Testimony of H. David Rosenbloom
Before the Committee on Finance
United States Senate
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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 pleased to respond to any questions that Members of the Committee may have.