between independent enterprises. Implicit in this article is the understanding that an item of income (e.g., interest) properly taxed by one jurisdiction will give rise to a corresponding item of expense in the other jurisdiction. Moreover, "Non-Discrimination" articles typically provide that nationals of a treaty partner will not be subject to more burdensome taxation than similarly situated U.S. nationals. Further, the Mutual Agreement Procedure article typically provides that taxation not in accordance with the terms of the treaty may be resolved by the competent authorities of the contracting states, specifically by allowing the competent authorities to agree to the same attribution of income, deductions, credits or allowances between taxpayers. It appears, however, that this new proposal could be construed to override all of these treaty provisions, in effect precluding application of the internationally accepted (and U.S.-supported) arm's length standard and subjecting foreign nationals to discriminatory treatment. Such an abrogation of our treaty obligations should not be pursued without first concluding, based on credible evidence, that this proposal addresses a substantial abuse, and that there is not another remedy to address the abuse without overriding U.S. treaty obligations.

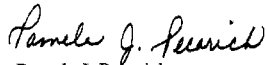
Also, this proposal interjects a substantial amount of complexity into an already complex arena, and will impose a significant burden on IRS auditors. For purposes of the proposal, the relative debt/equity ratios of the U.S. entity and the worldwide affiliated group are determined based on the adjusted basis of the assets. The foreign operations will, in almost all cases, maintain calculations of adjusted basis under foreign accounting and tax principles, which may be far different than U.S. principles. Thus, the use of adjusted basis will in many cases not serve the purpose for which it was intended – identifying differences in relative debt levels as a percentage of asset value. Perhaps more importantly, this issue will likely cause significant conflict between U.S. taxpayers and the IRS. In order to perform a thorough audit, the IRS will be compelled to audit all of the books and records of the foreign multinational parent and its subsidiaries covering many years, in most cases a difficult task. We note that no study has been conducted to provide objective evidence demonstrating that earnings stripping is a significant abuse that is not addressed under provisions of current law.

One final point is worth mentioning. It is inevitable that foreign tax authorities, including our treaty partners, will adopt some form of retaliation if this provision is enacted, denying deductions to foreign subsidiaries of U.S. multinational groups for interest paid on related-party loans. The consequences of such retaliation could further disadvantage USCCs.

* * * * *

We thank you for your leadership in this area. The AICPA is pleased to see and support many of the provisions in Title III of H.R. 5095, and we would be happy to offer our further assistance on this legislation. Please contact me at (805) 653-6300 or ppecar@aol.com; Andrew Mattson, Chair of the AICPA's International Tax Technical Resource Panel, at (408) 369-2566 or Andy@mohlernixon.com; or Eileen Sherr, AICPA Technical Manager at (202) 434-9256 or esherr@aicpa.org.

Sincerely,


Pamela J. Pecarich
Chair, Tax Executive Committee

[cc's omitted]

Attachment D

**INTERNATIONAL TAX EXCERPTS FROM THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TAX DIVISION'S COMMENTS ON****RECOMMENDATIONS OF THE STAFF OF THE
JOINT COMMITTEE ON TAXATION
TO SIMPLIFY THE FEDERAL TAX SYSTEM**

Submitted

February 7, 2002

[Excerpt Begins]

IX. INTERNATIONAL TAX

Anti-Deferral Regimes Applicable to Income Earned Through Foreign Corporations
(JCT page 398)

The Joint Committee staff's proposal would: (1) eliminate the rules applicable to foreign personal holding companies (FPHC) and foreign investment companies; (2) exclude foreign corporations from the personal holding company rules; and (3) include certain personal services contract income targeted under the present-law FPHC rules as subpart F foreign personal holding company income.

The AICPA supports this recommendation as it would eliminate complex, redundant, and outdated anti-deferral regimes. A multitude of anti-deferral regimes have been enacted, which are sometimes overlapping and inconsistent with each other.

The proposed changes would make foreign corporations' passive income subject to U.S. tax under either the controlled foreign corporation rules or the passive foreign investment company (PFIC) rules. As the JCT staff points out, eliminating the other anti-deferral regimes may result in certain gaps in coverage, but the gaps do not represent significant avenues for evading tax on passive foreign income.

Expand Subpart F De Minimis Rule
(JCT page 419)

The AICPA strongly supports the Joint Committee staff's proposal to modify the subpart F de minimis rule to be the lesser of five percent of gross income or \$5 million.

Subpart F contains a set of highly complex rules primarily designed to tax currently the passive income and other types of highly mobile income (collectively, "foreign base company income")

of controlled foreign corporations (CFCs). Under the current de minimis rule F, if the gross amount of a CFC's foreign base company income for the tax year is less than the lesser of five percent of the CFC's gross income or \$1 million, then no part of the CFC's gross income is treated as foreign base company income. The \$1 million limitation has the effect of applying a smaller percentage of gross income test for those CFCs with gross income in excess of \$20 million (because \$1 million is less than five percent of any amount greater than \$20 million).

Accordingly, by increasing the dollar limitation prong of the de minimis rule, the proposal would reduce complexity and filing burdens for taxpayers with CFCs engaged in active businesses and having only a relatively insignificant portion of the CFCs' gross income constituting foreign base company income. This proposal would particularly benefit smaller companies, by sparing them the difficulties and costs of understanding and complying with the subpart F rules.

Look-Through Rules for Dividends from Noncontrolled Section 902 Corporations
(JCT page 421)

The AICPA strongly supports the Joint Committee staff's proposal to immediately apply the "look through" approach to all dividends paid by a so-called 10/50 company, also known as a "noncontrolled section 902 corporation." This recommendation would also render moot the timing of the accumulation of the earnings and profits out of which the dividend is paid.

The current rules for dividends from 10/50 companies are complex and result in significant compliance burdens for taxpayers. Dividends paid currently from a 10/50 company are categorized in a separate category (or "basket") for foreign tax credit purposes. Thus, a U.S. taxpayer with interests in multiple foreign corporate joint ventures (in which the U.S. taxpayer owns at least 10 percent but no more than 50 percent) must perform multiple foreign tax credit limitation computations.

New rules are scheduled to come into effect for dividends paid in a tax year beginning after December 31, 2002. Under these new rules, dividends paid from pre-2003-generated earnings will be categorized in a single 10/50 basket, whereas dividends paid from post-2002-generated earnings will be subject to "look through" rules. Thus, the new rules offer some simplification compared to the current rules, but contain some additional complexity of their own.

The JCT recommendation would further simplify taxpayers' record-keeping requirements by accelerating and completing the elimination of the separate basket approach.

Foreign Tax Credits Claimed Indirectly through Partnerships
(JCT page 424)

The Joint Committee staff recommends that a U.S. corporation should be entitled to claim deemed-paid foreign tax credits under section 902 with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, if the U.S. corporation owns (through the partnership) at least 10 percent of the foreign corporation's voting stock.

The AICPA strongly supports this recommendation as it would clear up an ambiguity created by the IRS's published statements. Whether U.S. corporations may claim deemed-paid credits through pass-through entities is uncertain. In Rev. Rul. 71-141, the IRS concluded that a U.S. corporate partner in a U.S. general partnership could claim deemed-paid credits with respect to dividends paid by a foreign subsidiary owned through the partnership. However, the preamble to the 1997 final regulations under section 902 indicates that the IRS is unsure whether the principles set forth in Rev. Rul. 71-141 should apply in other contexts (such as in the case of limited partnerships or foreign pass-through entities). The JCT staff, however, believes that, generally, the same principles should apply in these other situations as well, and we concur.

Conform Sections 30A and 936
(JCT page 428)

This Joint Committee staff proposal would combine the credit computation rules into one Code section and conform the application of the possessions tax credit across all possessions, should Congress choose to extend the credits past their current scheduled expiration of 2005.

The Section 30A credit is a separate rule applicable only to operations in Puerto Rico. Although this credit is a subset of section 936 and is computed under the same general rules, it is contained in an entirely separate, non-adjacent Code section. This arrangement creates unnecessary complexity for credit claimants in Puerto Rico.

The AICPA supports this recommendation, as well as the renewal of the credits to which it relates. The harmonization of the possessions credit rules for all possessions should have the effect of rendering neutral the tax considerations of investing in one possession versus another.

Application of Uniform Capitalization Rules for Foreign Persons
(JCT page 432)

The Joint Committee staff recommends that U.S. generally accepted accounting principles (GAAP) be used for purposes of determining a foreign person's earnings and profits (E&P) and Subpart F income, instead of the uniform cost capitalization (Unicap) rules which are used by domestic taxpayers.

The AICPA supports this proposal. Even in domestic situations, the Unicap rules are highly complex and burdensome to taxpayers. In our experience, many IRS auditors do not even understand them. Requiring foreign persons to determine their E&P and Subpart F income using the Unicap rules is very burdensome given the multiple sets of books that usually must be maintained already (e.g., for foreign financial accounting purposes, for foreign tax purposes, for U.S. financial accounting purposes, for U.S. tax purposes, and for internal reporting purposes).

It is also worth noting that the purpose of the Unicap rules is simply to defer recognition of deductions via the conversion of certain currently deductible period costs into capitalized product costs. Accordingly, only the timing of the recognition of tax revenues would be affected.

Secondary Withholding Tax on Dividends from Foreign Corporations
(JCT page 436)

The Joint Committee staff's proposal would eliminate the secondary withholding tax on dividends paid by certain foreign corporations.

The AICPA supports this recommendation, given the clear redundancy and practical difficulties in administering this tax.

The branch profits tax was enacted as a part of the Tax Reform Act of 1986 and was designed to replace the secondary withholding tax. If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax applies.

Some foreign corporations are not subject to the branch profits tax as a result of particular provisions in U.S. tax treaties with certain countries. Many of these treaties, however, also prevent the imposition of a secondary withholding tax. Thus, the secondary withholding tax applies today only in very limited situations where a treaty prohibits the application of the branch profits tax rules but not the secondary withholding tax. There are also significant enforcement and monitoring problems with the secondary withholding tax in the case of dividends paid by foreign corporations to foreign shareholders.

Capital Gains of Certain Nonresident Individuals
(JCT page 440)

The Joint Committee staff's proposal would eliminate section 871(a)(2), which imposes a 30-percent tax on certain U.S.-source capital gains of non-resident individuals.

The AICPA supports this provision given the statutory provision's very limited application today. Section 871(a)(2) applies to *non-resident* aliens who are present in the United States for at least 183 days in a tax year. However, under the "substantial presence test" of section 7701(b), an individual who is present in the United States for at least 183 days generally is considered to be a *resident*. Thus, section 871(a)(2) can apply only if a foreign national spends at least 183 days in the United States but some or all of these days are not taken into account for purposes of section 7701(b) under very limited exceptions that rarely apply. Even where section 871(a)(2) otherwise would apply, in most cases the provisions of U.S. tax treaties would prevent its imposition.

U.S. Model Tax Treaties

(JCT page 445)

The Joint Committee staff calls for the Treasury Department to update and publish U.S. model tax treaties once per Congress.

The AICPA generally supports the concept underlying this recommendation. Regularly updated model treaties would provide taxpayers and practitioners with helpful guidance regarding current U.S. tax treaty policy. However, an updated model treaty would be useful only if it contains changes that arise from thoughtful reflection on recent experience with existing treaties.

Moreover, if Treasury were compelled to devote resources to the continual updating of the U.S. model treaty, we are concerned that insufficient resources would be available to deal with more pressing needs, such as more detailed guidance with respect to existing and newly signed treaties, as well as the expansion of the U.S. treaty network. Thus, the "once per Congress" requirement should be changed to a "once every five years" requirement, to allow sufficient time for the accumulation of additional experience and for thoughtful reflection, as well as a more appropriate allocation of resources.

Older U.S. Tax Treaties

(JCT page 448)

The Joint Committee staff proposes that the Treasury Department should report to Congress on the status of older U.S. tax treaties once per Congress.

The AICPA generally supports the concept underlying this recommendation. Such a report would provide taxpayers and practitioners with helpful information regarding the status of U.S. tax treaty negotiations, and may allow for more informed public commentary on these negotiations. Some information, however, such as the priority given to a particular treaty, would seem to be too politically sensitive to disclose in a public report (e.g., a country given a lower priority than it believes it deserves could be offended). Other information, such as the impact of significant law changes on treaties, would seem to be more appropriately addressed at the time the law change is proposed, rather than in a periodic Treasury report. Moreover, we believe that a balance needs to be struck between updating old treaties and dealing with other important treaty-related matters, such as expanding the U.S. treaty network and resolving important issues with respect to recently ratified treaties.

[Excerpt Ends]

Attachment E

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTERNATIONAL TAX EXCERPTS
FROM THE
STATEMENT OF
PAMELA J. PECARICH
CHAIR, AICPATAX DIVISIONTO THE SENATE FINANCE COMMITTEE
HEARINGS ON TAX SIMPLIFICATION

Held April 26, 2001

[Excerpt Begins]

Simplify the foreign tax credit rules - The core purpose of the foreign tax credit (FTC) is to prevent double taxation of the same income by both the United States and a foreign country. Although these rules may never be truly simple, action can be taken to temper the extraordinary complexity of the current regime. At a minimum, Congress should act to: consolidate the separate baskets of income for businesses that are either starting up abroad or that constitute small investments; and, eliminate the alternative minimum tax credit limitations on using the FTC. Accelerating the effective date of the look-through rules for dividends from so-called 10/50 companies should also be considered.

Simplify application of Subpart F - In general, 10-percent or greater U.S. shareholders of a controlled foreign corporation (CFC) are required to include certain income of the CFC (Subpart F income) in current income. The Subpart F rules were created almost four decades ago, and sorely need updating to deal with today's global economy in which companies are centralizing their services, distribution, invoicing, and often manufacturing operations. Substantial simplification could be achieved through basic measures, including exempting smaller taxpayers or smaller foreign investments from the Subpart F rules; excluding foreign base company sales and services income from current taxation; and treating European Union member states as a single country for purposes of the same-country exception.

Limit application of the passive foreign investment company rules - In 1997, the passive foreign investment company (PFIC) rules were simplified by eliminating the CFC-PFIC overlap and allowing a mark-to-market election for marketable stock. However, a great deal of complication remains, and further simplification is necessary. We recommend, for example, that Congress eliminate the application of the PFIC rules to smaller investments in foreign companies whose stock is not marketable.

[Excerpt Ends]

COMMONWEALTH OF PUERTO RICO

Mr. Chairman and Members of the Committee on Finance, my name is Milton E. Segarra, and I am Secretary of Economic Development and Commerce for the Government of the Commonwealth of Puerto Rico. On behalf of Governor Sila Calderon, I am pleased to have this opportunity to present testimony in support of a new tax incentive (the "Section 956 proposal") to replace the now repealed possessions tax credit (Sections 936 and 30A of the U.S. Internal Revenue Code ("Code")) and to create jobs and economic growth in Puerto Rico. Under the Section 956 proposal, a qualified U.S.-controlled foreign corporation ("CFC") organized in and engaged in the active conduct of a trade or business in the Commonwealth of Puerto Rico (or in the U.S. possessions) would be permitted to repatriate qualified earnings to the U.S. parent on a tax-preferred basis, providing Puerto Rico and the small U.S. terri-

tories with a limited but important compensatory advantage over CFCs operating in competitor foreign jurisdictions.

The need for federal tax incentives to attract U.S. outbound investment to Puerto Rico is demonstrated by experience and economic reality. U.S. tax incentives for investment and economic growth in Puerto Rico are not new. The antecedents of the possessions tax credit were first enacted in 1921 to assist the development of Puerto Rico's isolated and dependent agrarian economy. Since the establishment of Operation Bootstrap in 1948, the interplay of federal and local tax incentives in Puerto Rico has helped fuel the transformation of one of the poorest islands in the Caribbean into a modern industrial society with the highest standard of living in all of Latin America. Indeed, in large part as a result of these enlightened federal and Commonwealth policies, Puerto Rico has increased its per capita income from 16.2 percent of the U.S. average in 1948 to 32.3 percent in 2002, while supporting a dynamic manufacturing sector that today represents more than 42 percent of Puerto Rico's economic output.

In 1996, Congress voted to repeal Section 936 and Section 30A, subject to a 10-year phase-out for existing claimants and lines of businesses, as a "revenue offset" for a number of tax relief provisions intended to help small businesses in the United States mitigate the impact of the concurrent statutory increase in the federal minimum wage. While the federal minimum wage laws also apply to Puerto Rico, the business relief provisions enacted in 1996 did not benefit Puerto Rico. Indeed, in just under seven years since the repeal of Section 936 and Section 30A, Puerto Rico has lost over 26,000 manufacturing jobs—roughly 18 percent of its manufacturing employment—while unemployment has increased to over 12 percent, double the U.S. rate. Unless Congress acts, the loss of high-paying manufacturing jobs—the foundation of Puerto Rico's middle class economy—will only accelerate as the 2005 date for the expiration of Sections 936 and 30A approaches.

While it is true that tax policy alone cannot create or sustain economic growth in the absence of other necessary conditions such as an educated workforce, and adequate infrastructure and telecommunications, it is also true that, in the competition for U.S. foreign investment, targeted tax incentives can help offset the higher operational costs faced by Puerto Rico as a result of its geographic isolation from the mainland, its relative lack of natural resources, and externally imposed factors such as the application U.S. minimum wage laws, environmental standards, and other regulatory requirements.

To address the job losses and harm to the Puerto Rico economy caused by the repeal of Section 936 and Section 30A, the Commonwealth Government has developed a new proposal, based on the fact that many of the U.S. companies that have chosen to remain in Puerto Rico have restructured their operations and converted their domestic entities into CFCs.¹ By utilizing CFCs, U.S. companies earning active business income in Puerto Rico exchange partial exemption from U.S. tax under the scheduled phase-out of Section 936 and Section 30A for the possibility of unlimited deferral of U.S. tax, provided that the Puerto Rico earnings of the CFC are not repatriated to the United States.² Without some modification of the Subpart F rules, however, the CFC model has limited value and utility for investment in Puerto Rico. In fact, CFCs in Puerto Rico are in direct competition with CFCs in low-wage and low-cost countries around the world. In particular, Puerto Rico is at a significant disadvantage in competing for U.S. investment with many countries such as Mexico, Malaysia, Ireland and Singapore. These disadvantages include the application of U.S. minimum wage laws, U.S. environmental, health and safety regulations, and other federal regulatory standards generally more rigorous than those imposed by competitor countries. CFC status, by itself, does not offset the higher cost of doing business in Puerto Rico in comparison with these other foreign jurisdictions.

Under the Commonwealth proposal, which was introduced in the House of Representatives and in the U.S. Senate on a bi-partisan basis in the last Congress as

¹Under Subpart F of the U.S. Internal Revenue Code, a "controlled foreign corporation" is a foreign corporation, 50 percent or more of the combined voting power or total value of the stock of such corporation is U.S.-owned. See generally Code §951-964.

²While U.S. corporations are generally subject to U.S. tax on their worldwide income, income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until it is repatriated as a dividend to its U.S. shareholders. Under Subpart F, however, 10 percent U.S. shareholders of a CFC are taxed currently on certain categories of CFC income even if such income is not repatriated or distributed. For example, dividends, interest and other passive income received by a CFC generally are taxable on a current basis even if such income is not repatriated as a dividend to the CFC's U.S. shareholders. In addition, foreign earnings of a CFC otherwise eligible for deferral but which are invested in qualified "U.S. property" are taxable as if the underlying earnings had been distributed to the CFC's U.S. shareholders as a dividend. See Code §956.

H.R. 2550 and S. 1475, respectively, a CFC organized in Puerto Rico or in a U.S. possession would be incentivized to invest their Puerto Rico or possession source earnings in the United States when those earnings were not currently needed for operations in Puerto Rico or the U.S. possessions. By providing an incentive not generally available to CFCs doing business in other foreign jurisdictions, the proposal would enable Puerto Rico to maintain and, over time, strengthen its economic base. By providing an incentive to invest surplus earnings in the United States rather than in other foreign jurisdictions, the proposal would, consistent with the original intent of the possessions tax credit, also benefit the U.S. economy and create jobs in the United States. In addition, under existing U.S. tax rules, the tax-deferred income of a CFC organized and doing business in Puerto Rico or a U.S. possession would, like all other CFCs, remain subject to U.S. tax when ultimately repatriated as a dividend.³

Much of the concern over the Section 936 and Section 30A program since its inception has been not its unquestioned success in transforming the economy of Puerto Rico, but rather the perceived high cost of the program attributable to the special rules governing the allocation of intangible income between certain U.S. companies and their Puerto Rico subsidiaries. Indeed, as recently as two years ago, the Joint Committee on Taxation estimated the cost of the existing credits as high as \$4 billion for 2001 and as much as \$16.6 billion for the five-year period 2001-2005.

By eliminating the special allocation rules and applying standard arms-length transfer pricing rules set forth in Section 482 of the Code, together with the modifications to H.R. 2550 and S. 1475 discussed above, the Section 956 proposal was preliminarily estimated by the Joint Committee on Taxation last year to cost approximately \$600 million a year beginning in 2006—a fraction of the estimated cost of the existing credits.

Even these preliminary estimates may be far too high if one accepts that the competition for U.S. investment is not between the United States and Puerto Rico, but rather between Puerto Rico and foreign jurisdictions such as Mexico, Malaysia and Singapore. Indeed, studies by the Puerto Rico Industrial Development Company (“PRIDCO”) indicate that most U.S. companies leaving Puerto Rico relocate as CFCs in other foreign jurisdictions rather than return to the United States. Further studies by the U.S. Treasury Department also suggests that most income earned by CFCs is, in fact, reinvested abroad and thus U.S. parent companies currently pay little, if any, U.S. tax on their CFC income.⁴

Puerto Rico’s proposal for revitalized tax incentives for U.S. investment in the Commonwealth economy cannot be viewed in isolation, but rather must be considered in the context that a strong Puerto Rico economy is essential to the economic prosperity of the United States. Indeed, Puerto Rico is not only one of the largest markets for U.S. products, it is also ranked among the top four per capita con-

³As originally introduced, H.R. 2550 and S. 1475 had four substantive components. First, in accordance with prior Congressional legislation, sections 30A and 936 would be allowed to expire at the end of 2005. Second, section 956 of the Code (relating to investments in U.S. property by CFCs) would be amended to defer from current U.S. tax 90 percent of the otherwise taxable investments in U.S. property (e.g., loans to the CFC’s U.S. parent corporation or investments in the U.S. parent’s stock) made by a qualified CFC out of its “qualified income” (i.e., income from the active conduct of a trade or business in Puerto Rico or a possession of the U.S.). Third, as an alternative to the new section 956 rule, the qualified CFC could elect to have its shareholders in the U.S. benefit from an 85 percent dividends received deduction for dividends paid by the qualified CFC out of its qualified income. Fourth, a special transition rule was provided for certain companies now doing business in Puerto Rico or a possession that would be required to transfer those operations to a CFC in order to benefit from the new tax incentives.

The proposal now before the Committee has been modified, as a result of continuing discussions with staff of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation, in order to reduce the revenue cost of the original proposal. First, the new tax incentives would take effect only after the existing Section 936 and Section 30A credits expire at the end of 2005. Second, a qualified CFC must be organized in Puerto Rico or a U.S. possession, as well as be engaged in the active conduct of a trade or business in Puerto Rico or a U.S. possession. Third, the transition rule contained in the original proposal would be eliminated; as a result, the general rules of the Code, including the transfer pricing rules, would be applicable to transactions in which a branch of a U.S. corporation now conducting operations in Puerto Rico is incorporated in order to be eligible for the new tax incentives. And fourth, additional requirements have been included to ensure that qualified active businesses have a substantial business presence in Puerto Rico and that certain passive investment activities could not qualify for the new tax incentives.

⁴For example, IRS data for 1994 indicate that CFCs in “tax haven” countries paid an effective income tax rate of 9.1 percent on current earnings and profits and repatriated only 13.9 percent of such earnings and profits not subject to the anti-deferral rules of Subpart F. As a practical matter, U.S. companies generally do not repatriate low-tax foreign income unless U.S. tax on such income can be offset by excess foreign tax credits on high-tax foreign income.

sumers of U.S. products in the world. In 2001, Puerto Rico purchased nearly \$16 billion worth of U.S. products, surpassing much larger countries such as Italy, Spain, Argentina, Russia and Australia. With over \$55 billion in total exports and imports, Puerto Rico is the eighth largest trading partner of the United States in the world. Indeed, over 30 percent of the entire U.S. maritime coastwise trade is between Puerto Rico and the U.S. mainland.

A recent study by PricewaterhouseCoopers concluded that 73,000 U.S. jobs were *directly* attributable to the production and distribution of U.S. goods exported to Puerto Rico in 2001, while 201,000 U.S. jobs were *indirectly* attributable to U.S. exports to Puerto Rico in the same year, for a total of 274,000 jobs—an average of 5,400 jobs per state. A copy of the PWC study and a list of the number of jobs in each state attributable to exports to Puerto Rico have been separately provided to the Committee on Finance.

Mr. Chairman, the Section 956 proposal enjoys the strong support of all of the major business groups, manufacturers associations, and unions in Puerto Rico. A copy of the Statement of Principles signed by organizations representing over 95 percent of Puerto Rico's private sector is attached hereto as Appendix B. Failure to enact new incentives to stem the current accelerating loss of manufacturing jobs in Puerto Rico as a result of the scheduled phaseout of the existing Section 936 and Section 30A tax credits will inevitably have dire consequences for the Puerto Rico economy, as well as for the U.S. economy. Puerto Rico and the United States, as partners bound by common citizenship and history, have a moral, if not an economic, obligation to work together to restart the engines of progress for the U.S. shining star in the Caribbean and Latin America. Accordingly, I respectfully urge your support for inclusion of the Section 956 proposal in the international tax reform bill which will be considered by this Committee later this year and which is the subject of the present hearing.

Thank you very much.

APPENDIX A

STATEMENT OF PRINCIPLES

ECONOMIC STIMULUS FOR THE COMMONWEALTH OF PUERTO RICO

As our national leaders in the Congress and Administration develop initiatives to stimulate the economy it is important for us in the Commonwealth of Puerto Rico's business community to voice our support for measures that will provide for the long term economic future of Puerto Rico.

Currently, Puerto Rico's unemployment rate is 11.4 percent compared to 5.8 percent nationwide, close to twice the national average. In 1996 Congress enacted a phase out of Section 936, which has been a tax incentive designed to attract investment to the Island and available in various forms since 1921. Since the enactment of the phase out, the Island has lost 17 percent of its manufacturing jobs, most of which have gone to foreign countries.

The phase out of Section 936 not only removes federal incentives for investment in Puerto Rico but it effectively eliminates any economic value of tax benefits Puerto Rico has instituted in the Commonwealth's tax code because of the structure of the foreign tax credit in the US tax code.

In order to counter the effect of this phase out and prevent further loss of jobs, as well as helping to bring a more stable, secure and attractive investment climate to the Island, Governor Calderon and Resident Commissioner Acevedo-Vila continue to aggressively work with Congress and the President's Administration to pursue the enactment of a proposal to attract new investment to the Island.

The Governor's plan is designed to bring benefits to both the Island and the mainland, and it recognizes that many large employers in the Commonwealth have changed their status from domestic corporations to Controlled Foreign Corporations (CFCs) since Congress enacted the phase out of Section 936 incentives in 1996. The Governor's proposal calls for amending Section 956 of the IRS Code to allow CFCs to defer tax payment of 90 percent of taxable income if invested in U.S. property or exclude 85 percent of dividends received only if that income is attributable to active business operations in the Commonwealth of Puerto Rico or U.S. territories.

Puerto Rico is the 13th largest trading partner of the United States, generating and supporting over 270,000 jobs on the U.S. mainland. This economic incentive will make Puerto Rico more competitive and will act as a stimulus for Puerto Rican CFCs to reinvest their earnings in the mainland United States rather than abroad. Therefore, this proposal will benefit Puerto Rico and the United States, and will also serve to protect the national security interests of both as well as those companies who will return to the United States to operate their businesses in Puerto Rico.

The undersigned participants support and join in the efforts of the Commonwealth to urge the prompt enactment of the Section 956 proposal in order to preserve the flexibility of the Commonwealth's tax system and to provide a level business environment so the Commonwealth can more effectively compete with investments targeted for offshore locations.

As witnesses and party to the preceding, the Resident Commissioner in Washington, the Secretary of Economic Development and Commerce and members of Government, Private Industry and Commerce subscribe to this joint proposal on this day, March 31, 2003, in the city of San Juan, Puerto Rico.

s/s Anibal Acevedo-Vila

Hon. Anibal Acevedo-Vilá
Resident Commissioner

s/s/ Milton Segarra

Hon. Milton Segarra
Secretary of Economic Development
and Commerce

s/s Hector Jimenez Juarbe

Hector Jimenez Juarbe
Puerto Rico Industrial Development Company

s/s Jose Suarez

Jose Suarez
Executive Director
Puerto Rico Tourism Company

s/s Antonio Sosa Pascual

Antonio Sosa Pascual
Executive Director
Promoexport

s/s Manuel Cidre

Manuel Cidre
Chairman
Puerto Rico Manufacturers Association

s/s Julio E. Torres

Julio E. Torres
President
Food Marketing, Industry &
Distribution Association

s/s Jose Joaquin Villamil

Jose Joaquin Villamil
Chairman
Chamber of Commerce

s/s Cynthia Anderson

Cynthia Anderson
Chairperson
Pharmaceutical Industry Association

s/s Salvador Vassallo

Salvador Vassallo
President
Puerto Rico Export Council

s/s Rick Newman

Rick Newman
Chairman
Puerto Rico Hotel and Tourism
Association

s/s Jose Ramon Gonzalez

Jose Ramon Gonzalez
President
Puerto Rico Bankers Association

s/s Benjamin Negrón

Benjamin Negrón

President

Chamber of Commercial Wholesalers
of Puerto Rico, Inc.

s/s Ricardo Calero

Ricardo Calero

President

United Retailers Association

s/s Miguel A. Ferrer

President

Securities Industry Association

s/s Rolando Avila

Rolando Avila

President

Association of Puerto Rican
Products

COWEN, ROBERT, SENIOR VICE PRESIDENT AND CHIEF OPERATING OFFICER,
OVERSEAS SHIPHOLDING GROUP

I. INTRODUCTION

On behalf of the Overseas Shipholding Group, Inc. ("OSG"), I appreciate the opportunity to submit this statement to the Senate Finance Committee on international competitiveness issues raised by the U.S. tax system. My statement focuses on the significant problems created by the present-law rules under subpart F of the Internal Revenue Code applicable to shipping income.

OSG, a Delaware corporation listed on the New York Stock Exchange and headquartered in New York, is a major international shipping enterprise owning and operating through its subsidiaries a diversified fleet of oceangoing oil tankers and other bulk cargo vessels. Measured by the carrying capacity of our fleet, OSG is the sixth largest tanker owner in the world. OSG charters its ships to commercial carriers and to U.S. and foreign governmental agencies for the carriage of petroleum and related products to destinations around the world and in the United States.

As a result of tax-law changes enacted in 1975 and 1986, U.S. shipping companies are required to pay tax on income earned by subsidiaries overseas immediately rather than when such income is later brought back to the United States. This treatment represents a sharp departure from the generally applicable income tax principle of "deferral" and, as the Treasury Department has noted on several occasions, operates to place U.S.-based owners of international fleets at a distinct tax disadvantage compared to their foreign-based competitors. The upshot is that the number of international tankers and vessels owned by the U.S. companies has fallen to historically low levels, a state of affairs that is raising dramatic national security and economic security concerns. Congress can reverse this trend, and strengthen U.S. security, by enacting legislation that restores international parity for the U.S.-owned shipping industry.

II. OSG'S SHIPPING OPERATIONS

OSG is engaged in the ocean transportation of crude oil petroleum products and dry bulk cargoes in both the worldwide and self-contained U.S. markets. It is one of the largest bulk shipping companies in the world, owning and operating a fleet (including vessels on order) currently numbering 52 vessels with an aggregate carrying capacity of almost 7.5 million deadweight tons. Ownership of a diversified fleet, with vessels of different flags, types, and sizes, provides operating flexibility and permits maximum usefulness of its vessels. For a variety of business reasons, each vessel is owned by a separate corporate subsidiary, most of which are organized in foreign countries.

With respect to the domestic bulk shipping markets, OSG is one of the largest independent owners of U.S.-flag bulk tonnage, with a fleet that consists of 9 vessels aggregating almost 600,000 deadweight tons. U.S. flag bulk vessels, which must be crewed by U.S. seamen, cannot typically compete in foreign trades. The operating costs of a U.S. flag tanker are significantly higher than those of a comparable foreign flag tanker. Today, U.S. flag bulk vessels primarily serve U.S. coastal trade and other niche domestic markets and government programs.

International bulk shipping markets are primarily served by "open registry" ships. To serve these worldwide markets, OSG employs a modern fleet of 45 foreign flag vessels, amounting to almost 7.1 million deadweight tons. These foreign flag vessels include 43 tankers that range in size from the large double-hull crude carriers moving out of the Middle East to product tankers serving U.S. ports on the Atlantic and Pacific coasts. Competition in these markets is extremely keen, and the markets served by OSG are highly dependent upon world oil production and consumption. Charter rates are determined by market forces and are highly sensitive to changes in supply or demand. Thus, any change in labor or other operational costs—including taxes—or any governmental regulations can have a direct and adverse impact if borne by some but not all carriers.

The economic viability of OSG's foreign flag fleet has special importance to the viability of its U.S. flag fleet. When markets served by the U.S. flag fleet deteriorate, the revenues generated by the foreign fleet can provide critical support for these domestic operations.

III. DECLINE IN U.S.-OWNED INTERNATIONAL SHIPPING

The number of U.S.-owned foreign flag ships has dropped precipitously in the aftermath of the 1975 and 1986 tax-law changes, which are discussed further below.

In 1976, there were 739 U.S.-owned foreign flag ships. The U.S.-owned foreign flag fleet had shrunk to 429 ships by 1986 and to 273 ships by 2000. (See Exhibit A.)¹

This decline is also pronounced in the tanker market, which is particularly vital to U.S. security interests, as discussed further below. From 1988 to 2000, the number of U.S.-owned foreign-flag tankers fell by nearly 50 percent, from 246 ships to only 126 ships. (See Exhibit B.)

As a result, U.S. companies now hold precious little share of the world shipping marketplace. From 1988 to 1999, the number of U.S.-owned foreign flag ships as a percentage of the world merchant fleet dropped from 5.6 percent to 2.9 percent. (See Exhibit C.)

Part of this decline in recent years has been attributable to corporate restructurings that had the effect of moving the headquarters of global shipping companies outside the United States. Consider the following three transactions:

- In April 1997, American President Lines (“APL”), then the largest U.S. shipper, announced that it was merging with Neptune Orient Lines (“NOL”) of Singapore and that the headquarters of the newly merged company would be in Singapore.
- In 1998, OMI Corporation distributed to its shareholders stock of a subsidiary in a transaction that resulted in OMI’s international shipping operations being owned by a Marshall Islands corporation.
- In December 1999, the A.P. Moller Group, headquartered in Copenhagen, Denmark, acquired the international liner business of Sea-Land Services, Inc., a subsidiary of CSX Corporation, to form Maersk Sealand. Sea-Land Services, Inc., was previously the largest U.S. shipper of containers.

Absent a change to the subpart F rules, whose defects are discussed further below, a continued loss of U.S. ownership of international merchant fleets can be expected.

IV. ECONOMIC, NATIONAL SECURITY ISSUES

The decline in U.S.-owned international shipping is fundamentally inconsistent with national security and economic objectives. The U.S. military, in times of emergency, relies on the ability to requisition U.S.-owned foreign-flagged tankers, bulk carriers, and other vessels to carry oil, gasoline, and other materials in defense of U.S. interests overseas. These vessels comprise the Effective United States Control (“EUSC”) fleet.² The sharp decline in the EUSC fleet since the 1975 and 1986 tax-law changes, and the resulting adverse strategic consequences, were confirmed in a study commissioned by the Department of the Navy and released in December of last year. That study concluded that **“the cause for decline in the size of the EUSC fleet of tankers has been legislation that changed the fundamental economics of American ownership of open registry vessels.”** The study recommended that in the short term the most practical and cost-effective means of reversing this trend would be to **“revise legislation to reflect tax deferral of income for some or all EUSC and U.S. flag vessels.”**

American security also depends in no small part on our ability to maintain adequate domestic oil supplies in times of emergency. The United States consumes approximately 19.6 million barrels of oil per day, of which roughly 55 percent, mostly crude, is imported into the United States. It is estimated that 95 percent of all oil imported into the United States by sea is now imported on foreign-owned tankers. This means that one half of every gallon of oil consumed in the United States is carried on foreign-owned vessels. This growing dependence on foreign parties—who may not be sympathetic to U.S. interests—to deliver our oil in times of global crisis is cause for potential alarm.

The importance of a robust U.S.-owned international shipping fleet was underscored in a 1989 National Security Directive on “sealift” sent by President George Bush to Cabinet officials (including the Treasury Secretary) directing them to take steps to enhance the competitiveness of the U.S. industry:

¹ Sources for data include Marcus, Henry et al, “U.S. Owned Merchant Fleet: The Last Wake-Up Call?” M.I.T., 1991; Dean, Warren L. and Michael G. Roberts, “Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping,” Thomas Coburn LLP, 1999; U.S. Maritime Administration; *Fearnleys World Bulk Fleet*, July 1998, July 1993, July 1999; *Fearnleys Review*, 1993, 1998, 1999; *Fearnleys Oil & Tanker Market Quarterly*, No. 1, 2000; *Fearnleys Dry Bulk Market Quarterly* No. 2, 2000.

² The EUSC fleet is comprised of merchant vessels, flagged in “open registry” countries (e.g., Liberia, Panama, Honduras, the Bahamas, and the Marshall Islands), that are owned and operated internationally (often through foreign subsidiaries) by American companies, and which are available for requisition, use, or charter by the United States in the event of war or national emergency.

[A]ppropriate agencies shall ensure that international agreements and federal policies governing use of foreign flag carriers protect our national security interests and do not place US industry at an unfair competitive disadvantage in world markets. During peacetime, federal agencies shall promote, through efficient application of laws and regulations, the readiness of the US merchant marine and supporting industries to respond to critical national security requirements.³

In terms of U.S. tax policy affecting the shipping industry, it is clear that this mandate has not been met.

V. THE PROBLEM WITH U.S. TAX LAW

The dramatic reduction in U.S.-controlled international shipping, and the EUSC fleet, over the last 25 years can be traced in no small part to a succession of U.S. tax law changes that have placed U.S.-based shipping companies at a significant disadvantage to their competitors. Most foreign-based carriers pay no home-country taxes on income they earn abroad from international shipping.

By way of background, the United States generally does not tax the income earned abroad by separately incorporated controlled foreign subsidiaries of U.S. corporations until the income is repatriated (e.g., as a dividend by the foreign subsidiary to the U.S. parent corporation). The so-called "subpart F" provisions enacted in 1962 are an exception to this general tax principle. Under the subpart F regime, 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 that income is earned by the CFC, even though the income may not yet have been repatriated to the U.S. parent.

From 1962 until 1975, the subpart F regime specifically excluded foreign shipping income from its operation.⁴ Accordingly, under the general "deferral" principles applicable to subsidiaries of U.S. corporations, the income attributable to foreign operations of the EUSC fleet was, during that period, subject to U.S. tax only to the extent it was actually (or constructively) repatriated to the United States.

In the Tax Reduction Act of 1975, Congress designated foreign shipping income of a CFC as subpart F income, but provided that such income would not be subject to the subpart F current taxation rule to the extent the 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.

In the Tax Reform Act of 1986, Congress repealed the reinvestment exception and thereby eliminated the ability to defer tax on shipping income generated by foreign subsidiaries of U.S. corporations. The Joint Committee on Taxation staff noted, as a reason for eliminating deferral, that "shipping income is seldom taxed by foreign countries."⁵ As an aside, one wonders what staff thought would be the consequence of having the United States become the *only* country to attempt to tax such income. Whatever may have been the "tax policy" rationale for subjecting shipping income to the subpart F taxing regime, the change had but one effect: reducing the viability of EUSC foreign shipping operations by imposing a tax burden not applicable to competitors.

Because of the 1986 Act change, U.S. investors in international shipping effectively now pay a "premium" because their investments must be made with after-tax dollars, while most foreign-controlled competitors invest with pre-tax dollars. Over time, these premiums on U.S. investments require U.S.-owned 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-based competitors. To the extent such comparatively higher charter income cannot be obtained—and it is clearly not possible to do so—the overall economic picture of U.S.-owned shipping will continue to be eroded.

The 1975 and 1986 tax-law changes trace closely to the decline in U.S.-owned shipping highlighted above. Before subpart F was extended to shipping income in 1975, the U.S.-owned share of the world's open-registry shipping fleet stood at 26 percent. By 1986, when the reinvestment exception was eliminated, the U.S. share had dropped to 14 percent. By 1996, the U.S. share had dropped to 5 percent.⁶

³National Security Directive 28, October 5, 1989.

⁴According to the 1962 legislative history, this exclusion for shipping income was provided "primarily in the interests of national defense."

⁵General Explanation of the Tax Reform Act of 1986, at 970.

⁶Price Waterhouse, "Decline in the U.S.-Controlled Share of the Open-Registry Merchant Shipping Fleet Since 1975," June 6, 1997. The U.S. share percentages discussed in the Price

In its recent preliminary report on corporate inversion transactions, the Treasury Department clearly stated the problem with present law applicable to U.S.-owned shipping:

. . . the U.S. tax system imposes current tax on the income earned by a U.S.-owned foreign subsidiary from its shipping operations, while that company's foreign-owned competitors are not subject to tax on their shipping income. Consequently, the U.S.-based company's margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S.-based company has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company.

Without prompt action by the Congress to reverse the misguided application of subpart F rules to shipping income, in a short time there are likely to be more "run-away headquarters" transactions like those described above and therefore little or no remaining U.S.-controlled international shipping.

OSG is encouraged that bipartisan legislation that would seek to address the problems created by current law has been introduced in this Congress by Senator Gordon Smith (RO) (S. 1326) and Rep. Jerry Weller (R-IL)(HR 772). OSG appreciates that other Members of Congress, including Rep. Clay Shaw (R-FL), have introduced similarly oriented bills in the past.

VI. RECOMMENDATION

OSG respectfully urges the Congress to enact legislation as soon as possible that will help level the playing field for U.S.-based carriers operating abroad. Such action will help provide the United States with a robust available fleet in times of global crisis, which will restore U.S. strategic capabilities and strengthen our economic security. OSG looks forward to working with all affected parties to fashion a solution, which not only will help U.S. companies reclaim their share of the global shipping markets but also will help preserve and enhance U.S.-flag shipping.

Waterhouse study relate to the world's total open registry fleet, which is smaller than the total world merchant fleet referenced in other statistics cited in this testimony.

Exhibit A

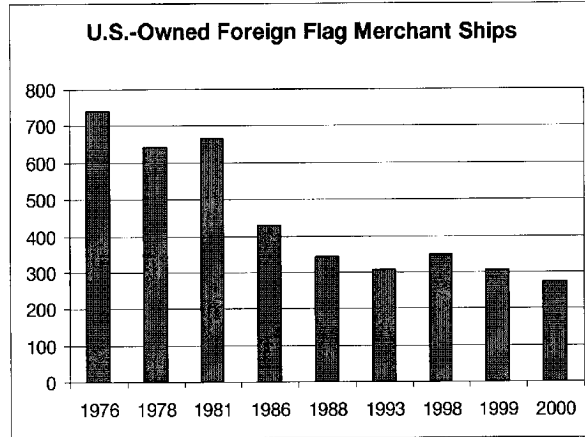


Exhibit B

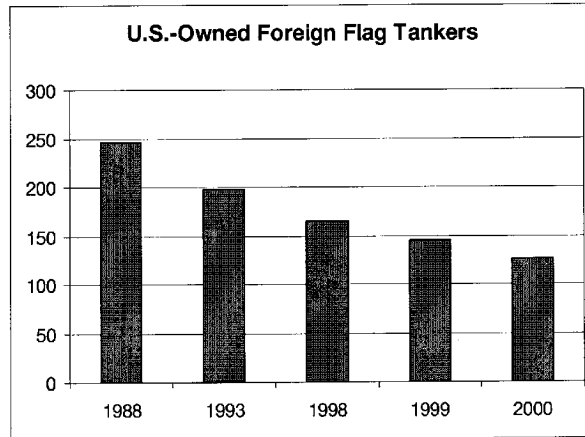
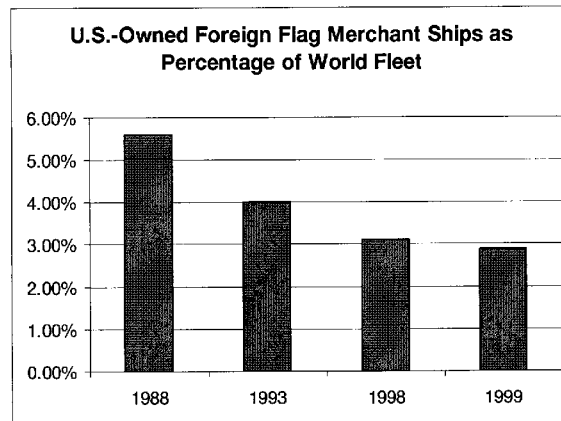


Exhibit C



Sources for data include Marcus, Henry et al, "U.S. Owned Merchant Fleet: The Last Wake-Up Call?" M.I.T., 1991; Dean, Warren L. and Michael G. Roberts, "Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping," Thomas Coburn LLP, 1999; U.S. Maritime Administration; *Fearnleys World Bulk Fleet*, July 1998, July 1993, July 1999; *Fearnleys Review*, 1993, 1998, 1999; *Fearnleys Oil & Tanker Market Quarterly*, No. 1, 2000; *Fearnleys Dry Bulk Market Quarterly* No. 2, 2000.

CENTER FOR FREEDOM AND PROSPERITY

[SUBMITTED BY ANDREW F. QUINLAN, PRESIDENT]

Thank you for the opportunity to share my views with you. My name is Andrew Quinlan, President of the Center for Freedom and Prosperity, an Alexandria, Virginia-based, 501(c)(4) citizen organization that lobbies Congress and the Administration on tax competition, financial privacy and fiscal sovereignty.

I also coordinate the activities of the Coalition for Tax Competition, which is made up of more than three-dozen free-market public policy organizations, including taxpayer groups, senior citizen and family organizations, civil liberties activists, and industry and business advocates.

The Committee is examining how the impact of U.S. policies on foreign investment in the U.S. economy. This is a critical issue in today's economy, and I applaud this muchneeded assessment.

There are two types of investment in the U.S. economy, direct and indirect. The typical example of foreign direct investment is a factory built by a foreign-based company. Foreign direct investment is very important to the United States and is responsible for millions of American jobs.

Indirect investment occurs when foreigners invest money in America. Foreign indirect investment can take many forms, including money deposited in U.S. banks, purchases of stocks and/or bonds issued by U.S. companies, and purchases of U.S. government debt. These various forms of indirect investment boost U.S. financial markets and help finance businesses and provide capital for home mortgages and car loans.

My testimony will focus on indirect investment, specifically an IRS proposal that significantly could undermine the flow of capital to the U.S. banking system.

IRS's Interest Reporting Regulation.

U.S. banks and financial institutions benefit greatly from the bank deposits of nonresident aliens. These deposits, in turn, benefit every American by helping to create jobs, finance small business loans and improve the general welfare of all. For decades, United States lawmakers have understood the importance of attracting capital to America, which is why Congress has chosen not to tax the interest paid on bank deposits of nonresident aliens and, the further step, of not reporting this deposit income to their home governments.

In fact, foreigners have invested more than \$1 trillion in capital in the United States banks. This influx of capital will be jeopardized if a proposed Internal Revenue Service rule is implemented. The regulation (133254-02) would require banks to report interest paid to nonresident aliens, although their deposits are not subject to U.S. taxes. This would harm America's economy and undermine the competitiveness of U.S. financial institutions.

Unfortunately, despite the clear intent of Congress, the Internal Revenue Service is seeking to require the reporting of bank deposit interest paid to nonresident aliens. This information, according to the proposed regulation, would then be turned over to foreign tax collectors. The price is high, especially given that the IRS does not have the authority to issue this rule.

More than 100 individuals and institutions have denounced the proposed regulation, including Senators (18), Congressmen (58) and Public Policy Organizations (35). They are joined by many U.S. financial institutions [<http://www.freedomandprosperity.org/against-irsreg.pdf>].

The following are ten reasons why this regulation should be withdrawn.

IRS Abuse of Its Regulatory Authority.

Executive branch agencies and departments are supposed to issue regulations that implement laws enacted by Congress. More specifically, the IRS is supposed to promulgate regulations that help enforce U.S. tax law. Since the United States government does not tax bank deposit interest paid to nonresident aliens, the IRS does not need to collect this information. Indeed, the IRS admits that the purpose of this regulation is to help foreign governments tax the income their citizens earn in the United States.

The IRS Is Flouting the Law.

Congress has examined the tax treatment of indirect foreign investment for the last 82 years. The desire to attract capital has always led lawmakers to decide not to tax or require reporting of bank deposit interest paid to nonresident aliens. The proposed IRS regulation, however, seeks to overturn the outcome of this democratic process. This would undermine the rule of law and President Bush's efforts to rein in regulatory abuses. For more information, the CF&P Foundation issued a paper entitled "Who Writes the Law: Congress or the IRS?" [Link: <http://www.freedomandprosperity.org/Pi/pers/irsreg/irsreg.shtml>]

Capital Will Flee American Banks.

As the Figure shows, the current tax and privacy rules for foreign investors have been a huge success, attracting about \$1 trillion to U.S. financial institutions. These funds finance car loans, home mortgages and small business expansion in America. If the regulation is approved, however, foreigners will shift a substantial share of their funds to London, Hong Kong and other jurisdictions that protect investors' interests. In fact, the Federal Deposit Insurance Corporation has expressed grave concerns that the rule will drive capital from the U.S. and threaten the soundness and security of the U.S. banking system. [Link <http://www.freedomandprosperity.org/gfdic.pdf>]

U.S. Banks Will Be Less Competitive.

Financial institutions around the world compete for liquid capital. American banks have successfully competed, but this profitable source of deposits will become very unstable if banks are forced to put foreign tax law above U.S. tax law. Money will flow out of America, making it more difficult for U.S. banks to meet the challenge of foreign competition. The economic loss would be substantial; Stephen Entin of the Institute for Research on Economics of Taxation estimates the regulation would annually cost \$80 billion in lost output, or 0.8 percent of U.S. gross domestic product.

Banks' Paperwork Burden Will Increase.

The IRS asserts that the total regulatory burden on financial institutions will increase by only 500 hours. This estimate is absurdly low. To read and interpret the

rule, seek appropriate legal and accounting advice and report on thousands of accounts will surely impose a far greater burden.

The Rule Is Bad Tax Policy.

The IRS regulation is a slap in the face of tax reformers. All proposals to fix the tax code, such as the flat tax, are based on common-sense principles such as taxing income only once and taxing only income inside our borders. But the new regulation would sabotage tax reform by helping foreign governments double-tax income earned in America.

For example, the European Union would like the United States to join a cartel for the purpose of double-taxing cross-border savings. The Bush administration has rejected the EU request, but the IRS rule undermines that position. In fact, the EU considers the proposed regulation supportive of its cartel.

The Required Cost-Benefit Analysis Was Not Performed.

The IRS is ignoring laws requiring cost-benefit analysis of proposed regulations. It has effectively exempted itself from regulatory oversight by incorrectly declaring most of its regulations either "interpretative" within the meaning of the Administrative Procedure Act or not "major" within the meaning of Executive Order 12866. Yet many IRS regulations impose significant economic costs and should be subject to regulatory review.

International Competition for Capital Will Be Undermined.

Collecting private financial information on nonresident investors and sharing that data with foreign governments hinders jurisdictional competition. It enables high-tax governments to impose levies on income earned outside their borders, particularly discriminatory taxes on capital. Thus the regulation would encourage governments to increase marginal tax rates on mobile capital.

The Rule Differs Little from the Clinton Administration's Proposal.

The current version of the regulation is a slight modification of a rule proposed in the waning days of the Clinton administration. The original proposal required reporting deposit interest paid to all nonresident aliens, but intense opposition led to its withdrawal in the summer of 2002. The IRS immediately issued the new version, which limits information collection to residents of 15 developed countries, including some EU members. However, it is clear that the IRS intends to eventually extend the regulation to citizens of all nations.

The Regulation Violates the Treasury Department's Position on Information-Sharing.

The regulation is also contrary to the administration's position on the treatment of confidential taxpayer information. On several occasions, former Secretary Paul O'Neill and other Treasury officials stated that the U. S. government does not support automatic information sharing. Rather, O'Neill said information should only be provided on a case-by-case basis in response to specific requests—and with full respect for due process and individual privacy. The proposed rule clearly violates this commitment, since any information collected would be automatically forwarded to foreign governments. The following link is to a Southeastern Legal Foundation memorandum on this topic: <http://www.freedomandprosperity.org/slf-memo.pdf>

Conclusion.

The proposed IRS regulation is bad tax policy and bad regulatory policy. It is inconsistent with President Bush's tax reform agenda. And it will hurt the U.S. economy by reducing the capital available for workers, consumers, homeowners and entrepreneurs. The rule would become effective following its final publication in the Federal Register. Therefore, on behalf of millions of Americans represented by the members of the Coalition for Tax Competition, I today ask that your Committee review this regulation and then ask the Treasury Department to permanently withdraw it as soon as possible.

The following is a link to additional information on the IRS's Interest Reporting Regulation: <http://www.freedomandprosperity.org/update/irsreg/irsreg.shtml>

Thank you.

PUERTO RICO BUSINESS ALLIANCE

[SUBMITTED BY SYLVIA HERNANDEZ, ESQ.]

Chairman Grassley, Ranking Minority Member Baucus, and other Distinguished Members:

During the Committee's May 9th meeting, Members suggested that the question of replacing Internal Revenue Code Section 936 be considered in a hearing regarding the taxation of income from outside the States of companies based in the States. I am submitting this statement because I understand that this hearing will be the last on the subject before the Committee considers legislation on it.

I am also submitting this statement to ensure that you are aware of the perspective of common citizens and business owners in the U.S. territory of Puerto Rico. I know that you have been lobbied heavily on behalf of the self-serving objectives of a limited group of multinational and national corporations and the local government's current plurality administration.

The Puerto Rico Business Alliance is an organization of local business and professional men and women concerned with Puerto Rico's economic development. We are, for the most part, small business owners, entrepreneurs and professionals interested in sound fiscal policy and a favorable business climate for the people of Puerto Rico.

As you know, Sec. 936 was enacted to encourage businesses in the States to make jobcreating investments in U.S. territories. It provides a credit against the tax on 40% of the income that companies attribute to business in the islands. As you also know, Sec. 936 was repealed because it has provided many companies with tax benefits much greater than the economic benefits to Puerto Rico—the territory in which almost all of the companies using it operated. In repealing the credit, the Congress gave the companies a generous phase-out of more than nine years that expires at the end of 2005.

The territorial administration, working hand-in-hand with many of these companies, has proposed a replacement that would be similar to Sec. 936 in effect—although it would lavish a bigger tax cut on the companies. Amending IRC Sec. 956, it would permanently exempt from the corporate income tax 85%, 90%, or 100% of profits that Controlled Foreign Corporations in U.S. territories transfer to parent companies in the States. (The percentage would depend on the method of transfer that a company uses. Descriptions of the proposal only highlight the 85% and 90% exemption methods; the legislative language would also effectively enable 100% of the profits to escape taxation.)

As you know, companies already enjoy an indefinite deferral of taxation on these profits until the income is actually transferred from their territorial subsidiaries. A goal of the proposal is to make Puerto Rico a more attractive location for manufacturing by companies based in the States than anywhere else in the world—the States as well as foreign countries.

The proposal would immediately add billions of dollars to the profits of companies already in Puerto Rico by relieving them of their current tax liability. The Congress' Joint Committee on Taxation has estimated that the proposal would cost up to \$33.1 billion in revenue over 10 years.

These companies do not need the windfall; by definition, they would already have to be profitable to obtain the tax benefit. In fact, they are already so profitable in Puerto Rico that many are expanding their operations here.

Investments by pharmaceutical companies—the primary users of the 936 credit and the majority of the companies lobbying for the 956 amendment—prove the point. These major corporations have invested \$2.9 billion in Puerto Rico since Sec. 936 was sunsetted in 1996—creating 5,500 jobs. They are now making \$3.5 billion in additional investments through 2009—which will create thousands more jobs—even though the 936 credit will expire as of 2006.

The 956 proposal would not, however, require companies to make investments or create jobs to have their income exempted from federal taxation. The drug companies would avoid billions of dollars in federal taxes without necessarily making any greater contribution to Puerto Rico's economy than they would without federal tax exemption.

These and other manufacturers from the States also enjoy territorial tax rates as low as 0%. This means that a company that took full advantage of the 956 amendment would pay no income taxes to either the territorial or federal governments.

My principal problem with the proposed 956 amendment is the same problem that led to the bipartisan repeal of 936: it would benefit the limited number of companies using it far more than it would benefit our territorial community.

I believe that the primary reason that Members of the Congress have considered Sec. 936 and the Sec. 956 amendment is that they have wanted to help their fellow citizens in the territory. In reality, however, both measures are prime examples of "trickle-down" economics. Gallons of federal economic incentives are being poured to help Puerto Ricans but only drops trickle down to most of us.

This is why 936 was called "the poster child of corporate welfare." It used the needs of the low-income majority of our population to mask huge tax grants to

wealthy companies. The 956 amendment can fairly be called “the return of the poster child of corporate welfare.”

The 956 amendment—like 936—also is a strategy for an artificial economy. Businesses that would never be viable if they had to make the same contribution to society that other businesses make are subsidized. They are not given a “leg-up” until they can stand on their own feet; they are perpetually propped up. Sustainable development is not promoted and real economic development does not occur.

Both measures, additionally, encourage disinvestment from Puerto Rico. The tax benefits provide an incentive to take earnings out of the territory. Most profits are not reinvested and the investment in our community is not permanent.

There is also an inequity in the benefits that do accrue to Puerto Ricans. A relative few blue collar workers and white collar supervisors get good jobs. Work is also created for lawyers, accountants, and bankers. Despite \$100 billion in federal corporate tax breaks over the years, however, our unemployment rate is in the double digits and our labor participation rate is low.

In noting our employment problem, I must also point out that our jobless rate decreased from 1993 through 2000—despite the 1993 reduction and 1996 sunset of 936—and that it has only increased over the past two years. Combinations of national economic developments and local policies cut the jobless rate in the 1990s and other combinations hiked it over the past couple of years.

You know about the national economic developments. You should also know about the local policies. In the 1990s, a previous territorial administration worked to diversify our economy and markets, substantially enhance our physical and human infrastructure, and facilitate entrepreneurship and investment. During the past couple of years, a new administration has idled the wheels of government and construction and made tax exemptions for selected companies from the States the centerpiece of its economic plan. Because of its failures, its leader has been forced to abandon her campaign for a second term.

During this period, Puerto Rico has lost a number of plants in labor-intensive industries such as garment manufacturing—as have the States. Companies relocated plants to countries which now have the advantage of no U.S. trade barriers in addition to the advantage of low wage and other costs.

The 956 amendment’s tax exemptions would not have helped keep these plants in the territory . . . and it was not intended to. The plants would not have been helped because—unlike the pharmaceuticals, for example—they did not have significant profits to exempt from taxation. The territorial administration chose to seek tax exemptions for profitable companies rather than trying to retain operations such as garment plants.

One of my greatest concerns about the 956 amendment is that Members of the Congress would be misled into thinking that they would substantially help their 3.8 million fellow citizens in the territory by passing it and would, therefore, not take other measures that would really help our economy and people as a whole.

My goal in this statement is to convince you to take the other measures instead. These measures need not be special exemptions for special interests. Our territory and people would be helped more by policies already applied to our fellow citizens elsewhere in the nation.

Three measures would be of particular help—expanding the consumer demand that actually drives the economy, rewarding work, and filling a gaping hole in the social safety net.

- No measure would have a greater, more positive economic impact or benefit more Americans in the territory than extending the Earned Income Credit as it applies to workers in the States and the District of Columbia with incomes too low to have a federal income tax liability.
- A related measure would extend the refundable Child Credit as it applies in Puerto Rico to workers with three or more children to workers with one child or two children—families who are covered in the States and D.C.
- The third measure would extend Supplemental Security Income for the needy aged, blind, and disabled—the neediest in society. Still under SSTs predecessor program, they currently receive a tiny fraction of the aid that SSI would provide.

What reason can there possibly be for not extending these programs to American citizens in American territory? These citizens do not enjoy the federal tax exemptions that wealthy companies from the States and wealthy Puerto Ricans enjoy. They have the same tax liability as beneficiaries of the programs in the States—payroll taxes. They can receive the benefits of the programs simply by moving to the States—at costs to the States as well as the federal government.

I respectfully suggest that it would be a travesty to grant special tax exemptions to wealthy companies from the States in Puerto Rico but not extend equal treatment to low-income workers and the neediest in society in the territory.

There are also measures that the territorial government should take that you should require as a condition of any special assistance.

- One would be to require the government to collect its own taxes. It is widely agreed in Puerto Rico that the underground economy in the territory is half the real, total economy. Rampant tax evasion—including by government employees—penalizes those of us who pay all our taxes . . . as well as federal taxpayers. It is a significant factor in statistics such as labor rates.
- The other condition would be to require that special assistance beyond that granted to States, such as the third of a billion dollars a year in transfers to the territorial treasury of federal excise taxes on rum and federal Customs duties, be expended for economic development purposes, such as transportation infrastructure and job training and apprenticeship.

I have been candid in this statement and reflected views that many others in the local business and broader communities have been afraid to express. The territorial government is very centrally controlled and exercises extensive powers in permitting, contracting, etc. to marshal support for its programs and silence criticism. Many in business have gone along with the 956 amendment, for example, because the local administration has insisted on it and has been unwilling to consider alternatives. As a citizen, however, I believe that I have a right to petition my national government for what is best for my community even if the local plurality, lame-duck administration is serving other interests.

I would be honored to work with the Committee to further the ideas that I have expressed or on other matters that would benefit my territory and nation.

SENATE OF PUERTO RICO, USA

[SUBMITTED BY HON. KENNETH D. MCCLINTOCK]

Chairman Grassley, Ranking Minority Member Baucus, and other Members of the Committee:

My name is Kenneth D. McClintock. I am the Floor Leader in the SENATE OF PUERTO RICO from the territorial political party that received 46.5% of the vote in Puerto Rico's most recent general election and an absolute majority in the preceding election. I am also Puerto Rico's DEMOCRATIC NATIONAL COMMITTEEMAN and a former Chairman of the COUNCIL OF STATE GOVERNMENTS of the United States.

My purpose in submitting this statement is to urge respectfully that the Committee include, in a bill pertaining to the taxation of companies based in the 50 states that have subsidiary operations situated outside the 50 states, a provision to preserve and enhance Section 30A of the Internal Revenue Code [IRC].

As you know, Section 30A grants tax credits based on *the payment of wages and local taxes in Puerto Rico as well as capital investments in the territory*. It dates to a 1993 reform of Section 936, which provides credits for income merely attributed to territorial operations.

The reform continued the attributed income based credit but scaled it down from 100% of tax liability to 40% and also created what was later renumbered as Section 30A as a federally preferred alternative credit.

Providing an incentive for companies to make job-creating investments in U.S. territories, which are relatively less developed areas of the American political family, had been the congressional purpose in enacting Section 936. The provision was abused for years, however, by some companies and regulatory and statutory restrictions failed to end the abuse.

The primary abuse was that companies attributed income to Puerto Rico that should have been attributed to the States. This enabled them to avoid billions of dollars a year in taxes on income for which taxable stateside operations were responsible.

At the same time, the companies were employing relatively few workers in Puerto Rico in comparison to the taxes they were avoiding. In the heyday of the Section 936 era, *some enterprises were reaping tax credits equal to several hundred thousand dollars for each individual on their Puerto Rico payrolls*.

Continuing concerns about abuses of the Section 936 credit based on attributed income led the Congress in 1995 and 1996 to pass legislation to phase-out the credit. The 1996 bill was enacted. It limited the credit to existing users, capped the credit in 2002, and ends it entirely as of 2006.

It also, however, applied the phase-out to the federally-preferred alternative credit based on wages, capital investments, and local taxes, although that provision was renumbered as Section 30A.

There were bipartisan efforts from 1997 through 2000 to open Section 30A to new investments and extend it. Proposals won support from a majority of the members of this committee and the House committee but were blocked by the then House committee chairman, who had been in the small minority of the Congress that supported Section 936. He is no longer a member of the Congress.

In 2001, the now lame-duck governor of Puerto Rico and a number of profitable companies with plants in Puerto Rico, primarily multinational pharmaceuticals, came up with a new proposal. In contrast to Section 30A, it has not won the support of a majority of the members of this committee or the House committee or the Treasury Department or the White House. This is because it is similar to Section 936 prior to the 1993 reform, essentially recreating that discredited provision. It would exempt, depending on the method used, 85–100% of the profits that subsidiaries of companies based in the States organized as Controlled Foreign Corporations (CFCs) in territories transfer to their parent companies.

The proposal would amend Section 956. It would simply add to profits rather than provide tax benefits for employment or investment. It also would not address the challenge that free trade has created for labor-intensive manufacturing in Puerto Rico as well as labor-intensive manufacturing in the States.

The immediate beneficiaries would be the existing profitable pharmaceutical and similar subsidiaries that worked with the governor to craft the amendment. And they would benefit to the extent of billions of dollars a year. The Congress' Joint Committee on Taxation estimated the taxes they would escape paying at \$33.1 billion over ten years and at \$4.6 billion in the first year alone. At the same time, the proposal does not link tax benefits to jobs or investments.

The companies that would get the windfall have been *prospering and expanding* in Puerto Rico since Section 936 was “sun-setted.” The pharmaceuticals alone have invested \$2.9 billion in Puerto Rico since 1996 and created 5,500 new jobs in the territory. They are now investing another \$3.5 billion, planning investments that will extend years past the total end of Section 936 and that will create thousands more jobs.

At the same time, *labor-intensive* manufacturing operations have been lured to low-wage foreign locations from which they can now send products into the U.S. market duty and quota free. The makers of numerous consumer products have been mounting a gradual retreat from Puerto Rico.

Unlike the pharmaceuticals, for example, these operations have not been big money-makers in Puerto Rico. Their operations in the territory have been marginal. For this reason, they would not benefit from the governor's proposal to exempt profits from taxation. The proposal, aides to the governor have acknowledged, accepts the departure of these plants and jobs from Puerto Rico.

The proposal, they say, is also intended to make Puerto Rico more competitive as a location for manufacturing than anyplace else in the world—including the States.

It is because of failed policies such as this that the governor has been forced by public opinion to drop her bid for a second term. It is also because of flaws, such as those I have described, that neither the Committee nor its colleagues in making federal tax policy have approved the proposal despite two years and tens of millions of dollars of lobbying by the governor and the companies that would receive an immediate multibillion dollar windfall addition to their already substantial profits.

A June 26, 2003 MOODY'S [INVESTORS SERVICE] OPINION report sums up Puerto Rico's situation:

“Puerto Rico's economy continues to adjust to . . . the phase-out of Section 936 . . . ; while some US-owned manufacturers have downsized or left . . . , others have continued to expand; the ultimate economic impact of the Section 936 phase-out is still developing . . . ; the island has lost . . . in low-skill sectors such as textiles, apparel, food products, and electronics assembly. However, the important pharmaceutical sector has continued to see plant expansions and job growth in recent years, which is a positive sign of the island's ability to remain competitive in technical/high-skill sectors. We expect the island's economy to recover reasonably well.”

The labor-intensive firms that are being lured away from Puerto Rico by low-cost foreign locations create relatively more jobs than, for example, the pharmaceuticals. And while the overall economy of the territory may be able to “recover reasonably well” if Sections 936 and 30A both expire as scheduled, many thousands of Puerto Rican families may not.

They—and the companies they work for—would, however, be helped by an extension of Section 30A. The plants that are at risk do not have big profits to exempt from taxation, but they do have big wage costs.

From statements by members of the Committee, I know that it shares my goal of job retention and creation in Puerto Rico.

Because I come not to bury the governor's moribund proposal, but to praise Section 30A, it is without rancor that I volunteer the following two observations in closing:

- The proposal and the pharmaceuticals contemplate the creation of a *permanent* tax exemption. This implies that Puerto Rico will forever be incapable of achieving convergence with the national economy; that Puerto Rico can never be self-sustaining. Puerto Ricans are just as capable as other citizens are, but we need a leg-up. The governor's pessimistic, condescending hypothesis ignores the territory's impressive levels of development over the past halfcentury. If her proposal were an orthopedic surgeon, it would permanently consign every leg injury victim to a wheel chair when temporary physical rehabilitation programs might quickly have most such patients back on their feet.
- Lobbyists for the proposal of the governor and the pharmaceuticals point out that Puerto Rico's unemployment rate is *double* the national average. What they omit mentioning is that, until after the sun-setting of Section 936, Puerto Rico's unemployment rate was *triple* the national average. It is thus preposterous to allege that the territory's high unemployment rate is, in any general sense, a direct consequence of the Section 936 phase-out. Moreover, *total Puerto Rico employment is higher today than it was in 1996 when Congress sun-setted Section 936. In addition unemployment in Puerto Rico was down to the single digits when the current governor took office in January 2001. Unemployment has since increased because of the national and world economic slowdowns as well as because of the economic policies that contributed to the governor's political demise and the departure of the labor-intensive companies that would not have been helped by the proposal of the governor and the pharmaceuticals.*

This Committee can best support the goal of boosting productive territorial employment by extending Section 30A and opening it to new investments.

UNIVERSITY OF MICHIGAN LAW SCHOOL

[SUBMITTED BY MARTIN B. TITTLE, RESEARCHER]

INTRODUCTION

My name is Martin B. Tittle. I am a licensed attorney in the state of Michigan, and I am employed as a researcher at the University of Michigan Law School in Ann Arbor. One of my research topics for the past twelve months has been the Foreign Sales Corporation and Extraterritorial Income Exclusion Act cases in the World Trade Organization (WTO) and the U.S. response to those cases. My statement is submitted on my own behalf and not on behalf of any government or private entity.

At the July 15 Senate Finance Committee hearing, Assistant Treasury Secretary Pamela F. Olson stated that it would be worthwhile for the United States to "tak[e] a long-term look at the structure of the Tax Code to see whether or not our worldwide system continues to make sense or whether we would be better off with a territorial system." Senate Committee on Finance, "Treasury's Olson Testifies on Need for New U.S. International Tax Plan," 2003 Worldwide Tax Daily 142-13 para. 383 (July 24, 2003). Worldwide systems tax residents on their worldwide incomes, whereas territorial systems usually do not tax residents on active foreign-source income.

A THIRD OPTION: EXTENDING FOREIGN TAX CREDIT TO VATS

The "either-or" choice presented by Secretary Olson should be broadened to include a third option. We could alter our worldwide system to achieve a territorial result—little or no taxation of offshore business income—without the upheaval of changing to a territorial system. One alteration that would help achieve this result is foreign tax credit for value added taxes (VATs).

VATs are transaction taxes that businesses must pay on in-country sales. They differ from sales taxes in that they have an internal mechanism for giving businesses a credit for the VAT they pay on their purchases. VATS exist in more than 120 countries that cumulatively account for about 70% of the world's population. Liam Ebrill et al., *The Modern VAT* xiv (2001). Therefore, many U.S. companies doing businesses overseas will have paid VAT to one or more foreign governments.

Allowing credit for VATS would tend to eliminate U.S. taxation of foreign-source business income because VAT is a tax on gross sales, while income tax is a tax on net income. For instance, sale of \$100 worth of widgets on which the profit margin is 10% would yield a profit of \$10 and an income tax of only \$3.50, assuming a tax rate of 35%. That same sale, however, would yield \$15 of VAT in Luxembourg, where the standard VAT rate is 15%, and \$25 dollars in Denmark or Sweden, where the rate is 25%.

Credit for VATS need not be an all-or-nothing proposition; it could be phased in. We could either limit the credit to a percentage of each VAT dollar and allow that percentage to increase over time, or we could offer dollar-for-dollar credit with a cap on the maximum reduction of any single year's tax bill, and gradually raise the cap.

THEORETICAL BASIS FOR EXTENDING CREDIT TO VATS

Historically, U.S. foreign tax credit has been limited to income-type taxes, but the reason for this limitation remains a mystery. No explanation was included in the 1918 act that introduced the credit, and, surprisingly, none has been enunciated in subsequent legislation.

In 1956, Professor Stanley Surrey speculated that the basis for the limitation might lie in the purported "nonshiftability" of income taxes. Stanley S. Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," 56 *Colum. L. Rev.* 815, 820–821 (1956). "Shifting" taxes, he explained, were those whose economic incidence was generally assumed to be passed on from the statutory or nominal payor to someone else. Examples included sales, turnover, and excise taxes. Income taxes, on the other hand, were generally assumed to be "nonshiftable," and therefore actually borne, or suffered by the taxpayer.

Five years later, Elisabeth Owens came to same conclusion, saying "the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax." Elisabeth Owens, *The Foreign Tax Credit* 83 (1961), *quoted* in Karen Nelson Moore, "The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal," 7 *Am. J. Tax Pol'y* 207, 217–218 (1988).

Joseph Isenbergh repeated that theory of creditability in 1984, calling it the "only plausible explanation that has ever appeared for limiting the foreign tax credit to income taxes." Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227, 288 (1984).

The issue of shiftability is not merely a technical one. As Judge Karen Nelson Moore has correctly noted, "the goal of achieving tax neutrality between foreign and domestic investment [sometimes called capital export neutrality, or CEN] is satisfied [only] if taxes do not alter the relative rates of return on investments; allowance of a tax credit limited to taxes that are not shifted to others is consistent with that goal, since taxes that can be shifted do not affect the taxpayer's rate of return." Moore, *supra*, at 217 (paraphrasing Owens, *supra*, at 84).

Shiftability and nonshiftability are understood today, not as separate states that are fixed characteristics of different taxes, but as the opposite ends of a continuum across which all taxes move in response to market circumstances. In 1989, Judge Moore reviewed over 40 sources before saying, "The tax policy maker must conclude that a conclusive answer is not available today to the question whether the corporate income tax is shifted or whether it is in fact borne by the corporation and its owners." *Id.* at 222. That question has not been resolved in the years between 1989 and the present. *See, e.g.*, Douglas A. Kahn and Jeffrey S. Lehman, *Corporate Income Taxation* 22–25 (5th ed. 2001) (noting "substantial uncertainty about the incidence of the corporate income tax"); Cheryl D. Block, *Corporate Taxation* 14 (1998) (noting that the extent and direction of corporate tax shifting "is the subject of much debate and the incidence question remains unresolved").

Similarly, Liam Ebrill and his co-authors freely admit in the International Monetary Fund's book *The Modern VAT* that "[t]he effective incidence of a VAT, like that of any other tax, is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers The real burden of the VAT tax may not fall entirely on consumers but may in part be passed back to suppliers of factors through lower prices received by producers." Ebrill, *supra*, at 15, 76. The VAT that U.S.-based e-tailers are now required to pay under the EU's e-commerce VAT Directive is likely nonshiftable either largely or completely because they face EU competition that can charge lower VAT and no VAT. *See* Martin B. Tittle, "U.S. Foreign Tax Creditability for VAT: Another Arrow in the E/TI/E-VAT Quiver," 30 *Tax Notes International* 809, 813815 (May 26, 2003).

Judge Moore's solution to the income tax's quasi-shiftable character was to suggest that the foreign tax credit be eliminated as a windfall, and that foreign income taxes be returned to their pre-1918, deductible-only status. Moore, *supra* at 226. However, an equally rational solution would be to continue the credit for income taxes, so as not to disadvantage businesses when income taxes cannot be shifted, and, with appropriate limitations, to expand the credit to VATs and other taxes that, like income taxes, are sometimes nonshiftable. See Isenbergh, *supra*, at 294–295 (suggesting expansion of the foreign tax credit to include all foreign taxes and noting that, if the amount of the credit is capped, “the Treasury has little reason to care about [the foreign government’s] precise methods [of taxing]”).

The fact that the shiftable of both income taxes and VATS varies dynamically in step with market forces is indicative of a broader similarity. Direct taxes like income tax and indirect taxes like VAT are not opposites, but rather are alternate methods for allocating the same tax burdens. For example, it is widely acknowledged that VATs are essentially equivalent to a combination of several direct taxes, including a direct tax on business profits and a direct tax on wages. Ebrill, *supra*, at 18–19, 198.

On the other hand, taxes that, under WTO rules, must be classified as direct are sometimes so similar to VATs that the difference is not substantive. For instance, the flat tax proposed by Congressman Richard Armey and Senator Richard Shelby in 1995 was essentially a flat-rate subtraction VAT in which collection of the tax had been divided between business and individuals. See Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995). That division of collection was not considered significant by knowledgeable observers including University of California, Berkeley economics and law professor Alan J. Auerbach. See Michael J. Graetz, “International Aspects of Fundamental Tax Restructuring: Practice Or Principle?,” 51 U. Miami L. Rev. 1093, 1098 (1997). It was, however, enough to make the flat tax a direct, and not an indirect tax under existing WTO rules. As such, it could not have been remitted on exports and applied to imports, as VATs are, despite the fact that it was in essence a “broad-based flat rate consumption tax.” *Id.* at 1097.

In the face of this virtual equivalence, it is no wonder that House Ways and Means Committee Chairman William M. Thomas, R-California, has said that the distinction between direct and indirect taxes is, “in today’s world, . . . a distinction without a difference.” Chuck Gnaedinger and Natalia Radziejewska, “U.S. Lawmakers Still Divided Over FSC–ETI Remedy,” 2003 Worldwide Tax Daily 31–1 (Feb. 14, 2003).

Senators Max Baucus, D-Montana, and Charles E. Grassley, R-Iowa, have voiced similar sentiments. See Chuck Gnaedinger and Natalia Radziejewska, “Baucus Deems WTO Dispute Settlement System ‘Kangaroo Court’ Against U.S.,” 2002 Worldwide Tax Daily 188–1 (Sept. 27, 2002) (quoting Senator Baucus as saying, “The [WTO] appellate body’s FSC decisions make an unworkable distinction between countries that rely primarily on direct taxes . . . and countries that rely primarily on indirect taxes Although the appellate body acknowledged countries’ sovereign right to set their own tax systems, they interpret WTO rules in a way that heavily favors one particular system.”); Chuck Gnaedinger and Natalia Radziejewska, “White House Urges U.S. Senate Finance Committee To Repeal ETI Act,” 2002 Worldwide Tax Daily 147–5 (July 31, 2002) (quoting Senator Grassley as saying, with respect to the distinction between direct and indirect taxes, “How can we justify allowing this distinction to continue?”).

Recognition of both the economic parity between income taxes and VATS and their equivalence in meeting the foreign tax credit criterion of nonshiftable strongly suggests that both income taxes and VATs should be creditable. Alternate bases for extending credit to VATs could include the competitive needs of U.S. businesses, see Glenn E. Coven, “International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes,” 4 Fla. Tax Rev. 83, 86 (1999), or the fact that VAT is the “principal tax” of various foreign countries. See Surrey, *supra*, at 820 (noting the need, in 1954, to exclude sales and turnover taxes from the “principal tax” proposal). The nonshiftable criterion has the advantage of being a classic theory and thus does not require “breaking new ground” to validate VAT creditability.

PROPOSED STANDARDS FOR VAT CREDITABILITY

The standards for creditability of VATS may need to be slightly more stringent than the standards for income taxes. The three criteria for income tax creditability are: (1) the tax must be due from the taxpayer (the “technical taxpayer” rule), (2) there must be proof of payment, and (3) the tax must not have been refunded. See I.R.C. 1.901–2(t) (the “technical taxpayer” rule); 1.905–2 (taxpayer must present

proof of payment); 1.905-3T (refund of a foreign tax constitutes a change in foreign tax liability).

The first and third of these should be applied to VATs without change. With respect to the second, however, the “gross-up” rule allows foreign tax credit for taxes paid by others as long as the taxpayer claiming credit was liable for the tax. See I.R.C. 1.901-2(f)(1)-(2). If that rule were applied to VAT creditability, then in theory everyone with an invoice showing a charge for VAT might claim a tax credit. Allowing credits on this basis would undermine the rationale for extending credit in the first place—to prevent double taxation from discouraging business activity abroad—because people who make a single purchase abroad are not necessarily attempting to engage in business activity there, even if the purchase is for business purposes.

It would be possible to bar such claims on the ground that the taxpayer could not demonstrate that the tax shown on the invoice had actually been paid by the party issuing the invoice (that is, that it had not been partially or totally offset by deductions). Alternatively, it could be argued that the claimant was not the “technical taxpayer.” That argument would be more tenuous because, according to the EU’s Sixth Directive, all taxable persons must pay VAT, and the term “taxable persons” includes everyone “who independently carries out in any place” any of the economic activities of “producers, traders, and persons supplying services.” That category includes even those who, as members of special classes, are exempted from payment, and therefore, it might also include casual purchasers. Therefore, unless there is a clear advantage in keeping the criteria for income tax and VAT creditability identical and addressing this issue in an exception, VAT creditability should require that the taxpayer demonstrate direct payment of VAT to the foreign government. That proof could be a VAT return and payment authorization, or, if no VAT return has been or will be filed, it could be the receipt issued to the taxpayer or its representative by customs when VAT was paid at the time of importation into the VAT jurisdiction. Either way, those with no more than an invoice showing a charge for VAT should not be able to claim the credit.

